EDEXCEL A LEVEL BUSINESS YEAR 1(AS) COURSE COMPANION

Essential Topic-by-Topic Study Notes for the Edexcel A Level Business Year 1 (AS) Specification Content

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Topic: The Market

Theme 1: Section 1.1 Meeting Customer Needs

What You Need to Know
• Niche and mass marketing • Market size & growth • Market share • Dynamic markets • How competition affects markets • Risk and uncertainty

Niche and Mass Marketing

One way of analysing the differences between markets is to make a distinction between **niche** and **mass** markets. This is a similar idea to market segmentation, although it is based more on the overall characteristics of a market (e.g. size, extent of product differentiation) than other ways in which customer needs and wants are different.

Niche Marketing	Where a business targets a **smaller segment of a larger market,** where customers have specific needs and wants
Mass Marketing	Where a business sells into the **largest part of the market**, where there are many similar products offered by competitors

The key features of a mass market (reverse these to identify key features of a niche) are:

- Customers form the majority in the market
- Customer needs and wants are more "general" & less "specific"
- Associated with higher production output and capacity + potential for economies of scale
- Success usually associated with low-cost (highly efficient) operation or market leading brands

So, given that a mass market is a larger opportunity, why might a business want to target a niche? As with all marketing choices there are potential benefits and drawbacks:

Advantages of Targeting a Niche	Disadvantages of Targeting a Niche
Less competition - a "big fish in a small pond" Clear focus - target particular customers Builds up specialist skill and knowledge Can often charge a higher price Profit margins often higher Customers tend to be more loyal	Lack of economies of scale Risk of over dependence on a single product or market Likely to attract competition if successful Vulnerable to market changes – all "eggs in one basket"

Market Size

As the name implies, market size is a measure of the total available demand for competitors in a market. Key points to remember about market size are:

- It indicates the potential sales for a firm (the "size of the prize")

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- Normally measured in terms of annual sales or volume sold per year
- Usually measured in terms of both volume (units) and value (sales)
- Size of individual segments within the overall market can also be measured
- Not normally a marketing objective – since a firm cannot influence it
- Not always easy to measure, since how you define the market determines what you are trying to measure!

Index numbers are a useful way of illustrating how market size changes over time:

Year	Market Size (£)	Index Number (2012 = 100)
2012	5,000,000	100
2013	5,250,000	105
2014	5,600,000	112
2015	6,250,000	125

Market Growth

Market growth measures the rate of change of market size, which might be rising, falling or remaining stable. Key points to remember about market growth are:

- A key indicator for existing and potential market entrants – more businesses might be expected to try to enter fast-growing markets
- Growth rate can be calculated using either value (e.g. market sales) or volume (units sold)
- Market growth is usually expressed as a percentage change on the previous period
- Growth is usually measured on an annual basis

An example of how market growth is calculated is shown in the table below. In this example we've used volume sold as the measure of market size. The same kind of calculation would be applied to a revenue-based measure of market size.

Year	Units Sold [A]	Change (Units) [B]	Growth Rate (%) [B]/[A from previous year] x 100
2012	1,000,000	-	-
2013	1,100,000	100,000	10.0%
2014	1,350,000	250,000	22.7%
2015	1,475,000	125,000	9.3%

Market Share

Market share is a really important measure and in many businesses it forms the basis for a key corporate objective. Key points about market share:

- Expressed as a percentage
- Explains how the overall market is split between the existing competitors
- Tends to be calculated based on market value, but volume can also be used
- Good indicator of competitive advantage: market leaders (with the highest market share) usually have some kind of advantage

- Key is to look for significant +/- changes (for example a business that used to enjoy the largest market share but which has now lost its leadership position).

Here is an example of how the market share is calculated.:

Business	Sales in 2015 (£)	Cumulative Market Sales (£)	Market Share (%) in 2015
A	250,000	250,000	12.5%
B	400,000	650,000	20.0%
C	900,000	1,550,000	45.0%
D	175,000	1,725,000	8.75%
E	275,000	2,000,000	13.75%

Dynamic Markets
All markets are dynamic – they all change! But the pace and nature of change varies considerably by market. Key sources of change include:

- Customer tastes and preferences
- Impact of technology on what customers buy and how they buy
- Impact of new market entrants

Some examples of highly dynamic markets include:

- Film Industry
  - Disrupted by online streaming
  - E.g. Netflix
- Taxi Services
  - Disrupted by mobile apps
  - E.g. Uber
- Camera Market
  - Disrupted by sophisticated smartphones
  - E.g. Go Pro, iPhone

How Competition Affects the Market
You'll look in more detail later in your studies at the role of competition in markets. For now the key points to remember are:

- Battle for Market Share
  - A constant battle to gain or protect share
  - Threat of new market entrants always there
- Pricing
  - Price wars a regular feature of intense competition
  - Stronger competitors often set the market price
- Battle for Competitive Advantage
  - Product differentiation is a key part of competition
  - Can advantages be sustained?

The challenge for all businesses in a market is to establish and sustain an edge over the competition – this is known as competitive advantage.

Competitive advantage is:

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- The ability of a business to add more value for its customers than its rivals and attain a position of relative advantage
- A situation where a business has an advantage over its competitors by being able to offer better value, quality and/or service

The Role of Risk and Uncertainty in Markets

The key points to remember are:

RISK	UNCERTAINTY
The possibility that things will go wrong Risk can be assessed managed – e.g. through contingency planning	The unpredictable and uncontrollable events that affect business
Examples Risk in making business investments Managed through investment appraisal Risk of a product breaching health & safety regulations	***Examples*** Uncertainty about the sales success for a new product launch Unpredictable effects of launching a price war against the competition

Key Terms

Market size	The overall size (value or volume) or demand for a specific market
Market growth	The percentage rate of growth in market size over a period
Market share	The proportion of market size held by each competitor in a market
Niche market	A smaller segment of a larger market, where customers have specific needs and wants requiring differentiated products
Mass market	The largest part of the market, where there are many similar, undifferentiated products offered by competitors

Topic: Marketing Research

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What You Need to Know
Product and market orientation
Primary and secondary market research data
Quantitative and qualitative research
Limitations of market research, sample size and bias
Use of ICT to support market research
Segmentation (covered in a separate presentation)

What is Marketing Research?

Marketing research involves the gathering and analysis of research to help support the implementation of marketing strategy.

The right kind of market research can provide important insights that aid marketing strategy and decision-making. For example:

- Dimensions of the market (size, structure, growth, trends etc.)
- Competitor strategies (market share, positioning, USPs)
- Needs, wants and expectations of customers (& how these are changing)
- Market segments – existing and potential opportunities for new segments

Product and market orientation

A broad distinction can be made between a business that has a:

Product orientation	Business develops products based on what it is good at doing
Market orientation	Business responds to customer needs and wants – designs products accordingly

It is generally agreed that having a market orientation is more likely to result in a successful, sustainable business. Market orientation is linked to marketing success because:

Markets are much more dynamic	E.g. Impact of technological change which is shortening product life cycles
Customers are becoming much more demanding	E.g. Expecting much higher level of customer service and able to share experiences via social media
Barriers to market entry getting lower	E.g. Many new entrants to consumer markets utilising online and mobile technology

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Primary and Secondary Research

There are two main types of marketing research – primary and secondary:

Market Research	
Primary Research	Secondary Research
Data collected first-hand for a specific research purpose	Data that already exists and which has been collected for a different purpose

The main benefits and drawbacks of primary and secondary research are outlined below:

PRIMARY RESEARCH	SECONDARY RESEARCH
BENEFITS	
Directly focused to research objectives	Often free and easy to obtain
Kept private – not publicly available	Good source of market insights
More detailed insights – particularly into customer views	Quick to access and use
DRAWBACKS	
Time-consuming and costly to obtain	Can quickly become out of date
Risk of survey bias	Not tailored to business needs
Sampling may not be representative	Specialist reports often quite expensive

The main formats of primary and secondary research are:

PRIMARY RESARCH	SECONDARY RESEARCH
Focus groups Observation Surveys Telephone interviews Test marketing Experiments	Published market research reports Internal transactional data Google Official statistics (ONS) Trade associations Media reports Competitor materials

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More on the Main Methods of Primary Research

Observation	Watching how consumers behave provides many insights, but can leave questions unanswered. Observation works well in retail markets; sit outside a shop and watch how many people walk by, look at the window display etc.
Postal surveys	Sent to the address of potential customers who complete the form and send back in a pre-paid envelope. Relatively cheap, a postal survey can cover a wide geographical area and avoids the potential for interviewer bias. However, response rates (the proportion of people sending back a completed survey) are often very low and it can take be a long time before enough surveys are returned
Telephone interviews	Not to be confused with "telesales" (which is a method of selling), the telephone interview allows quicker feedback than a postal survey. However, potential customers are often wary of being called and may be reluctant to give anything other than short answers
Online surveys	Increasingly popular and relatively low cost, online surveys are widely used by small businesses as a way of capturing the views of existing and potential customers
Face-to-face surveys	Personal interviews conducted face-to-face. A costly, but good way to get detailed insights from an individual
Focus groups	Groups of potential customers are brought together to discuss their feelings about a product or market. Focus groups are a good way of getting detailed information about customer tastes and preferences
Test marketing	This involves selling a new product in a small section of the market in order to assess customer reaction. For example, a start-up could start by selling to a limited local area in order to iron-out product issues. Software firms often test-market their products by offering "beta" versions for testing by a small group of potential customers. Test marketing can be a good predictor of how a new product or service will be received by the larger market (provided that it can be kept secret from competitors!

Quantitative v Qualitative

Another useful way of categorising market research is to make a distinction between research that is based on hard data, and research that is based on views and opinions. This is what we mean be quantitative & qualitative research.

Key points on quantitative research:

- Concerned with and based on data
- Addresses research questions such as "how many?" "how often", "who?", "when?" and "where?"
- Based on larger samples and is, therefore, more statistically valid
- Main methods of obtaining quantitative data are the various forms of survey – i.e. telephone, postal, face-to-face and online

Topic: Marketing Research

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Key points on qualitative research:

- Based on opinions, attitudes, beliefs and intentions
- Answers research questions such as "Why"? "Would? or "How?"
- Aims to understand why customers behave in a certain way or how they may respond to a new product or service
- Focus groups and interviews are common methods used to collect qualitative data

The main benefits and potential drawbacks of qualitative research include:

BENEFITS	DRAWBACKS
Essential for important new product development and launches	Expensive to collect and analyse – requires specialist research skills
Focused on understanding customer needs, wants, expectations = very useful insights for a business	Based around opinions – always a risk that sample is not representative
Can highlight issues that need addressing – e.g. why customers don't buy	
Effective way of testing elements of the marketing mix – e.g. new branding, promotional campaigns	

The main benefits and potential drawbacks of quantitative research include:

BENEFITS	DRAWBACKS
Data relatively easy to analyse	Focuses on data rather than explaining why things happen
Numerical data provides insights into relevant trends	Doesn't explain the reasons behind numerical trends
Can be compared with data from other sources (e.g. competitors, history)	May lack reliability if sample size and method is not valid

Sampling in Marketing Research

Sampling involves the **gathering of data from a sample of respondents, the results of which should be representative of the population (e.g. target market) as a whole.**

Sampling is widely used in marketing research and it can provide statistically valid insights into the profile of the overall population (e.g. market) being analysed.

The main benefits and potential drawbacks of sampling are summarised below:

BENEFITS	DRAWBACKS
Even a relatively small sample size (if representative) can provide useful research insights	Biggest risk = sample is unrepresentative of population – leading to incorrect conclusions

Using sampling before making marketing decisions can reduce risk and costs	Risk of bias in research questions
Sampling is flexible and relatively quick	Less useful in market segments where customer tastes & preferences are changing frequently

Growing Use of IT to Support Market Research
The use of IT is now commonplace and essential in market research:

- The capabilities of modern business IT has transformed market research
- Now relative easy to learn about consumer preferences and buying habits by mining massive sets of quantitative data
- Complex algorithms can uncover patterns and correlations that enable more effective marketing

A great example is the increasingly widespread adoption of **data mining**:

- Data mining is an example of secondary research
- Relies on data that is already there
- Key benefits
  - Quick & automated
  - Huge data sets can be analysed = reduced need for sampling
  - Data can be linked (e.g. transactional data with customer profiles)

Another example is the use of **social media** to support market research:

- Social media data is a source of both primary and secondary research
- Software can quickly highlight what customers are saying about the product or brand (secondary research)
- Surveys easy to set up and analyse results in real-time
- Wide range of powerful software applications to manage social media research & integrate with other business systems

Key Terms

Marketing research	Collection of data to obtain insight and knowledge into the needs and wants of customers and the structure and dynamics of a market
Primary data	Research data collected first-hand for a specific purpose
Secondary data	Existing research data that has been collected and analysed for a different purpose
Quantitative research	Research based on numerical data
Qualitative research	Research based on views and opinions

Topic: Market Segmentation & Strategy

Theme 1: Section 1.1 Meeting Customer Needs

What You Need to Know
- Types and use of market segmentation
- Benefits and drawbacks of segmentation

Introduction: Role of Market Segmentation in Marketing

Businesses use marketing to create value for customers by making two key decisions:

Decision 1: Choose which customers to serve

This involves two elements:
- **Market segmentation** (analysing the different parts of a market)
- **Targeting** (deciding with market segments to enter)

Decision 2: Choose how to serve those customers

This also involves two important parts of marketing strategy:
- **Product differentiation** (what makes it difference from the competition)
- **Marketing positioning** (how customers perceive the product)

Market Segmentation

Market segmentation involves dividing a market into **parts that reflect different customer needs and wants**.

Segmentation is possible because in almost all markets there are differences in factors such as:
- Customer needs & wants
- How customers buy
- Location of customers
- Knowledge & experience of customers

Recognising and understanding these differences are the first steps in an effective approach to market segmentation.

Four traditional ways (bases) of segmenting a market are:

SEGMENT BASIS	SUMMARY
DEMOGRAPHIC	Dividing a market into segments based on demographic variables such as age, gender, family lifestyle, religion, nationality ethnicity etc.
INCOME	Dividing markets into different income segments, often on the basis of social-economic grouping
BEHAVIOURAL	Dividing a market into segments based on the different ways customers use or respond to a product and the benefits they seek
GEOGRAPHICAL	Dividing a market into different geographical units, such as nations, regions, cities, neighbourhoods or other territories

Topic: Market Segmentation & Strategy

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Benefits and Drawbacks of Market Segmentation

Among the key benefits are that segmentation:

- Focuses resources on parts of a market where the business can succeed
- Allows a business to grow share in markets or to "ride the wave" of fast-growing segments
- Helps with new product development – focused on needs of customers in the segment
- Helps make the marketing mix more effective – e.g. better targeting of promotion

On the other hand:

- Segmentation is an imprecise science – data about each market segment is not always available, up-to-date or reliable
- Just because you can identify a segment doesn't mean you can reach the customers in it!
- Markets are increasingly dynamic – fast-changing; so too are the segments

Key Terms

Market segmentation	Involves dividing a market into **parts that reflect different customer needs and wants.**
Niche market	A **smaller segment of a larger market,** where customers have specific needs and wants & successful products are highly differentiated
Mass market	The **largest part of the market**, where there are many similar (undifferentiated) products offered by competitors
Target market	The set of customers sharing common needs and wants that a business tries to connect with
Product differentiation	Where a product has a value proposition that is sustainably different from the competition

Topic: Market Positioning
Theme 1: Section 1.1 Meeting Customer Needs

What You Need to Know
- Market positioning
- Market mapping & maps
- Positioning and competitive advantage (USP)
- Product differentiation
- Adding value

Where Positioning Fits into Marketing
Businesses use marketing to create value for customers by making two key decisions:

Decision 1: Choose which customers to serve
This involves two elements:
- **Market segmentation** (analysing the different parts of a market)
- **Targeting** (deciding with market segments to enter)

Decision 2: Choose how to serve those customers
This also involves two important parts of marketing strategy:
- **Product differentiation** (what makes it difference from the competition)
- **Marketing positioning** (how customers perceive the product)

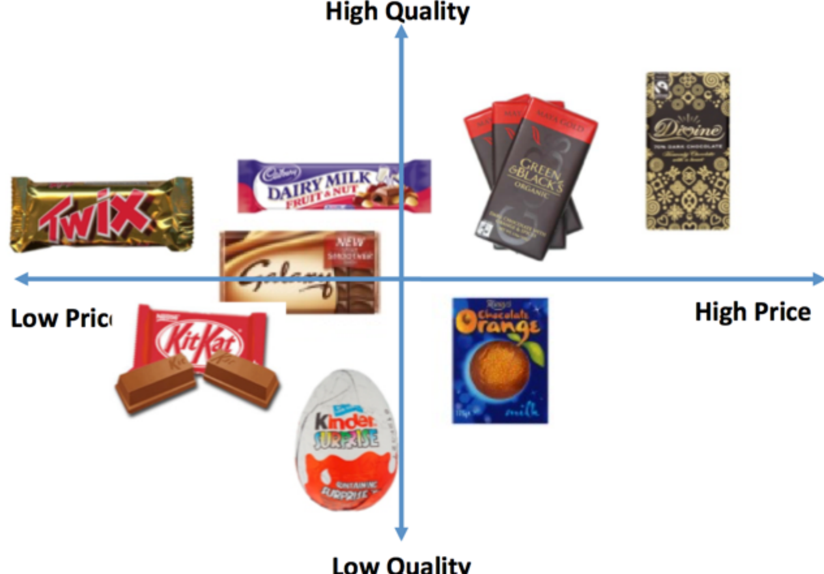
Market Positioning
Having analysed the market structure and chosen which segments to target – the next stage of the marketing strategy is to decide how to compete in those segments. Marketing people call this choice the **value proposition**.

It is important to remember that the market position (or value proposition) is defined by customers – the place a product occupies in customer minds relative to competing products.

A useful framework for analysing market positioning is a **"positioning map".** A market (or positioning) map illustrates the range of "positions" that a product can take in a market based on two dimensions that are important to customers. Some possible dimensions for the axes of a positioning map include:

Dimensions	
Low price	High price
Basic quality	High quality
Low volume	High volume
Necessity	Luxury
Light	Heavy
Simple	Complex
Unhealthy	Healthy
Low-tech	Hi-tech

An example of a positioning map for chocolate bars might look like this:



Whilst positioning maps are useful conceptual models, care has to be taken when using them in marketing decision-making:

- **Advantages of positioning maps**
  - Helps spot gaps in the market
  - Useful for analysing competitors
  - Encourages use of market research
- **Disadvantages of positioning maps**
  - Just because there is a “gap” doesn’t mean there is demand
  - Not a guarantee of success
  - How reliable is the market research?

Market Positioning and Competitive Advantage
Remember that customers choose products based on their perception of a product’s value proposition – how they perceive the merits of the product relative to the alternatives (competing products).

Therefore, providing a superior value proposition than the competition is a likely source of competitive advantage – but only if it can be sustained.
There are various possible value differences that have the potential to deliver competitive advantage:

Offer more for less	E.g. Aldi: good quality at low prices
Offer more for more	E.g. high-priced luxury products with prestige value
Offer more for the same	E.g. introduce new features & better performance for the same price
Offer less for much less	E.g. no-frills low cost flying and hotels; good quality, back to basics & low price

Topic: Market Positioning
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Product Differentiation

Product differentiation arises when customers perceive a distinct difference between your product and the alternatives provided by competitors. Effective differentiation allows a business to:

- **Compete effectively**
  - A source of competitive advantage
  - Ideally hard to copy
- **Protect and build a brand**
  - Build intangible value
  - Strengthen customer loyalty
- **Add more value**
  - Strong differentiation should allow a higher price
  - Higher profit margins

The key requirements for effective product differentiation are that the product is:
- Capable of delivering what is important to customers
- Distinctive – compared with the competition
- Communicated and visible to customers
- Not easily copied by competitors
- Affordable by the target customers
- Profitable

A product that is effectively positioned is often said to have a USP (unique selling point). A USP is something that sets a product apart from its competitors in the eyes of customers, both new and existing.

Adding Value

In their different ways, all businesses **add value** by taking resource inputs and transforming them into goods and services. This is known as the **transformation process.**

The transformation process describes what happens inside the business. This is where **value is added** to inputs to create outputs. Some examples of the transformation process are:

Topic: Market Positioning

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Industry	Key Inputs	Adding Value through the Transformation Process
Accountancy	People	Knowledge turned into professional advice
Restaurants	People, Ingredients, Buildings	Value added during cooking and through customer service
House-building	Land, People, Capital	Building process (design, implementation)

Key Terms

Market positioning	The place a product occupies in customer minds relative to competing products.
Product differentiation	Where a product has a value proposition that is sustainably different from the competition
Adding value	The process of adding value to the cost of inputs into and through the transformation process

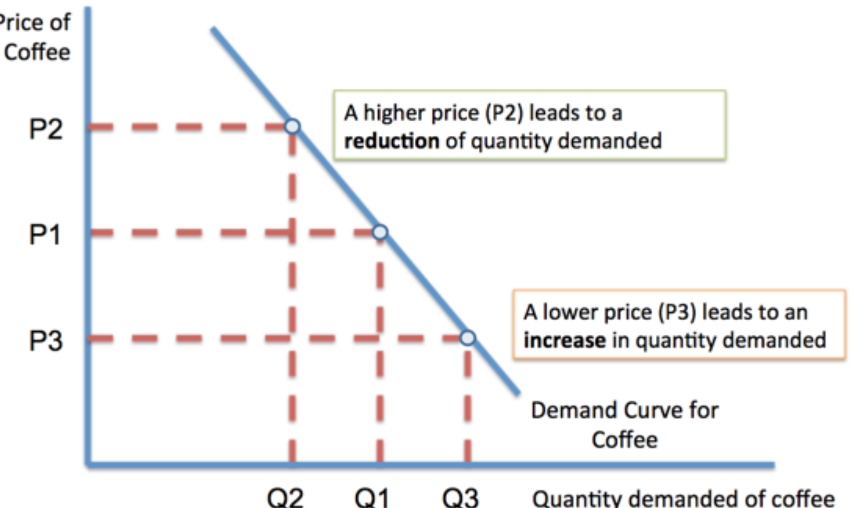
Topic: Market Demand
Theme 1: Section 1.2 The Market

What You Need to Know
• What is demand
• Main factors affecting demand for a product or service

Introduction to Demand
Demand for a good or service is the **quantity that customers are willing and able to buy at a given price in a given period of time.**

The **basic law of demand** is that demand varies inversely with price – lower prices make products more affordable for consumers.

This can be illustrated by plotting a **demand curve:**



Causes of Changes in Demand
The main causes of changes in market demand are:

Price	For most (normal) goods, a fall in price should result in an increase in demand The extent of the change depends on the price elasticity of demand
Incomes	As incomes rise, demand should normally rise However, for inferior goods, demand will fall as consumers choose better alternatives that are now affordable The extent of the change depends on the income elasticity of demand
Fashions, Tastes & Preferences	Demand for products that are fashionable or trendy will experience sharp fluctuations
Advertising & Branding	A key purpose of advertising and branding is to stimulate demand You look at this in more detail when you look at branding and promotion
External Shocks	A sudden and often significant change in the external environment E.g. a loss of consumer confidence in a product or brand
Seasonal Factors	For most products there will be seasonal peaks and troughs in production and/or sales E.g. Demand for plants at garden centres is linked to the planting season

Topic: Market Demand

Theme 1: Section 1.2 The Market

You look in more detail at the sensitivity (elasticity) of demand in response to changes in price and incomes in a separate topic.

A change in price can have both income and substitution effects, as summarised below:

Income Effects	Substitution Effects
• A fall in price increases the purchasing power of customers • This allows customers to buy more with a given budget • For normal goods, demand rises with an increase in incomes	• A fall in the price of good X makes it relatively cheaper compared to substitutes • Some customers will switch to good X leading to higher demand • Much depends on whether products are close substitutes

Key Terms

Demand	The quantity that customers are willing and able to buy at a given price in a given period of time.
Demand curve	The amounts (quantity) demanded of a product in the market at different price points.

Topic: Market Supply

Theme 1: Section 1.2 The Market

What You Need to Know

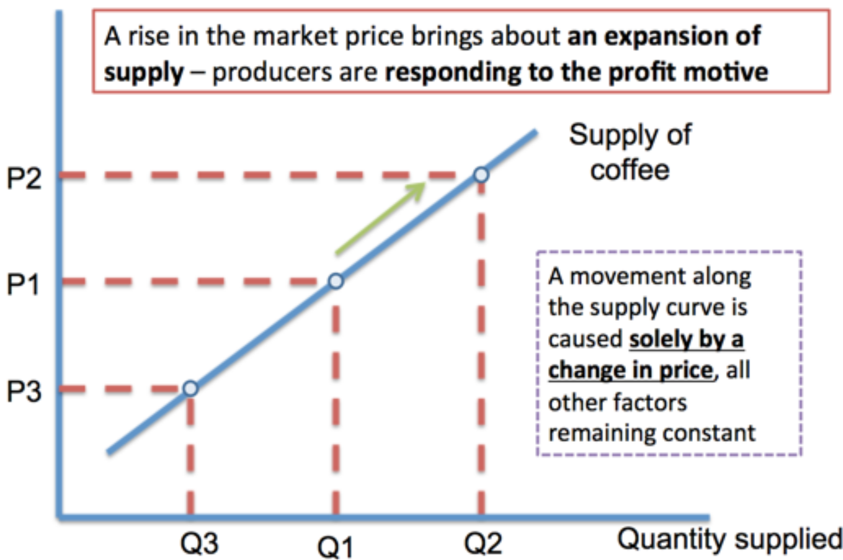
- What is supply?
- Drawing a supply curve
- Factors leading to a change in supply

Introduction to Supply

Supply is the **quantity of a good or service that a producer is willing and able to supply** onto the market at a given price in a given time period.

The Basic Law of Supply

The basic law of supply is that as the selling price of a product rises, so businesses expand supply to the market. The higher selling price acts as an incentive for businesses to produce more – and it may also attract other suppliers into the market. This is illustrated in the diagram below:



Causes of Changes in Market Supply

The four main causes of changes in the amount supplied to a market are:

- Costs of Production
- External Shocks
- New Technology
- Taxation & Subsidies

Let's look briefly at each of these

Supply and Costs of Production

It stands to reason that the costs of producing output will influence how much a business is able to supply:

- Lower **unit costs** mean that a business can supply more at each price – for example through higher productivity
- Higher **unit costs** cause an inward shift of supply e.g. a rise in wage rates or an increase in energy prices / other raw materials

Topic: Market Supply

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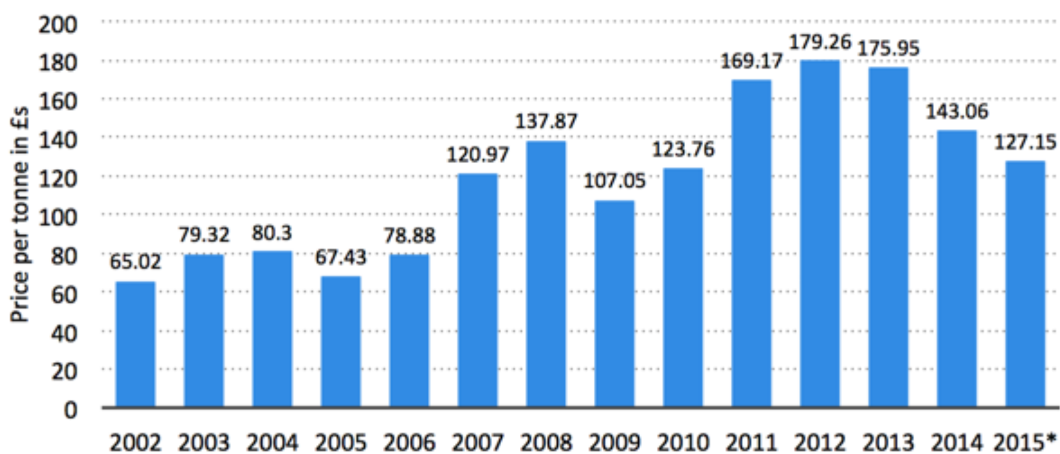
A good example of supply and costs of production is how changes in market prices of commodity ingredients change the costs of food producers.

The chart below shows how average prices of a key commodity food ingredient – wheat – have changed in recent years.



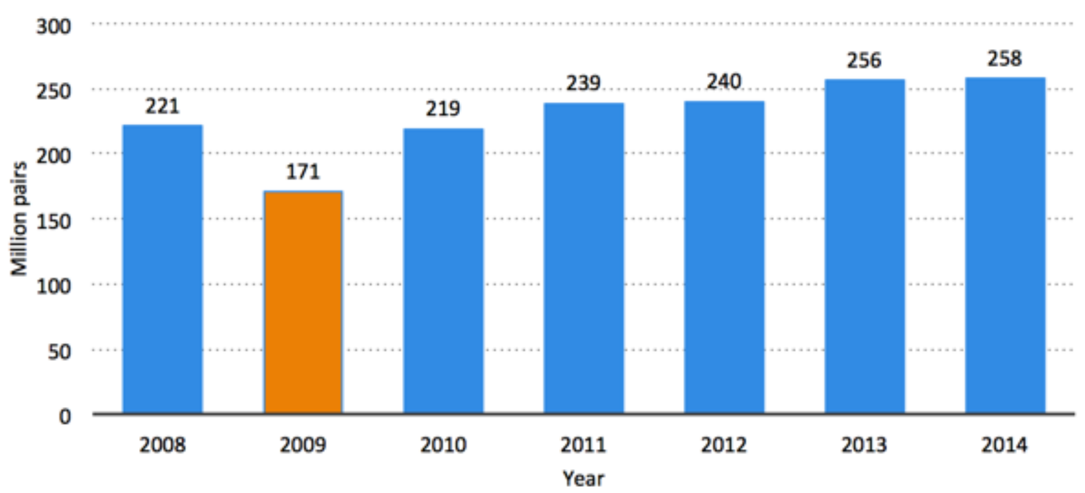
What might the effect of this be on supply? Falling wheat prices will cause a reduction in the resource costs for food manufacturers such as cereal producers. If other factors remain constant, producers who use wheat will be able to **supply more** for the same cost.

Supply and External Shocks

Significant and often unexpected changes in the external business environment usually impact on market supply.

For example, the sharp and sustained economic downturn between 2008-2012 across the world's developed economies led to many firms cutting back the scale of their operations, including cutting production capacity.

The chart below shows how in 2009 (during the global economic recession) demand for sports shoes declined and Adidas responded by cutting output.



Topic: Market Supply
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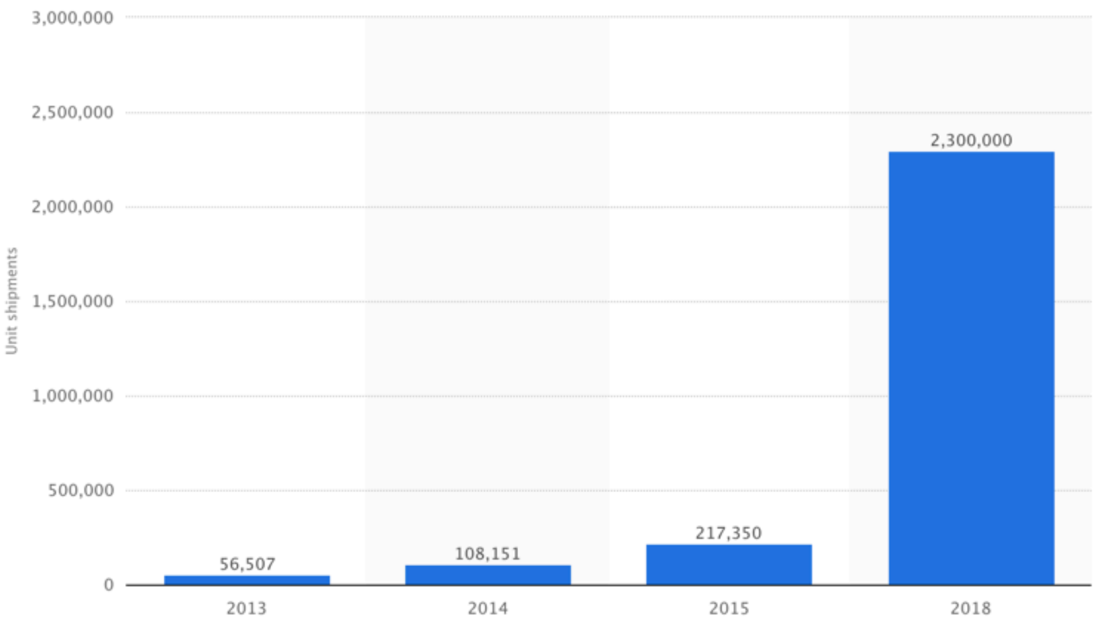
Supply and Technology
Technological change encourages new entrants to a market (increasing supply) and can also enable existing suppliers to become more efficient, thereby increasing their potential to supply.

A good example is the 3D printing industry where the rapid development of additive manufacturing techniques has led to an explosion in supply of and demand for 3D printers. As the chart below illustrates, in2014 there were 108k 3D printers produced. The forecast global supply for 2018 is 2.3 million printers.



Supply and Taxation
Changes in taxation can affect both supply and demand.

For example, the provision of subsidies to households and businesses installing solar panels in recent years encouraged a substantial increase in supply to the market.

A subsidy is any form of government support—financial or otherwise—offered to producers and (occasionally) consumers. Some examples of subsidies made available in the UK are shown below:

Topic: Market Supply
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Biofuel subsidies for farmers

Solar Panel "Feed-In Tariffs"

Apprenticeship Schemes

Aid to businesses making losses

Subsidies for wind farm investment

Food / fuel subsidies for consumers

Child Care for working families

Subsidies to the rail industry

Key Terms

Supply	The quantity of a good or service that a producer is willing and able to supply onto the market at a given price in a given time period.
Supply curve	A line (or curve) that shows the different combinations of quantity supplied and market price. Normally upward-sloping – i.e. higher quantities are supplied as the market price rises
Subsidy	Any form of government support—financial or otherwise—offered to producers and (occasionally) consumers

Topic: Market Equilibrium

Theme 1: Section 1.2 The Market

What You Need to Know

- Interaction of supply and demand
- Illustrating the causes and consequences of price changes

Introduction to Supply

A market is said to be in **equilibrium** when there is a balance between demand and supply. If something happens to disrupt that equilibrium (e.g. an increase in demand or a decrease in supply) then the forces of demand and supply respond (and price changes) until a new equilibrium is established.

In some markets, the equilibrium point is changing many times per second as demand and supply try to reach a point of balance (e.g. share prices). In other markets there is much less volatility and price changes are less frequent.

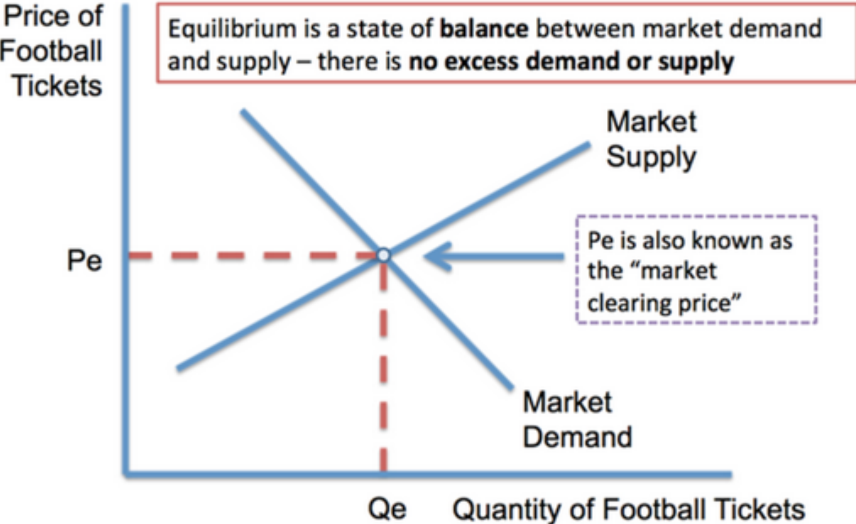
Let's look briefly at how the market equilibrium point is established using basic supply and demand analysis.

Basic Market Equilibrium

Consider the data in the table below. A football club has a fixed stadium capacity of 8,000 seats and has estimated the level of demand at different ticket prices as follows:

Ticket Price	Quantity demanded	Quantity supplied
£20	6,000	8,000
£18	7,000	8,000
£16	**8,000**	**8,000**
£14	9,000	8,000
£12	10,000	8,000

The equilibrium price for the football club is £16 where quantity demanded and supplied = 8,000 tickets. At a price of £16 per ticket, supply & demand are in balance. This can be illustrated using demand and supply curves as follows.



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Topic: Market Equilibrium

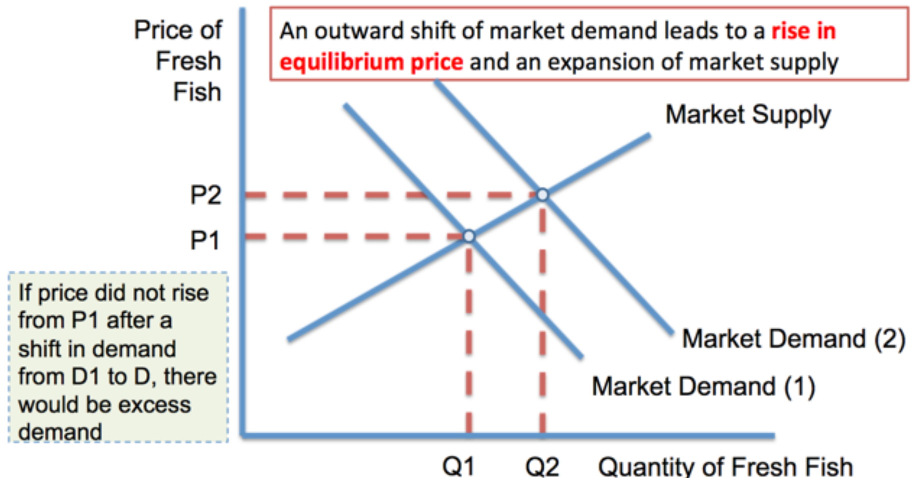
Theme 1: Section 1.2 The Market

What Happens to Market Equilibrium When Demand Increases?
Here's another example to illustrate what happens to the market equilibrium when demand increases.

The demand for and supply of fresh fish in a local market is shown in the table below. The original equilibrium price is £6 per kg.

Price per kg	Quantity demanded (1)	Quantity supplied	Quantity demanded (2)
£10	100	380	240
£9	130	340	270
£8	160	**300**	**300**
£7	190	260	330
£6	**220**	**220**	360
£5	250	180	390

If market demand rises by 80 kg at each and every price, then the new equilibrium price will be £8 with 300kg bought and sold. This change in market equilibrium - from an increase in demand - is illustrated below.

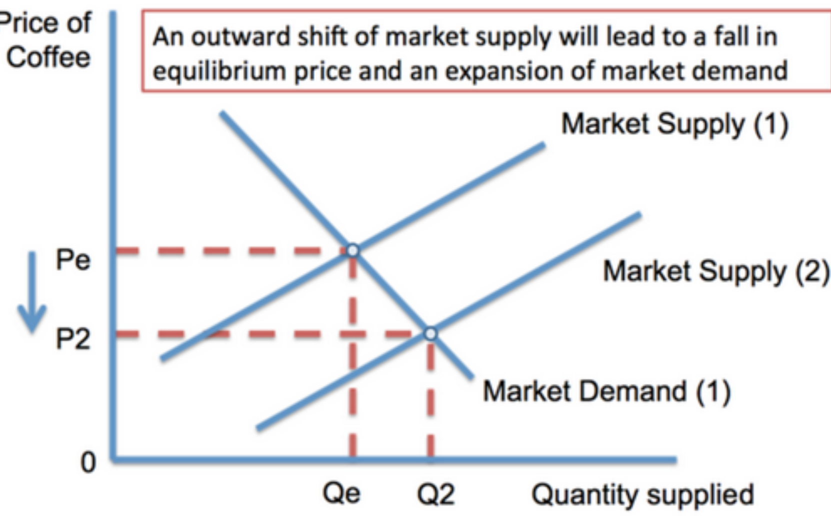


What Happens To Market Equilibrium When Supply Increases?
Here's another example to illustrate what happens to the market equilibrium when supply increases. The demand for and supply of cocoa beans in a local market is shown in the table below. The original equilibrium price is $30.

Price per kg	Quantity demanded (1)	Quantity supplied	Quantity Supplied (2)
$40	2,000	3,800	4,700
$35	2,500	3,400	4,300
$30	**3,000**	**3,000**	3,900
$25	**3,500**	2,600	**3,500**
$20	4,000	2,200	3,100
$15	4,500	1,800	2,700

If market supply increases by 900 tonnes at each price, then the new equilibrium price will be £25 with 3,500 tonnes bought & sold.

This can be illustrated using a market demand and supply diagram below:



Putting It All Together for Market Equilibrium
Here's a useful summary of how equilibrium prices change when conditions of demand/supply alter:

Change	Equilibrium Price	Equilibrium Quantity
Demand increases	Higher	Higher
Demand decreases	Lower	Lower
Supply increases	Lower	Higher
Supply decreases	Higher	Lower

Key Terms

Market equilibrium	When there is a balance between demand and supply in a market
Market demand	The total quantity (volume) demanded for a product in a market by all customers
Market supply	The total quantity (volume) of a product supplied to a market by suppliers

Topic: Price and Income Elasticity of Demand

Theme 1: Section 1.2 The Market

What You Need to Know
What is price and income elasticity of demand?
Determinants of price elasticity
Value of understanding elasticity to decision-makers
Classifying and interpreting price elasticity

Introduction to elasticity

The demand for goods and services varies depending on a range of factors. Elasticity measures the **responsiveness of demand** to a change in a relevant variable – such as price or income.

Price elasticity of demand

Price elasticity of demand measures the extent to which the quantity of a product demanded is affected by a change in price.

Price Elasticity of Demand (usually shortened to PED) is calculated as:

$$\frac{\textbf{\% Change in Quantity Demanded}}{\textbf{\% Change in Price}}$$

To interpret the result of the calculation:

	Value of PED	**Interpreting the Elasticity**
Price elastic	More than 1	Change in demand is more than the change in price
Price inelastic	Less than 1	Change in demand is less than the change in price
Unitary price elasticity	Exactly = 1	Change in demand = change in price

Let's look at two examples of calculating PED – one for a product with elastic demand; one inelastic.

Example of Elastic Demand

	Original Price	**New Price**
Product B	£1,000	£900
Quantity Demanded	200 units	250 units
Revenue (price x qty)	£200,000	£225,000
Change in Price		- £100
Change in Demand		+ 50 units
% Change in Price		(100/1000) x 100 = 10%
% Change in Demand		(50/200) x 100 = 25%
PED		**25% / 10% = 2.5**

Example of Inelastic Demand

Topic: Price and Income Elasticity of Demand

Theme 1: Section 1.2 The Market

	Original Price	New Price
Product A	£100	£125
Quantity Demanded	500 units	400 units
Change in Price		+ £25
Change in Demand		- 100 units
% Change in Price		(25/100) x 100 = 25%
% Change in Demand		(100/500) x 100 = 20%
PED		**20% / 25% = - 0.8**

Why does price elasticity demand matter?

If PED > 1 (price elastic) then a change in price will cause a larger change in demand

- Overall revenues would increase with a price cut
- Overall revenues would fall with a price increase

Opposite is the case if PED < 1 (price inelastic

A variety of factors will influence what the PED is for a product:

Factor	Effect on PED
Brand strength	Products with strong brand loyalty and reputation tend be price inelastic
Necessity	The more necessary a product, the more demand tends to be inelastic
Habit	Products that are demanded and consumed as a matter of habit tend to be price inelastic
Availability of substitutes	Demand for products that have lots of alternatives (substitutes) tends to be price elastic
Time	In the short-run, price changes tend to have less impact on demand than over longer periods

Income elasticity of demand

Income elasticity of demand measures the extent to which the quantity of a product demanded is affected by a change in income.

Income Elasticity of Demand (usually shortened to PED) is calculated as:

$$\frac{\text{\% Change in Quantity Demanded}}{\text{\% Change in Income}}$$

For most normal products

- A rise in consumer income will result in a rise in demand
- A fall in consumer income will result in a fall in demand

Extent of the change (elasticity)

- This will vary depending on the type of product (e.g. luxury v necessity)

Looking further at this distinction between luxuries and necessities:

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Topic: Price and Income Elasticity of Demand
Theme 1: Section 1.2 The Market

Luxuries	**Necessities**
Income elasticity more than 1	Income elasticity less than 1, but more than 0
As income grows, proportionally more is spent on luxuries	As income grows, proportionally less is spent on necessities
Examples:	***Examples:***
Consumer goods Expensive holidays Branded goods	Staple groceries (e.g. milk) Own-label goods

Watch out too for inferior goods. These have an income elasticity of less than one. For inferior goods, as income rises demand actually falls. Why does demand fall?

- Consumers switch to better alternatives
- Substitute products become affordable

Combining Price and Income Elasticity

It is important to consider the combined impact of price and income elasticity. How might the following price and income elasticity data for two products be interpreted?

	PRODUCT A	**PRODUCT B**
PED	- 1.5	- 0.2
IED	+ 0.5	+ 1.9
	Price elastic Income inelastic Likely to be a necessity	Price inelastic Income elastic Likely to be a luxury good (perhaps branded)

Some limitations of using elasticities

Care needs to be taken interpreting and using elasticity data in marketing. For example:

- It can be difficult to get reliable data on how demand changes in relation to price (although this is getting easier with the emergence of big data)
- Other factors affect demand (e.g. consumer tastes)
- Many markets subject to rapid technological change – make previous data less reliable
- Competitors will react – pricing decisions can't be taken in isolation!

Key Terms

Price elasticity of demand	Measures the extent to which the quantity of a product demanded is affected by a change in price
Income elasticity of demand	Measures the extent to which the quantity of a product demanded is affected by a change in income

Topic: Product & Service Design
Theme 1: Section 1.3 Marketing Mix and Strategy

What You Need to Know

- **Design mix:**
- *Function*
- *Aesthetics*
- *Cost*
- **Changes in the elements of the design mix to reflect social trends:**
- *Concern over resource depletion*
- *Designing for waste minimisation, re-use and recycling*
- *Ethical sourcing*

Introduction to Product Design

Product design is about much more than style. Design goes right to the heart of a product. Good design contributes to a product's usefulness as well as its look.

The traditional product design mix emphasises three elements:

Element	
Function	• The way a product works. • Does it do what it needs to do? • Is the product reliable?
Economic manufacture	• Does the design allow the product to be made and sold profitably? • How much value is added during the production process?
Aesthetics	• How the product appeals to the customer in terms of how it looks, feels etc. • Based on the subjective judgement of customer • A popular way to differentiate a product

Common Features of Products that Successfully Emphasise Function in the Design Mix

- More predictable and stable demand
- Longer product life cycles
- Lower promotional costs
- Build reputation for quality based on reliability
- Economic manufacture through economies of scale

Examples include:

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Topic: Product & Service Design

Theme 1: Section 1.3 Marketing Mix and Strategy

Common Features of Products that Successfully Emphasise Aesthetics in the Design Mix

- High added value
- Demand fuelled by customer aspiration
- Potentially shorter product life cycle
- Attracts imitation = need for design protection
- Need for greater promotional support

Examples include:

How Design Mix is Changing to Reflect Social Trends

There are three aspects to consider here. The key points to remember are:

Sustainability

- Sustainability involves making a product without affecting the long-term supplies of the inputs into the product
- Source inputs that are not supplied by damaging the environment
- Designing the product so it can be used (consumed) sustainably
- Minimise waste in production
- Enable recycling or re-use

To address sustainability, product design needs to consider a variety of environmental issues:

- Use of raw materials, water and other resources (inputs)
- Energy use and its impact on climate change
- Waste and pollution produced by the business
- The impact the business has on employees and the local, wider and international community

Ethical Supply Chains

- Consumers are increasingly interested in buying from "ethical" businesses
- "How" products are made is a key issue for many consumers
- There is potential for significant damage to a business reputation if issues discovered in the supply chain

Waste Minimisation

This links with the concept of lean production as well as being an important social issue. Businesses addressing this issue take care to ensure that products are designed to maximise their potential for recycling and also that the production process minimises waste.

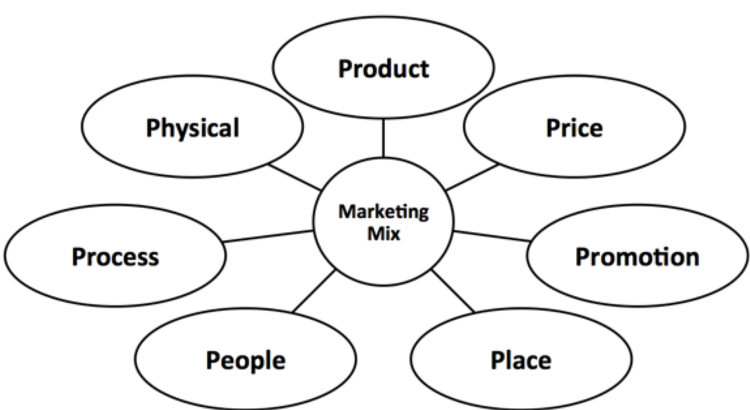
Topic: Product Life Cycle and Portfolio

Theme 1: Section 1.3 Marketing Mix & Strategy

What You Need to Know
The product life cycle (concept & stages)
Extension strategies
Boston Matrix & the product portfolio

Introduction to Product
A product is **anything that is capable of satisfying customer needs and wants.**

Product is often considered to be the most important part of the extended marketing mix:



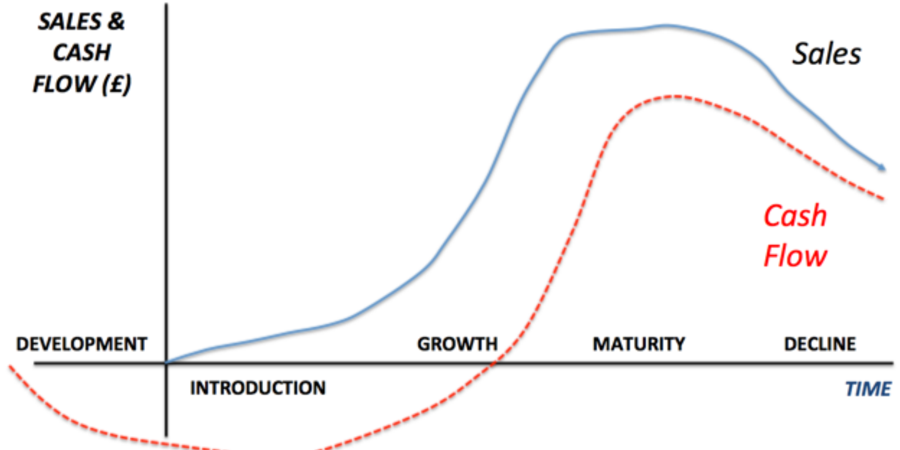
Product Life Cycle Model
The product life cycle is a theoretical model that describes the stages a product goes through over its life. This well-known and popular model can be used to:

- Forecast future sales trends
- Help with market targeting and positioning
- Help analyse & manage the product portfolio

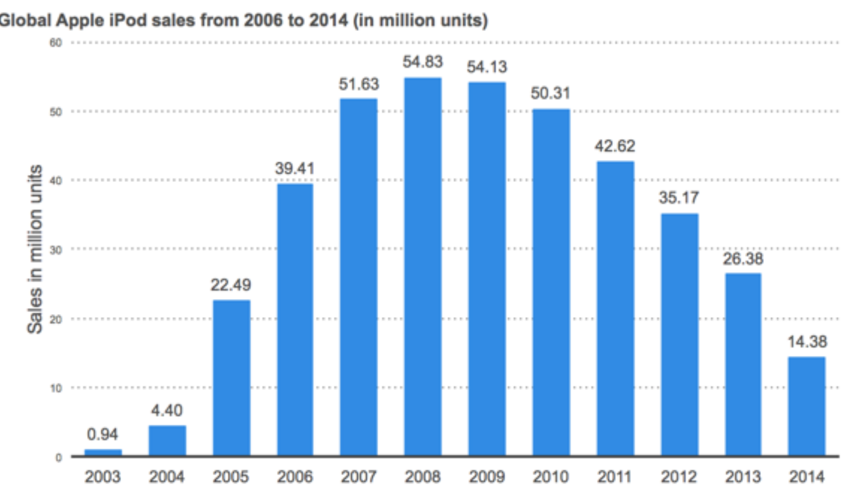
The five stages of the product life cycle are listed below together with a diagrammatical representation of the theoretical model of product sales and cash flow during the life cycle:

- Development
- Introduction
- Growth
- Maturity
- Decline / End

Topic: Product Life Cycle and Portfolio
Theme 1: Section 1.3 Marketing Mix & Strategy



A classic example of the life cycle in real life is the sales profile of the Apple iPod:



The key points to remember about each stage are:

Stage	Key Point
Development	• Often complex & time-consuming • Absorbs significant resources • Cost of development often rises as product approaches launch • May not be successful – high failure rate • Test launch may reduce the risk of product failure • Can be a long lead time before sales are achieved
Introduction	• New product launched on the market • Likely to be a low level of sales – penetration pricing may help build customer demand • Low capacity utilisation & high unit costs • Usually negative cash flow • Distributors may be reluctant to take an unproven product • Heavy promotion to make consumers aware of the product
Growth	• Fast growing sales, helped by wider distribution • Rise in capacity utilisation – should lower unit costs

Stage	Key Point
	• Product gains market acceptance • Cash flow may become positive • The market grows, profits rise but attracts the entry of new competitors
Maturity	• Slower sales growth as rivals enter the market = intense competition + fight for market share • High level of capacity utilisation • High profits for those with high market share • Cash flow should be strongly positive • Weaker competitors start to leave the market • Prices and profits fall
Decline	• Falling sales • Market saturation and/or competition • Decline in profits & weaker cash flows • More competitors leave the market • Decline in capacity utilisation – switch capacity to alternative products

Extending the Product Life Cycle
There are a number of strategies available to try to extend the life cycle of a product – particularly one that has generated high sales and profits in the growth and maturity stage. Extension strategies might include:

- Lowering the price
- Changing promotion (e.g. new promotional message)
- Changing the product - re-styling and product improvement
- Looking for alternative distribution channels
- Developing a new market segment
- Find new uses for the product
- Repositioning the product

Criticisms of the Product Life Cycle Model
As we have already mentioned, the product life cycle is a theoretical model, although the profiles of many products do exhibit the characteristics predicted by the model. Among the criticisms made of the model are:

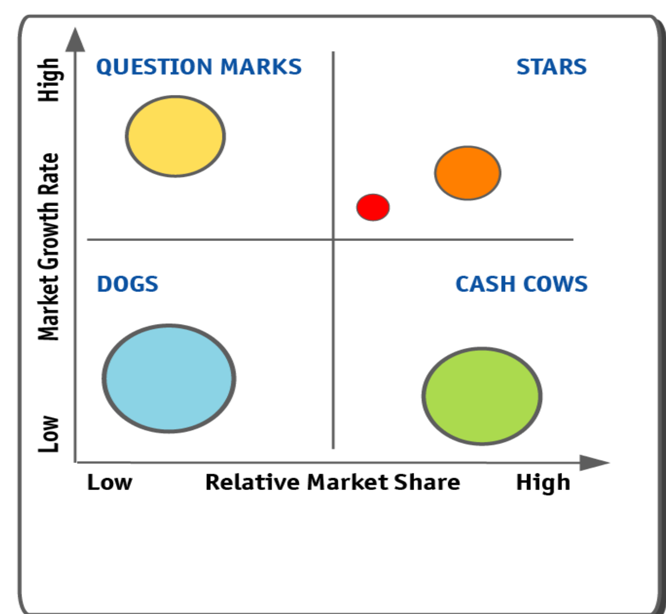
- The shape and duration of the cycle varies from product to product
- It is difficult to recognise exactly where a product is in its life cycle
- Length cannot be reliably predicted
- Decline is not inevitable

Product Portfolio Analysis
Most businesses of any size or complexity have more than one product. The most complex have thousands of products, many brands and individual business units.

Topic: Product Life Cycle and Portfolio

Theme 1: Section 1.3 Marketing Mix & Strategy

Product portfolio analysis assesses the position of each product or brand in a firm's portfolio to help determine the right marketing strategy for each. Perhaps the best-known and most popular model for portfolio analysis is the Boston Matrix.



The **Boston Matrix** categorises the products into one of four different areas, based on:

- **Market share** – does the product being sold have a low or high market share?
- **Market growth** – are the numbers of potential customers in the market growing or not

How does the Boston Matrix work? The four categories can be described as follows:

- **Stars** are **high growth products** competing in markets where they are strong compared with the competition. Often Stars need heavy investment to sustain growth. Eventually growth will slow and, assuming they keep their market share, Stars will become Cash Cows
- **Cash cows** are **low-growth products** with a high market share. These are mature, successful products with relatively little need for investment. They need to be managed for continued profit - so that they continue to generate the strong cash flows that the company needs for its Stars
- **Question marks** are products with low market share operating in high growth markets. This suggests that they have potential, but may need substantial investment to grow market share at the expense of larger competitors. Management have to think hard about "Question Marks" - which ones should they invest in? Which ones should they allow to fail or shrink?
- Unsurprisingly, the term **"dogs"** refers to products that have a low market share in unattractive, low-growth markets. Dogs may generate enough cash to break-even, but they are rarely, if ever, worth investing in. Dogs are usually sold or closed.

Ideally a business would prefer products in all categories (apart from Dogs!) to give it a balanced portfolio of products.

How valuable is the Boston Matrix?

- It is a useful tool for analysing product portfolio decisions
- But it is only a snapshot of the current position
- It has little or no predictive value
- Focus on market share and market growth ignores issues such as developing a sustainable competitive advantage

Topic: Product Life Cycle and Portfolio

Theme 1: Section 1.3 Marketing Mix & Strategy

Key Terms

Product	Any good or service that is capable of satisfying customer needs and wants
Product life cycle	A predictive model of the stages a product goes through from development to decline
Boston Matrix	A model use to analyse the strategic position of product and brand portfolios

Topic: Branding & Promotion

Theme 1: Section 1.3 Marketing Mix and Strategy

What You Need to Know

- Types of branding
- Benefits of branding
- Main methods of promotion
- Viral marketing & social media

Introduction to Branding

A brand is a product that is easily distinguished from other products so that it can be easily communicated and effectively marketed. A brand name is the name of the distinctive product.

The key business benefits of effective branding are:

- It adds significant value (from customer point of view)
- Business is able to charge higher prices + demand is more price inelastic
- Branding builds customer loyalty & aspiration

Types of Brand

There are several key types of brand:

Brand Type	Description	Examples
Product brand	Brands associated with specific products. Fast moving consumer goods brands (FMCG) are some of the best examples	Marmite, Persil, PotNoodle, Crest
Service brand	Brands that add perceived value to services, either delivered face-to-face or via online & apps	Dropbox, Vue, Uber, Netflix
Umbrella ("Family") brand	Brands that are assigned to more than one product. Umbrella branding makes different product lines easily identifiable by the consumer by grouping them under one brand name	P&G, Dove, Cadbury
Corporate & Own-Label brands	Promoting the brand name of a corporate entity, as opposed to specific products or services	Nestle, Unilever, BBC
Own-label	An example of corporate branding where retail outlets assign their corporate branding to a range of goods and services	Tesco Finest, Essential Waitrose
Global brand	Easily recognised and operating worldwide. These brands are based on familiarity, availability and stability	Ikea, McDonald's, Coca-Cola, Pepsi, DHL

Introduction to Promotion

Promotion in marketing has two key tasks – to i**nform** (communicate) and **persuade**.

The main aim of promotion is to ensure that **customers are aware of the existence and positioning of products.**

Promotion is also used to p**ersuade** customers that the product is better than competing products and to remind customers about why they may want to buy.

The Promotional Mix
The promotional mix describes the promotional methods that a business uses to pursue its marketing objectives: The main elements of the mix are:

- Advertising (offline & online)
- Sales promotion & merchandising
- Personal selling
- Public relations/publicity / sponsorship
- Direct marketing

Most businesses employ a variety of these elements rather than relying on just one. The important thing is that the elements must be integrated in a cohesive, consistent and logical manner. Key influences on which promotional elements are used (and how) include:

Stage in the product's life cycle	Position in the life cycle will require different promotional methods
Nature of the product	What information do customers require before they buy?
Competition	What are rivals doing? What promotional methods are traditionally effective in a market?
Marketing objectives & budget	What does promotion need to achieve? How much can the firm afford?
Target market	Appropriate ways to reach the target market segments

Let's look at the key points to remember for each main promotional method.

Advertising

Key points:
- Paid-for communication
- Many different advertising media (e.g. mobile devices, TV & radio, newspapers & magazines, online, social media, cinema, billboards)
- Consumers subjected to many advertising messages each day = hard to get through
- Mass-market advertising is very expensive
- Niche market advertising now much more cost effective due to growth of online & mobile)

Benefits of Advertising	Drawbacks of Advertising
Wide coverage Control of message Repetition means that the message can be communicated effectively Effective for building brand awareness and loyalty	Often expensive Most methods are impersonal (although less so for mobile & online) One way communication Lacks flexibility Limited ability to close a sale

Topic: Branding & Promotion
Theme 1: Section 1.3 Marketing Mix and Strategy

Personal Selling

Key points:
- Promotion on a person-to-person basis
- Uses two-way communication
- Usually involves meeting with potential customers to close a sale
- Many methods: by telephone, at meetings, in retail outlets, knocking on doors
- Highly priced, low volume and highly technical products rely heavily on personal selling

Benefits of Personal Selling	Drawbacks of Personal Selling
High customer attention Message is customised Interactivity Persuasive impact Potential for development of relationship Adaptable Opportunity to close the sale	High cost Labour intensive Expensive Can only reach a limited number of customers

Sales Promotion

Key points:
- Tactical, point of sale material or other incentives designed to stimulate purchases
- Examples include free samples, coupons, BOGOF-style offers
- Short-term incentives designed to increase sales, for example through impulse purchase
- Some promotions aimed at consumers; others at intermediaries or to help the direct sales force

Benefits of Sales Promotion	Drawbacks of Sales Promotion
Effective at achieving a quick boost to sales Encourages customers to trial a product or switch brands	Sales effect may only be short-term Customers may come to expect or anticipate further promotions May damage brand image

Public Relations (PR)
Public relations activities are those that create goodwill toward an individual, business, cause or product.

Key points:
The main aims of PR are to:
Achieve favourable publicity about the business
Build the image and reputation of the business and its products, particularly amongst customers
Communicate effectively with customers and other stakeholders

Typical PR activities:

Topic: Branding & Promotion

Theme 1: Section 1.3 Marketing Mix and Strategy

- Promoting new products
- Enhancing public awareness
- Projecting a business image
- Promote corporate social responsibility
- Projecting business as a good employer
- Obtain favourable product reviews / recommendations

Direct Marketing

Direct marketing involves the sending of promotional material directed through mail, email, social media or phone to individuals or businesses. The ultimate aim of direct marketing is to trigger a "response" – e.g. a purchase or an enquiry.

Key points:

- Allows a business to generate a specific response from targeted groups of customers
- Allows a business to focus on several marketing objectives at the same time:
    - Increasing sales to existing customers
    - Building customer loyalty
    - Re-establishing lapsed customer relationships
    - Generating new business

Key Terms

Brand	A product that is easily distinguished from other products so that it can be easily communicated and effectively marketed
Sales promotion	Tactical, point of sale material or other incentives designed to stimulate purchases
Advertising	Paid-for communication, aimed at informing or persuading
Direct marketing	Sending promotional materials and messages directly to the target audience
Promotional mix	The mix of activities and approaches taken to promoting a product

Topic: Marketing Pricing Strategies
Theme 1: Section 1.3 Marketing Mix and Strategy

What You Need to Know
• Types of pricing strategy • Factors influencing the choice of pricing strategy • Changing price to reflect social trends

Introduction – What is Price?
Price is:
- The money charged for a product or service
- Everything that a customer has to give up in order to acquire a product or service
- Usually expressed in terms of £
- The only element of the marketing mix that impacts directly on the value of sales
- Often the hardest part of the marketing mix to get right
- Closely linked to the concept of "value for money" and competitiveness

Price Setting and Corporate & Marketing Objectives
The setting of a price for a product is to a large extent determined by what objectives the business has. Since price directly affects the value of sales (and therefore cash flow) financial as well as marketing objectives are particularly important influences:

Financial Objectives	**Marketing Objectives**
Maximise profit Achieve a target level of profits Achieve a target rate of return Maximise sales revenue Improve cash flow	Maintain/improve market share Beat/prevent competition Increase sales Build a brand

Pricing Methods, Tactics and Strategies
Pricing works at different levels. The three main levels are:

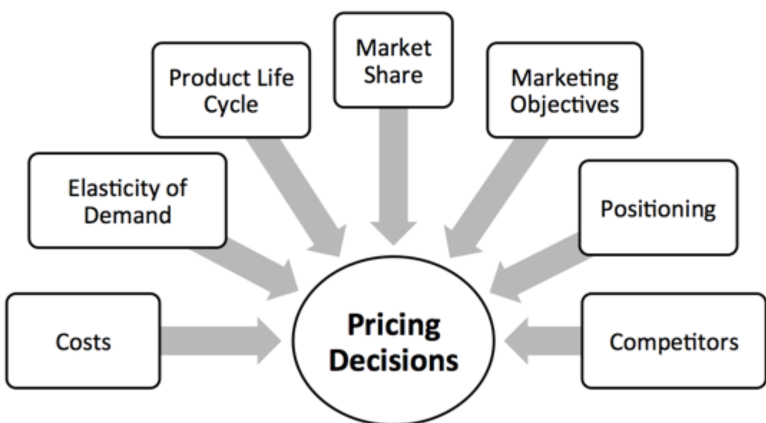
Pricing Methods	The methods used to calculate the actual price set (e.g. cost-plus)
Pricing Tactics	Adopted in the short run to suit particular situations Limited impact beyond the product itself
Pricing Strategies	Adopted over the medium to long term to achieve marketing objectives Have a significant impact on marketing strategy

Topic: Marketing Pricing Strategies

Theme 1: Section 1.3 Marketing Mix and Strategy

Main Influences on Pricing

In addition to corporate and functional objectives, there are a variety of other influences that determine what price is set.



Competitors are a particularly important influence, the extent of which is largely determined by the relative power of competitors in a market segment. When it comes to setting price a business can be said to be a:

Price taker	Business has no option but to charge the ruling market price
Price maker	Business is able to set its own price without worrying about rivals
Price leader	Market leader whose price changes are followed by rivals
Price follower	Follow the price-changing lead of the market leader

Pricing Based on Costs

If a business wants to operate profitably, then by definition its pricing must take some account of the costs of production or operation.

- Cost is an important influence on pricing
- Over time a price must be more than the related costs in order to make a profit
- Popular method of cost-based pricing is **"mark-up"** – widely used in retailing

An example of basing price using a mark-up approach would be:

Total Costs for producing 10,000 units	£100,000
Cost per Unit	£10
Add mark-up 100% of cost	£10
Selling price = cost + mark-up	£20

The main benefits and drawbacks of basing price on costs are:

BENEFITS	**DRAWBACKS**
Easy to calculate	Ignores price elasticity of demand
Price increases can be justified when costs rise	May not take account of competition
Managers can be confident each product is being sold at a profit	Profit is lost if price is set below the that customers are prepared to pay

BENEFITS	DRAWBACKS
	Sales are lost if price is set above the price customers are willing to pay
	Business has less incentive to control costs

Let's now briefly look at some other specific pricing tactics and strategies:

Price Skimming

- This involves setting a **high price to maximise profit**
- Product is sold to different market segments at different times
- Top segment is skimmed off first with the highest price
- Objective: maximise profit per unit to achieve quick recovery of development costs
- Works well for products that create excitement amongst "early adopters"
- Best used in introduction or early growth stage of product life cycle
- Electronic items provide many great examples

Penetration Pricing

- Penetration pricing is the opposite of price skimming
- Involves offering a product at a low introductory price
- Aim is to
    - Gain market share quickly
    - Build customer usage and loyalty
    - Build sales of higher-priced related items ("hook & bait" approach)
- Price can be increased once target market share is reached

Price Wars

- Price wars involve competitive price reductions by firms as part of the day-to-day competitive rivalry in the market
- Each firm seeks to increase market share by price reduction but the result is destructive spiral of price reductions
- The process continues until weaker firms go out of business or until a "truce" is called
- Price wars might be seen as good for customers in the short run but it is harmful in the long run if competition is reduced

Psychological Pricing

- You'll almost certainly have come across psychological pricing – and perhaps been taken in by it!
- In this case consideration is given to the psychology of prices and not simply the economics of pricing
- The classic example is charging at a price which ends in 99p is a way of deceiving people into believing that the product is cheaper than it really is!

Loss Leading / Loss Leaders

- A loss leader is a product prominently displayed and advertised and price below the normal price and even below cost to the seller

- A product which is sold at a low (even loss making) price in order to encourage customers to buy other full price products from the business along with the loss leader product
- Loss leaders are widely used by supermarkets to draw in customers from rival firms
- The aim is to encourage people to buy complementary goods at full price

Dynamic Pricing
Dynamic pricing is a pricing strategy in which businesses set **flexible prices** for products or services based on **current market demands.**

A good example is the use of variable pricing by online retailers such as Amazon and the so-called "surge pricing" model of businesses like Uber.

Key Terms

Cost-plus pricing	Price is set by applying a percentage margin based on the unit costs of production or supply
Price skimming	Charging a premium price when a product is first launched in order to maximise revenue per unit
Penetration pricing	Offering a significantly lower price than normal in an attempt to maximise volume sold and to build an installed base of product users
Dynamic pricing	Setting flexible prices for products or services based on current market demands

Topic: Distribution
Theme 1: Section 1.3 Marketing Mix & Strategy

What You Need to Know
- Methods of distribution (channels)
- Choosing appropriate distribution
- Changes in distribution to reflect social trends
- Increasing use of multi-channel distribution (including online)
- Changing from product to service – implications for distribution

Introduction to Distribution
Distribution (or place) is one of the four traditional elements of the marketing mix. It involves the ways in which a product reaches the end consumer.

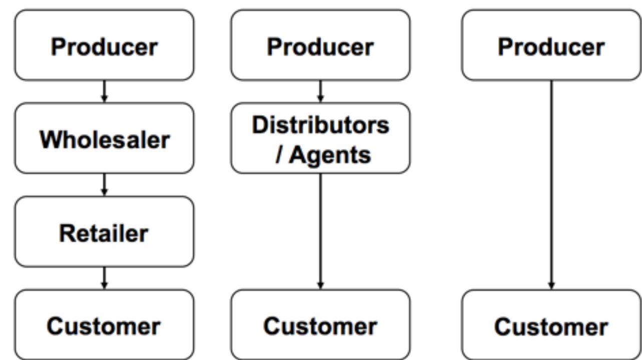
The ultimate aim of effective distribution is to make products available in the **right place** at the **right time** in the **right quantities**

The decisions about what methods of distribution to use are strongly influenced by the choice of target market and product positioning. Key questions for a business to consider include:

- How can the business ensure that its products reach existing and potential customers?
- How and where do customers prefer to buy the product?
- How important are factors such as stock availability, price & speed of delivery?

Distribution Channels
A distribution channel moves a product through the stages from production to final consumption.

Distribution channels can have more than one stage. A distribution channel with more than one stage will involve "intermediaries":



Distribution channels serve a variety of purposes:

- Provide a link between production and consumption
- Help gather market information
- Communicate promotional offers
- Find and communicate with prospective buyers
- Physical distribution - transporting and storing

- Financing – other parties finance the inventory
- Share risk taking – other parties take some risk by handling inventories

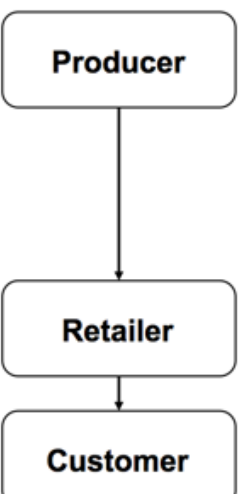
Let's look briefly at the four main kinds of distribution channel intermediary:

- Retailers
- Wholesalers
- Distributors
- Agents

Retailers

Key points about retailers:

- Retailer is the final step in the chain – deals directly with the customer
- Focused on consumer markets
- Various kinds of retailer:
    - Multiples – chains of shops owned by a single company (e.g. Sainsbury's or Next)
    - Specialist chains (e.g. fast fashion, perfume)
    - Department stores (e.g. Debenhams, John Lewis)
    - Convenience stores (e.g. Spar, Costcutter)
    - Independents – a shop run by an owner
    - Franchises (retail format operated by franchisee)



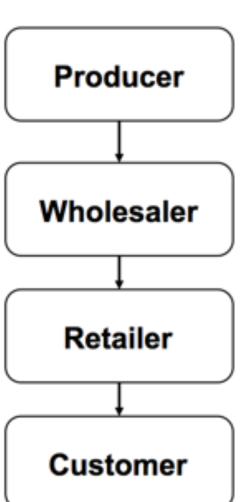
Distributing products via retailers obviously involves a significant loss of margin – since the retailer will add their own "mark-up" to the price charged. However, effective retail distribution offers significant potential advantages:

- Convenience for customers
- Often with a broad geographical coverage
- Retailer chooses the final price
- Retailer handles the financial transaction
- Retailer holds the stock
- Retailer handles after-sales support (e.g. returns)

Wholesalers

Key points about wholesalers:

- Wholesalers "break bulk"
    - Buy in large quantities from producers
    - Break into smaller quantities to sell to retailers
- Advantages
    - Reduce the producer's transport costs (fewer journeys to the wholesaler rather than many journeys to retailers)
    - Retailers can order in smaller amounts from wholesalers
- Wholesaler makes money by buying at a lower price from the producer and adding a profit margin onto the price paid by the retailer



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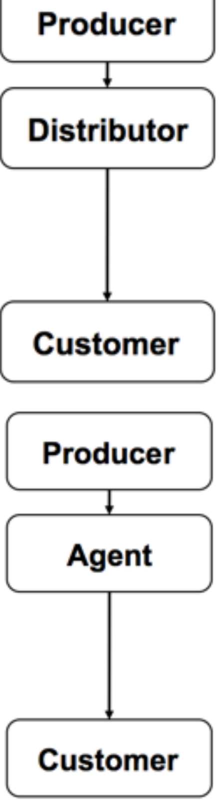
Distributors
Key points about distributors**:**



- Distribute (sell on) products and serve as a local sales point
- Usually specialise in a particular industry
- Examples – building supplies, electrical components, industrial clothing
- Offer products from many producers = greater choice
- Different from agents in that a distributor holds stock

Agents
Key points about agents:

- Specialist type of distributor
- Does not hold stock
- Tend to operate in tertiary sector (services); e.g.
  - Travel
  - Insurance
  - Publishing
- Agents normally earn commission based on sales achieved

Making Decisions About Which Distribution Channels to Use
Choosing the most effective approach is not easy. Key decisions to be made include:

- Channel length - direct or indirect?
- Choice of intermediary
- Use just one or several channels?
- How to move the goods through the channel?
- Control over the channel – e.g. who decides price, promotion, packaging?

A key distinction is made between **direct distribution** and **indirect distribution**:

Direct Distribution	Where a producer and consumer deal directly with each other without the involvement of an intermediary
Indirect Distribution	Involves the use of intermediaries between the producer and consumer

Direct distribution is increasingly popular, particularly with advances in the effectiveness of direct marketing methods, growing adoption of e-commerce.

However, there are still some good reasons to use indirect distribution, For example:

- Geography - customers may live too far away to be reached directly or spread widely
- Enables of consolidation of small orders into large ones

- Allows a business to make better use of resources elsewhere (e.g. less capital tied up in inventories)
- Business may lack of retailing expertise
- Segmentation - different segments of the markets can be best reached by different distribution channels. Mass-market products in particular continue to be distributed via retail channels.

Multichannel Distribution

Multichannel distribution involves a business **using more than one type** of distribution channel.

For example, a producer of branded consumer products may distribute via retail stores as well as sell directly to consumers using e-commerce.

Consumer electronics giant Apple is one of the best examples of multichannel distribution.

The benefits and possible drawbacks of multichannel distribution include:

BENEFITS	DRAWBACKS
Allows more target market segments to be reached	Potential for channel "conflict" –e.g. competing with retailers by also selling direct
Customers increasingly expect products to be available via more than one channel	Can be complex to manage
Enables higher revenues – e.g. if retail outlets have no stock, but customer can buy online	Danger that pricing strategy becomes confused (in the eyes of customers)

Some Key Changes in Distribution to Reflect Social Trends

As markets become more dynamic and e-commerce and mobile-commerce becomes widespread, the nature of distribution must change too. Some of the key changes in distribution that reflect social trends are summarised in the diagram below:

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- Traditional distribution channels and methods were and are focused on getting physical products to the consumer
- There will always be the need for distribution of tangible, physical products
- But the move to a mobile & cloud-based world is changing things quickly

A good example is the distribution of software. A decade ago most business software, for example, was sold in a box. Now, the vast majority of software is downloaded and much of it is now sold as "software as a service" or SAAS – where customers buy a subscription to the software and use it across one or more registered devices. The distribution of software via mobile phone "app stores" is another example of the same change in distribution.

Key Terms

Distribution channel	The route a product takes from production to final consumption.
Multichannel distribution	Where a business uses more than one channel of distribution

Topic: Approaches to Staffing

Theme 1: Section 1.4 Managing People

What You Need to Know
• Staff as an asset; staff as a cost • Flexible workforce: • *Multi-skilling* • *Part-time and temporary* • *Flexible hours and home working* • Outsourcing • Distinction between dismissal and redundancy • Employer/employee relationships • *Individual approach* • *Collective bargaining*

Staff as an Asset or Cost

In terms of approaches to how management view human resources, a popular distinction is made between treating staff as an asset (so-called "soft" HRM) and treating them as a cost (so-called "hard" HRM):

Staff as an ASSET **(SOFT HRM)**	• Treats employees as the most important resource in the business and a source of competitive advantage • Employees are treated as individuals and their needs are planned accordingly
Staff as a COST **HARD HRM**	• Treats employees simply as a resource of the business. • Strong link with corporate business planning – what resources do we need, how do we get them and how much will they cost

The key features of Soft and Hard HRM approaches can be summarised as follows:

Staff as an Asset (SOFT HRM)	**Staff as a Cost (HARD HRM)**
Focus: Concentrate on the needs of employees – their roles, rewards, motivation etc.	***Focus:*** Identify workforce needs of the business and recruit & manage accordingly (hiring, moving and firing)

Topic: Approaches to Staffing

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Staff as an Asset (SOFT HRM)	Staff as a Cost (HARD HRM)
Key features: • Strategic focus on longer-term workforce planning • Strong and regular two-way communication • Competitive pay structure, with suitable performance-related rewards (e.g. profit share, share options) • Employees are empowered and encouraged to seek delegation and take responsibility • Appraisal systems focused on identifying and addressing training and other employee development needs • Flatter organisational structures • Suits democratic leadership style	***Key features:*** • Short-term changes in employee numbers (recruitment, redundancy) • Minimal communication, from the top down • Pay – enough to recruit and retain enough staff (e.g. minimum wage) • Little empowerment or delegation • Appraisal systems focused on making judgements (good and bad) about staff • Taller organisational structures • Suits autocratic leadership style
Is it the best approach? • Seen as an approach that rewards employee performance and motivates staff more effectively. • However, be too "soft" and when all the employee benefits are added up, the cost of the workforce may leave a business at a competitive disadvantage.	***Is it the best approach?*** • Might result in a more cost-effective workforce where decision-making is quicker and focused on senior managers. • But a genuinely "hard" approach might expect to suffer from higher absenteeism and staff turnover and less successful recruitment.

Flexible Workforce

As we have seen when looking at employee motivation in practice, the adoption of flexible working practices has been increasingly common in many businesses – large and small. Refer to the topic note on Motivation in Practice for further information.

Multi-skilling

Multi-skilling arises where staff are allowed to carry out a variety of tasks rather than specialize: Key points to remember are

- Multi-skilling enables greater use of job rotation (with subsequent benefits for motivation)
- Common in service industries – e.g. retail, hotels
- Puts a greater requirement on training

Topic: Approaches to Staffing

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Outsourcing

Outsourcing involves delegating one or more business processes to an external provider, who then owns, manages and administers the selected processes to an agreed standard.

Outsourcing has become increasingly common for more complex businesses that want to focus on their core activities. It is also common to find smaller businesses outsourcing administrative functions (e.g. bookkeeping) until they have reached a size that justifies having specialist skills on the payroll.

Distinction between dismissal and redundancy

What happens when a business decides it needs or wants to remove employees from their employment?

A key distinction to understand is the difference between dismissal and redundancy, which is summarised below:

Dismissal	Redundancy
• Employee dismissed because of break of contract or other unacceptable behaviour or performance • May be considered "unfair" and subject to legal claim by employee	• Employee loses job because job is no longer required by the business • Requires consultation and redundancy payments payable

Employer/employee relationships

Employee representation arises when employees are part of a formal structure for involving them in the decision-making process of a business.

Employment law in the UK requires employers to involve employees in the following:

- Proposed redundancy programmes
- When employees are transferred from one employer to another (e.g. the sale of the business)
- On changes to pension arrangements
- Proposed changes to working time arrangements

It also makes good business sense to involve employees in a range of other decision-making processes. A formal system of employee representation helps:

- Make employees' views known to management
- Strengthen both management's and employees' understanding of workplace issues and other matters affecting the business
- Create an atmosphere of mutual trust between employees and management and therefore improve workplace relations

Overall, the key benefits and drawbacks of employee representation (from the business' perspective) can be summarised as follows:

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Advantages	Disadvantages
Increased empowerment and motivation of the workforce	Time-consuming – potentially slows decision-making
Employees become more committed to the objectives and strategy of the business	Conflicts between employer and employee interests may be a block to essential change
Better decision-making because employee experience and insights taken into account	Managers may feel their authority is being undermined
Lower risk of industrial disputes	

The Role of Trade Unions

A trade union is an organised association of workers in a trade, group of trades, or profession, formed to protect and further their rights and interests. The traditional role of trade unions is to:

- Protect and improve the real incomes of their members
- Provide or improve job security
- Protect workers against unfair dismissal and other issues relating to employment legislation
- Lobby for better working conditions
- Offer a range of other work-related services including support for people claiming compensation for injuries sustained in a job

The two key functions of a trade union are therefore to:

Represent	Represent & protect interest of employees
Negotiate	Negotiate on behalf of employees with employer

Although the employer – trade union relationship is often viewed as being confrontational, there are some sound business reasons to pursue a good working relationship between the two:

- Negotiating with trade unions (ideally a single union) saves time and cost rather than dealing with all employees individually
- Unions are part of the communication process between the business and employees
- Employee morale and motivation may be improved if they know that their interests are being protected by a union
- The trade union can be a supportive partner in helping a business undergo significant change

The Decline of Trade Union Membership

A significant feature of the UK labour market in recent years has been the slow, but steady decline in employee membership of trade unions, as illustrated by the chart below:

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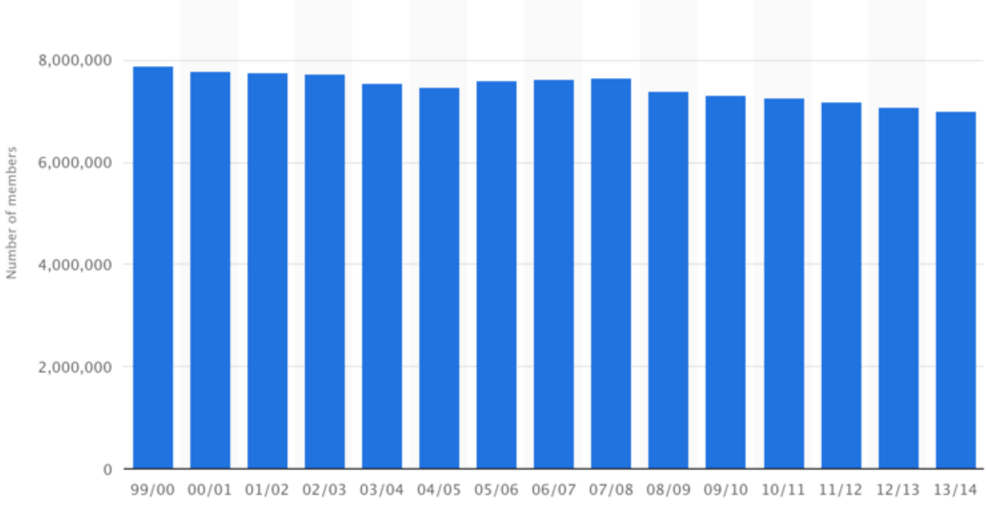


The key reasons for declining trade union membership include:

- Decline in employment in manufacturing (where union membership is traditionally high)
- Increased employment in the service sector (e.g. retail) where unions are less well established
- Growth in the number of small firms which tend not to recognise (or need) trade unions
- Significant growth in flexible working (part-time, temporary, seasonal) – where employees see less need for union protection
- Improved employee involvement in the workplace – so less perceived need for collective bargaining

Industrial Action
Industrial action arises when workers do something that is intended to force an employer to agree to something, especially by stopping work. The most common methods of industrial action are:

Method	Description
Work-to-rule	Employees follow the strict conditions of their employment contract – no voluntary overtime, no participation in supporting activities. Staff still get their basic pay.
Overtime ban	Employees refuse to work overtime. Can have a significant effect on production capacity during period of peak demand, but ineffective as a bargaining tool during quieter periods!
Go-slow	Employees work at the slowest or least-productive pace that is allowable under their employment contracts
Strike	The action of last-resort; fraught with danger for both employer and employee and strictly policed by legislation on industrial action.

In most cases of industrial action, **the effect is lose-lose**: i.e. both employees and employers suffer in the short-term. Some examples of this are provided below.

Damage for the Business	Damage for the Employee
Lost sales and profits from the lost output	Lost pay
Damage to customer satisfaction	Potential loss of jobs if the action results in action to cut costs
An internal distraction for management and the business (worse if competitors are not affected)	Possible loss of customer and public support (depending on the reasons for the action)
Damaged relationship with staff may adversely affect motivation, productivity etc.	Risk that illegal action will result in legal proceedings

It therefore makes sense for employees and employers to avoid industrial disputes where possible. Good communication is the key: for example;

- Regular consultations with a trade union - pick up problems before they escalate
- A staff forum or joint working group to pass on information and collect ideas from workers and consult with workers
- An employee consultative body to discuss major issues as they arise
- Team and group meetings and feedback sessions

Works Councils
A works council is a formal a group of employees representing a workforce in discussions with their employers. EU legislation make works councils mandatory for firms that operate in two or more EU countries and have more than 1,000 employees. The typical agenda for a works council includes:

- Business objectives and performance
- Workforce planning issues (e.g. recruitment, staffing levels)
- Employee welfare issues (working conditions, health & safety)
- Training and development programmes
- Compliance with legislation (e.g. discrimination)

Settling Industrial Disputes
The three main methods of settling industrial disputes are outlined below:

Method	Key Points
Conciliation	• Used when an employee is making, or could make, a specific complaint against their employer to an employment tribunal • Conciliator has no authority to seek evidence or call witnesses, or make decisions or awards • Conciliator discusses the issues with both parties in order to help them reach a better understanding of each other's position • Conciliator encourages the parties in dispute to come to an agreement between themselves, and so avoid the stress and expense of contesting the issue at an Employment Tribunal
Arbitration	• An alternative to a court of law • Held in private rather than in public (court case) • Arbitration involves an impartial outsider being asked to make a decision on a dispute

Method	Key Points
	• Arbitrator makes a firm decision on a case based on the evidence presented by the parties • Arbitration is voluntary, so both sides must agree to go to arbitration; they should also agree in advance that they will abide by the arbitrator's decision • Often used in disputes between employers and trade unions over collective bargaining issues (e.g. pay awards)
Mediation	• Involves an independent, impartial person helping two or more individuals or groups reach a solution that's acceptable to everyone • Aim is to restore and maintain the employment relationship wherever possible – not apportion blame • Best used early on in an industrial dispute • Agreements are not legally binding, but usually carried out

Topic: Recruitment, Selection and Training
Theme 1: Section 1.4 Managing People

What You Need to Know
- Recruitment and selection process
- Costs of recruitment, selection and training
- Internal versus external recruitment
- Types of training:
- *Induction*
- *On-the-job*
- *Off-the-job*

Introduction: How Work is Changing
The important context for this topic is that the world of work is changing fast, which has significant implications for how businesses manage their human resource requirements;

- The way we work is changing rapidly:
  - Increase in part-time working
  - Increases in numbers of single-parent families
  - More women seeking work
  - Ageing population
  - Greater emphasis on flexible working hours
  - Technology allows employees to communicate more effectively whilst apart
  - People rarely stay in the same job for life
- Businesses need to understand and respond to these changes if they are to recruit staff of the right standard – and keep them!

The Growth of Part-time and Flexible Working
Increasing numbers of people in the UK are working part-time and/or on flexible working arrangements:

- **Advantages of this trend for businesses**
  - Cheaper to employ as entitled to less benefits
  - More flexible workforce (easier to reduce labour hours when sales fall or add hours when demand increases)
  - Wide range of potential recruits (e.g. working mothers who want to restrict the number of hours they work)
- **Disadvantages of this trend for businesses**
  - Employees feel less loyal to business and therefore less motivated
  - Harder for managers to control and coordinate workforce

Reasons to Recruit Employees
Most businesses of any reasonable size and complexity find that they need to recruit people. This can be due to one or more of the following:

- Business expansion due to
  - Increasing sales of existing products
  - Developing new products
  - Entering new markets
- Existing employees leave:

  - To work with competitors or other local employers
  - Due to factors such as retirement, sick leave, maternity leave
- Business needs employees with new skills
- Business is relocating – and not all of existing workforce want to move to new location

Costs of Recruitment, Selection & Training

Recruitment & selection can be a costly activity for businesses of all sizes. There are two main elements to the cost:

- Lost output from replacing an employee
- Logistical cost of running a recruitment & selection process

A recent survey estimated the cost of the second element above at around £5,400 per person recruited, which comprised:

- Hiring temporary workers before the replacement starts: £3,618
- Management time spent interviewing candidates: £767
- Recruitment agency fees: £454
- Advertising the new role: £398
- HR time spent processing replacement: £196

Methods of Recruitment

The main methods of recruitment can be categorised into internal and external approaches, as listed below.

Methods of Internal Recruitment	Methods of External Recruitment
• Jobs given to staff already employed by business • Involves promotion and reorganisation	• Job centres • Job advertisements • Recruitment agencies (offline and online) • Headhunting • Personal recommendation

The main benefits and drawbacks of internal and external recruitment are summarised below:

Benefits of Internal Recruitment	Drawbacks of Internal Recruitment
• Cheaper and quicker to recruit • People already familiar with business and how it operates • Provides opportunities for promotion with in business	• Business already knows strengths and weaknesses of candidates • Limits number of potential applicants • No new ideas can be introduced from outside • May cause resentment amongst candidates not appointed • Creates another vacancy which needs to be filled

Benefits of External Recruitment	Drawbacks of External Recruitment

• Outside people bring in new ideas • Larger pool of workers from which to find best candidate • People have a wider range of experience	• Longer process • More expensive process due to advertisements and interviews required • Selection process may not be effective enough to reveal best candidate

Training & Development
Training costs can be significant in any business. Most employers are prepared to incur these costs because they expect their business to benefit from employees' development and progress.

Training is needed within a business for a variety of reasons. Common training needs include:

- Supporting new employees (induction training)
- To improve productivity
- To increase marketing effectiveness
- Supporting high standards of customer service and production quality
- Introduction of new technology, systems or other change
- Addressing changes in legislation
- Support employee progression and promotion (internal recruitment)

If the training and development provided is effective, then the potential business benefits are significant: for example;

- Better productivity
- Higher quality
- More flexibility through better skills
- Less supervision required
- Improved motivation - through greater empowerment
- Better recruitment and employee retention
- Easier to implement change in the business

Effective training is also linked with a better-motivated workforce:

- Assuming training is effective: then…
- Employees feel more loyal to firm
- Shows that business is taking an interest in its workers
- Provide employees with greater promotional opportunities
- Enables employees to achieve more at work – perhaps gaining financially from this

Given the potential business benefits, it seems odd that many businesses neglect employee and management training. Why? Possible reasons include:

- They fear employees will be poached by competitors (who will then benefit from the training)
- A desire to minimise short-term costs
- They cannot make a justifiable investment case

- Training takes time to have the desired effect
- Sometimes the benefits of training are more intangible (e.g. morale) than tangible

On-the-Job Training
On-the-job training is where an employee receives training whilst remaining in the workplace. The main methods of on-the-job training are:

- **Demonstration / instruction** - showing the trainee how to do the job
- **Coaching** - a more intensive method of training that involves a close working relationship between an experienced employee and the trainee
- **Job rotation** - where the trainee is given several jobs in succession, to gain experience of a wide range of activities (e.g. a graduate management trainee might spend periods in several different departments)
- **Projects** - employees join a project team - which gives them exposure to other parts of the business and allow them to take part in new activities. Most successful project teams are "multi-disciplinary"

The key benefits and drawbacks of on-the-job training include:

Advantages	Disadvantages
Generally most cost-effective Employees are actually productive Opportunity to learn whilst doing Training alongside real colleagues	Quality depends on ability of trainer and time available Bad habits might be passed on Learning environment may not be conducive Potential disruption to production

Off-the-Job Training
Off-the-job training is training that takes place away from the workplace. Common examples are:

- Day or part-time attendance at college
- Professional development courses or conferences
- Online training / distance learning

The key benefits and drawbacks of off-the-job training include:

Advantages	Disadvantages
A wider range of skills or qualifications can be obtained Can learn from outside specialists or experts Employees can be more confident when starting job	More expensive – e.g. transport and accommodation Lost working time and potential output from employee New employees may still need some induction training Employees now have new skills/qualifications and may leave for better jobs

Topic: Organisational Design
Theme 1: Section 1.4 Managing People

What You Need to Know
- **Organisational Structure:**
- *Hierarchy*
- *Chain of command*
- *Span of control*
- *Centralised and decentralised*
- **Types of structure:**
- *Tall*
- *Flat*
- *Matrix*
- *Impact of different organisational structures on business efficiency and motivation*

Introduction to Organisational Structure
The organisational structure shows how employees and management are organised in a business.

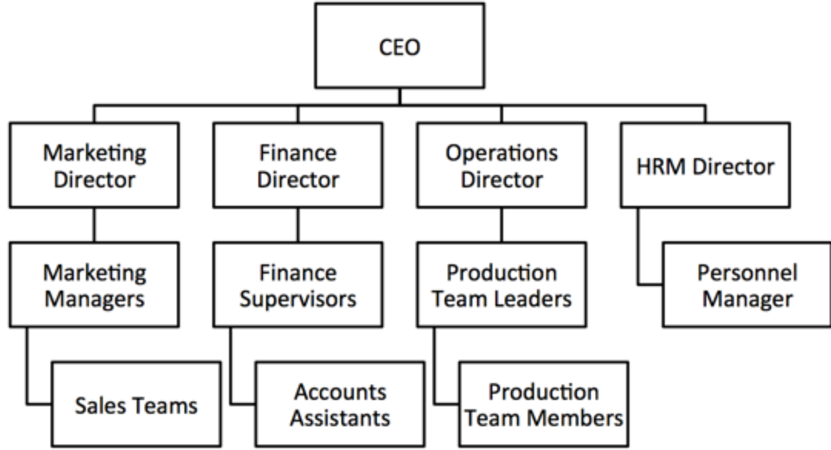
The organisational structure is vitally important because it determines:

- **Authority** and **responsibility** – who is responsible for whom and who is in charge?
- Individual job roles and titles
- The people to whom others are **accountable**
- The formal routes through which **communication flows** in the business

The simplest way to show how a business is organised is to look at an organisation chart. This shows the management hierarchy in a business. It works from the top to bottom and also illustrates:

- Span of Control
- Line management
- Chain of command

An example organisation chart is shown below:



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Topic: Organisational Design

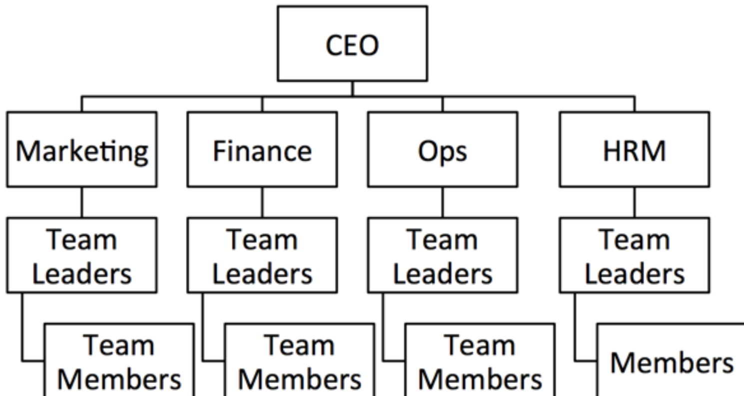
Theme 1: Section 1.4 Managing People

Hierarchy

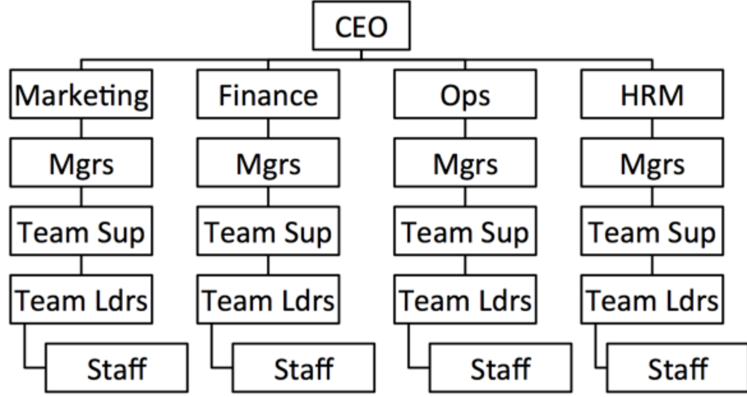
The levels of hierarchy refer to the number of layers within an organisation.

Traditional organisations were tall with many layers of hierarchy and were often authoritarian in nature.

The organisation chart above shows a business with four levels of hierarchy – from the Managing Director at the top, to assistants and team members at the bottom.

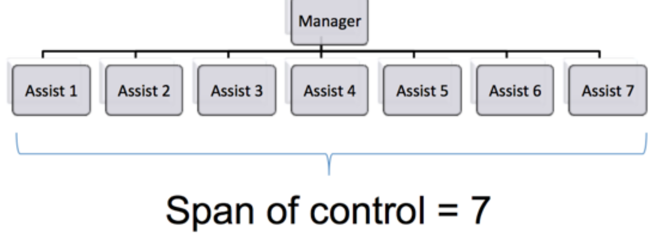


Below is another organisation chart, which shows a taller hierarchy.



Span of Control

The span of control is the number of subordinates for whom a manager is directly responsible. The two diagrams below illustrate two different spans of control:



Topic: Organisational Design
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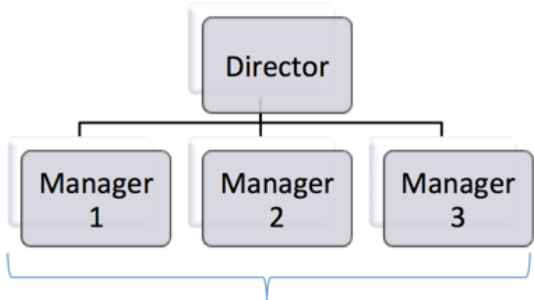
A span of control of 7 would be considered to be quite wide. Contrast this with a span of 3 below, which would be considered "narrow"



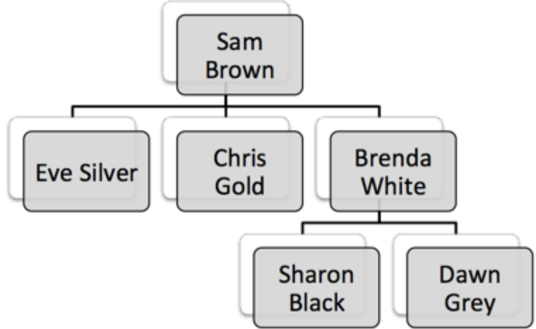
Is there an ideal span of control? The answer is generally no – a suitable span of control will depend on factors such as the:

- Experience and personality of the manager
- Nature of the business. If being a line manager requires a great deal of close supervision, then a narrower span might be appropriate
- Skills and attitudes of the employees. Highly skilled, professional employees might flourish in a business adopting wide spans of control
- Tradition and culture of the organisation. A business with a tradition of democratic management and empowered workers may operate wider spans of control

Should spans of control be wide or narrow?

Narrow Span of Control	Wide Span of Control
Allows for closer supervision of employees	Gives subordinates the chance for more independence
More layers in the hierarchy may be required	More appropriate if labour costs are significant – reduce number of managers
Helps more effective communication	

Chain of Command
The chain of command describes the lines of authority within a business. In the simple organisation chart below Sam is responsible for Eve, Chris and Brenda. Further down the chain, Brenda is responsible for Sharon and Dawn.



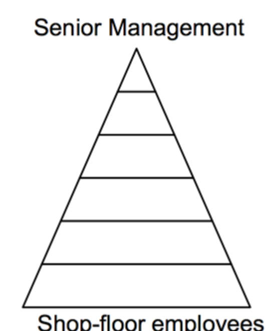
Topic: Organisational Design

Theme 1: Section 1.4 Managing People

What is the Most Effective Hierarchy?

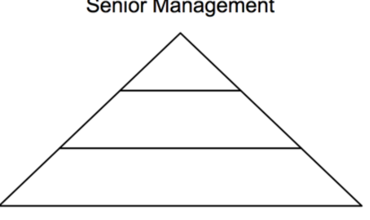
Although it is a generalisation, there are traditionally two categories of organisational structure based around the number of layers in the hierarchy and span of control: tall and flat

Tall structure



- Key features – many layers of hierarchy + narrow spans of control
- Allows tighter control (less delegation)
- More opportunities for promotion
- Takes longer for communication to pass through the layers
- More layers = more staff = higher costs

Flat structure



- Key features – few layers of hierarchy + wide spans of control
- Less direct control + more delegation
- Fewer opportunities for promotion, but staff given greater responsibility
- Vertical communication is improved
- Fewer layers = less staff = lower costs

Changing the Organisational Structure

Organisational structures are dynamic – they change! Indeed a business that doesn't regularly assess how effective its organisational structure may find itself becoming uncompetitive.

- **Why change the structure?**
  - Growth of the business means a more formal structure is appropriate
  - Reduce costs and complexity (key)
  - Employee motivation needs boosting
  - Customer service and/or quality improvements
- **Challenges of changing the structure**
  - Manager and employee resistance
  - Disruption and de-motivation = potential problems with staff retention
  - Costs (e.g. redundancies)
  - Negative impact on customer service or quality

Delayering (from Tall to Flat)

Delayering involves removing layers of management from the hierarchy of the organisation. The potential benefits and drawbacks of delayering an organisational structure include:

Benefits of Delayering	Drawbacks of Delayering
Lower management costs Faster decision making Shorter communication paths Stimulating employee innovation	Wider spans of control – too wide? Potential loss of management expertise

Topic: Organisational Design
Theme 1: Section 1.4 Managing People

Matrix Structures
In a matrix structure, individuals work across teams and projects as well as within their own department or function.

For example, a team established to develop a new product might include engineers and design specialists as well as those with marketing, financial, personnel and production skills.

These teams can be temporary or permanent depending on the tasks they are asked to complete. Each team member can find himself/herself with two managers - their normal functional manager as well as the team leader of the project.

An example of a matrix structure might look like this:

	Marketing	Operations	Finance	HRM
	Marketing Manager	*Operations Manager*	*Finance Manager*	*HR Manager*
Project A (Team Leader)	Marketing Team (A)	Operations Team (A)	Finance Team (A)	HR Team (A)
Project B (Team Leader)	Marketing Team (B)	Operations Team (B)	Finance Team (B)	HR Team (B)
Project C (Team Leader)	Marketing Team (C)	Operations Team (C)	Finance Team (C)	HR Team (C)
Project D (Team Leader)	Marketing Team (D)	Operations Team (D)	Finance Team (D)	HR Team (D)

The benefits and drawbacks of a matrix structure are summarised below:

Advantages of a Matrix Structure	Disadvantages of a Matrix Structure
Help to breaks down traditional department barriers, improving communication	Members of project teams may have divided loyalties as they report to two line managers
Individuals get to use their skills within a variety of contexts	May not be a clear line of accountability for project teams
Likely to result in greater motivation amongst the team members	Difficult to co-ordinate
Encourages sharing of good practice and ideas across departments	Team members may neglect their functional responsibilities
A good way of sharing resources across departments	It takes time for matrix team members to get used to working in this kind of structure

Topic: Organisational Design

Theme 1: Section 1.4 Managing People

Authority and Organisational Design: Who Makes the Decisions?

Decision-making in an organisation is about a**uthority.**

A key question is whether authority should rest with senior management at the centre of a business (**centralised**), or whether it should be delegated further down the hierarchy, away from the centre (**decentralised**).

Centralised Decision-Making

Businesses with a centralised structure keep decision-making firmly at the top of the hierarchy (amongst the most senior management). The main benefits and drawbacks of a centralised approach include:

Advantages of Centralisation	Disadvantages of Centralisation
Easier to implement common policies and practices for the whole business	More bureaucratic – often extra layers in the hierarchy
Prevents other parts of the business from becoming too independent	Local or junior managers are likely to much closer to customer needs
Easier to co-ordinate and control from the centre – e.g. with budgets	Lack of authority down the hierarchy may reduce manager motivation
Economies of scale and overhead savings easier to achieve	Customer service does misses flexibility and speed of local decision-making
Quicker decision-making (usually) – easier to show strong leadership	

Decentralised Decision-Making

In a decentralised organisational structure, decision-making is spread out to include more junior managers in the hierarchy, as well as individual business units or trading locations. The main benefits and drawbacks of a decentralised approach include:

Advantages of Decentralisation	Disadvantages of Decentralisation
Decisions are made closer to the customer	Decision-making is not necessarily "strategic"
Better able to respond to local circumstances	Harder to ensure consistent practices and policies at each location
Improved level of customer service	May be some diseconomies of scale – e.g. duplication of roles
Consistent with aiming for a flatter hierarchy	Who provides strong leadership when needed (e.g. in a crisis)?
Good way of training and developing junior management	Harder to achieve tight financial control – risk of cost-overruns
Should improve staff motivation	

Topic: Organisational Design
Theme 1: Section 1.4 Managing People

Using Organisational Design to Improve Motivation: Delegation & Empowerment

Two ways in which the way work is organised better to improve employee motivation are delegation and job empowerment:

Delegation

Be careful not to confuse delayering with a similar-sounding term: delegation. **Delegation** is the assignment to others of the authority for particular functions, tasks, and decisions. The advantages and disadvantages of encouraging greater delegation include:

Advantages of Delegation	Disadvantages of Delegation
Reduces management stress and workload Allows senior management to focus on key tasks Subordinates are empowered and motivated Better decisions or use of resources (potentially) Good method of on-the-job training	Cannot / should not delegate responsibility Depends on quality / experience of subordinates Harder in a smaller firm May increase workload and stress of subordinates

Job Empowerment

Job (or employee) empowerment is about giving employees the power to do their job. The concept is closely linked to motivation and customer service. Put simply, employees need to feel that their actions count. Empowerment is a catch-all term that covers:

- Giving authority to make decisions to front-line staff (e.g. hotel receptionist, call centre assistant)
- Encouraging employee feedback
- Showing more trust in employees

Key Terms

Hierarchy	The structure and number of layers of management and supervision in an organisation
Span of control	The number of employees who are directly supervised by a manager
Delegation	Where responsibility for carrying out a task or role is passed onto someone else in the business.
Empowerment	Delegating power to employees so that they can make their own decisions
Delayering	The process of removing one or more layers from the organisational structure
Centralisation	An organisational structure where authority rests with senior management at the centre of the business
Decentralisation	An organisational structure where authority is delegated further down the hierarchy, away from the centre

Topic: Employee Motivation in Theory

Theme 1: Section 1.4 Managing People

What You Need to Know

- The importance of employee motivation to a business
- Motivation theories:
- *Taylor (scientific management)*
- *Maslow (hierarchy of needs)*
- *Herzberg (two factor theory)*
- *Mayo (human relations theory)*

Introduction to Motivation

Motivation is will to work. Motivation comes from enjoyment of work itself and/or from desire to achieve certain goals e.g. earn more money or achieve promotion.

There are two broad approaches available to motivate employees

- Financial methods (e.g. salary, bonus)
- Non-financial methods (passing on responsibility or praise)

Theories of Motivation

Let's look in more detail at four classic theories of how to motivate employees:

- *Taylor (scientific management)*
- *Maslow (hierarchy of needs)*
- *Herzberg (two factor theory)*
- *Mayo (human relations theory)*

Taylor (Scientific Management)

Taylor's "scientific" approach to management is summarised in the diagram below:

Work study
- Identify most efficient methods of production

Identify
- Spot the most efficient workers and see why they are so good

Train
- Train the remaining workers to work like the best

Reward
- Pay workers based on productivity (e.g. piece rates)

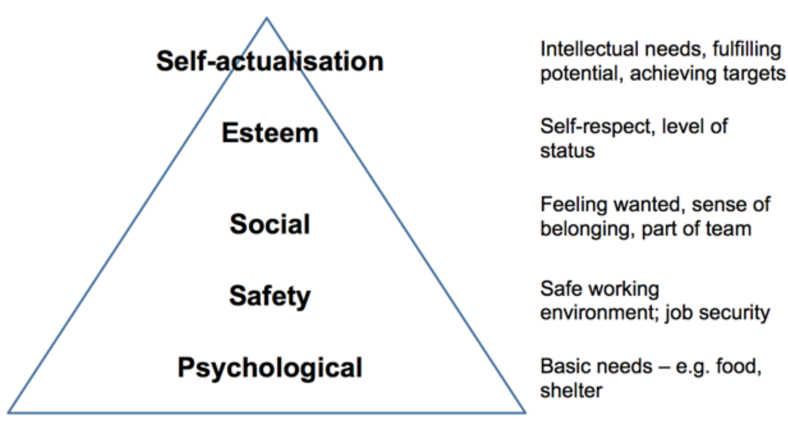
Topic: Employee Motivation in Theory

Theme 1: Section 1.4 Managing People

The key points to remember about Taylor are:

- Managers should maintain close control and supervision over their employees.
- Autocratic style of management- managers make all decisions themselves
- Consistent with Theory X (McGregor) approach to workers - believe workers are lazy and are only motivated by money
- Motivate workers using piece-rate payment (pay based on how much they produce)

Maslow (Hierarchy of Needs)



Maslow's famous hierarchy of needs suggested that:

- There are five levels of human needs which employees need to have fulfilled at work
- Only once a lower level of need has been fully met, would a worker be motivated by the opportunity of having the next need up in the hierarchy satisfied
- A business should therefore offer different incentives to workers in order to help them fulfill each need in turn and progress up the hierarchy

Herzberg (Two Factor Theory)

Herzberg suggested that there were two key factors in workplace motivation:

Motivators

- Factors that directly motivate people to work harder
- Giving responsibility, recognition for good work, opportunities for promotion

Hygiene (maintenance) factors

- Factors that can de-motivate if not present but do not actually motivate employees to work harder
- Pay, working conditions, job security

Herzberg argued that managers should:

- Motivate by using motivators plus ensuring hygiene factors are met
- Use job enrichment and empowerment (delegating more power to employees to make their own decisions).

Topic: Employee Motivation in Theory
Theme 1: Section 1.4 Managing People

Mayo (Human Relations Theory)
Mayo believed that workers are not just concerned with money but could be better motivated by having their social needs met whilst at work (something that Taylor ignored).

Mayo introduced the Human Relations School of thought, which focused on managers taking more of an interest in the workers, treating them as people who have worthwhile opinions and realising that workers enjoy interacting together.

Mayo concluded that workers are best motivated by:

- Better communication between managers and workers
- Greater manager involvement in employees working lives
- Working in groups or teams

His theory most closely fits in with a paternalistic style of management.

Key summary for Mayo:

- Workers motivated by having social needs met
- Workers should work in teams
- Managers should have greater involvement in employee's working life
- More two-way communication between managers and workers

Importance of Motivation: Employee Engagement
Employee engagement is a relatively new concept in HRM although it is attracting significant attention. Employee engagement is a workplace approach designed to ensure that employees are committed to their organisation's goals and values, motivated to contribute to organisational success, and are able at the same time to enhance their own sense of well-being.

There are three main elements to employee engagement:

Intellectual Engagement	Thinking about the job & how to do it better
Affective Engagement	Feeling positive about doing a good job
Social Engagement	Takes opportunities to share work-related issues with others at work

Topic: Employee Motivation in Theory
Theme 1: Section 1.4 Managing People

Employee engagement is related to, but is not quite the same as employee motivation:

Employee Engagement	**Employee Motivation**
• Employee is positive about his /her work • Thinks hard about how to improve • Engaged with fellow employees	• Employee has a will to work • Due to work incentives and/or satisfaction from work itself

Key Terms

Motivation	The will to work
Employee engagement	Employees are deeply integrated into their work, including supporting the values of the organisation

Topic: Employee Motivation in Practice
Theme 1: Section 1.4 Managing People

What You Need to Know

- **Financial incentives to improve employee performance:**
- *Wages and salaries*
- *Piecework*
- *Commission*
- *Bonus*
- *Profit share*
- *Performance-related pay*
- **Non-financial techniques to improve employee performance:**
- *Delegation*
- *Consultation*
- *Empowerment*
- *Team working*
- *Flexible working*
- *Job enrichment*
- *Job rotation*
- *Job enlargement*

Introduction to Financial Incentives
Whilst financial rewards are an important and core reward from working, they are just one part of the source of motivation at work.
People work:

- To earn money
- For a sense of achievement or job satisfaction
- To belong to a group
- For a sense of security
- To obtain a feeling of self-worth

The motivational theorists recognised this, although they differed in terms of how important they thought financial rewards were in terms of motivation:

- Taylor was only theorist to emphasise pay, in particular piece-rate, as best way of motivating employees
- Mayo, Maslow and Herzberg all felt that non-financial rewards, such as team working, empowerment or job enrichment, acted as a better incentive for employees to work harder.

Main Financial Incentives and Rewards at Work
These can be summarised as follows:

Topic: Employee Motivation in Practice

Theme 1: Section 1.4 Managing People

Wages	Normally paid per hour worked and receive money at end of week
Salaries	Normally an annual salary which is paid at end of each month
Bonus system	Usually only paid when certain targets have been achieved
Commission	Some workers, often salesmen, are partly paid according to number of products they sell
Profit sharing	A system whereby employees receive a proportion of company's profits
Performance related pay	Paid to those employees who meet certain targets
Share options	Common incentive for senior managers who are given shares in company rather than a straightforward bonus or membership of a profit sharing scheme
Fringe benefits	Items an employee receives in addition to their normal wage or salary e.g. company car, private health insurance, free meals

Let's look in a little more detail at some of these financial rewards. The key points to remember about each are:

Wages and Salaries

Wages	• Paid by hour with pay packet normally received at end of each week • Often paid to lower skilled workers or to temporary staff • Any additional hours worked normally paid a higher rate on an overtime basis
Salaries	• Often set on an annual basis but payment is made at end of each month • Normally paid to managers or those higher up in a company • A set number of hours is not normally agreed but employment contract requires enough hours worked to get job done

Fringe Benefits

- Often also known as 'perks'
- Items an employee receives in addition to their normal wage or salary
- E.g. company car, private health insurance, free meals
- Often increases loyalty to company as these benefits are not always taxed or are taxed at a reduced rate
- More likely to recruit best people to the business

Overtime and Bonus Pay

- **Overtime**
  - Additional hours worked over and above normal working hours
  - E.g. at weekends or on bank holidays
  - Paid at a higher rate - often 1.5 or 2 times normal hourly wage
- **Bonus pay**

- – Given out when certain performance targets have been met
- – Normally applicable at manager level in a company
- **How bonuses are used**
  - By motivating employees to work harder in order to meet a realistic yet challenging target and therefore achieve a bonus payment
  - Would only be effective if bonus payments were a significant sum

Profit Sharing

- **What it is:**
  - A system whereby employees receive a proportion of business profits
- **Advantages**
  - Creates a direct link between pay and performance
  - Creates a sense of team spirit- helps remove 'them and us' barrier between managers and workers if all employees involved
  - May improve employee's loyalty to company
  - Employees more likely to accept changes in working practices if can see that profits will increase overall

Performance-Related Pay (PRP)

- Increasingly popular method of paying people
- Paid to those employees who meet certain targets
- **Advantages**
  - Senior managers can easily monitor and assess individual employee performance during appraisal process
  - Setting of targets for employees can ensure they are all closely focused to company objectives
- **Disadvantages**
  - Discourages a team based approach- can create unhealthy rivalry between managers
  - Can be difficult to accurately measure performance of some workers e.g. in service sector firms
  - Incentives may not be larger enough to motivate employees

Piece-rate Payments

- Relatively unusual and old-fashioned way of payment
- Pay per item produced in a certain period of time
- **Advantages**
  - Requires low levels of manager supervision
  - Encourages high speed production
  - Provides good incentive for workers who are mainly motivated by pay
- **Disadvantages**
  - Workers are focused on quantity not quality
  - It is repetitive for workers and can be de-motivating
  - Workers are only used to one set method of production and may resistant change

Commission

- A popular and widely-used financial incentive usually linked to achievement of sales
- Typical set-up
  - % commission for £value of sale achieved
  - Basis commission rate set at low rate
  - Higher rate offered once sales targets are achieved
- Main advantage – clear link between sales and remuneration
- Main disadvantages – sales may be influence by factors outside of employee control (e.g. mature product, customer service)

Main Non-Financial Incentives and Rewards at Work
These can be summarised as follows:

Job empowerment	Delegating power to employees so they can make their own decisions
Praise	Recognition for good work
Promotion	Promoting employees to a position of higher responsibility
Job enrichment	Giving employees more challenging and interesting tasks
Job enlargement	Giving employees more tasks of a similar level of complexity
Job rotation	Moving employees through a range of related jobs and tasks in order to increase interest and motivation
Better communication	Employees have a chance to give feedback and advice to managers
Working environment	Providing a safe, clean, comfortable environment to work in
Team working	Offers employees an opportunity to meet their social needs and often accompanied by empowerment for team
Flexible working	A range of employment options (e.g. part-time, job share) that provide an alternative to full-time permanent employment

Let's look in a little more detail at some of the above

Job empowerment
Job (or employee) empowerment is about giving employees the power to do their job. The concept is closely linked to motivation and customer service. Put simply, employees need to feel that their actions count. Empowerment is a catch-all term that covers:

- Giving authority to make decisions to front-line staff (e.g. hotel receptionist, call centre assistant)
- Encouraging employee feedback
- Showing more trust in employees

Job enrichment
Job enrichment attempts to give employees greater responsibility by increasing the range and complexity of tasks they are called upon to complete and giving them the necessary authority. It motivates by giving employees the opportunity to use their abilities to the fullest.

Herzberg argued that job enrichment (through motivators) should be a central element in any policy of motivation.

According to Herzberg, enriched jobs should contain a range of tasks and challenges at different ability levels and clear opportunities for achievement and feedback on performance. Job enrichment necessitates training.

Job enlargement

Job enlargement involves the addition of extra, similar, tasks to a job.

In job enlargement, the job itself remains essentially unchanged. However, by widening the range of tasks that need to be performed, hopefully the employee will experience less repetition and monotony that are all too common on production lines which rely upon the division of labour.

With job enlargement, the employee rarely needs to acquire new skills to carry out the additional task, and the motivational benefits of job enrichment are not usually experienced.

One potentially negative aspect is that job enlargement is sometimes viewed by employees as a requirement to carry out more work for the same amount of pay!

Job rotation

Job rotation involves the movement of employees through a range of jobs in order to increase interest and motivation. Job rotation can improve "multi-skilling" but also involves the need for greater training.

In a sense, job rotation is similar to job enlargement. This approach widens the activities of a worker by switching him or her around a range of work.

For example, an administrative employee might spend part of the week looking after the reception area of a business, dealing with customers and enquiries. Some time might then be spent manning the company telephone switchboard and then inputting data onto a database.

Job rotation may offer the advantage of making it easier to cover for absent colleagues, but it may also reduce' productivity as workers are initially unfamiliar with a new task.

Flexible Working

Flexible working describes a range of employment options designed to help employees balance work and home life. It is because flexible working relates to working arrangements where there are a variety of options offered to employees in terms of working time, working location and the pattern of working.

Amongst the most popular flexible working practices are:

- Part-time working
- Term-time working
- Working from home

- Career breaks
- Job sharing
- Annual hours contracts
- Shift swapping

There are good business reasons why businesses are increasingly likely to offer employees one or more flexible working options. For example:

Cost savings
A business can make substantial savings on overheads if it does not have to provide office and other accommodation for so many employees or if staff can work from home rather than commute into work every day

Improving recruitment and staff retention
There is lots of evidence that flexible working results in better job satisfaction and higher staff morale

Reflecting the changing profile of the UK workforce
There are more women in the labour market and an ageing population – as a result it is increasingly common for staff to have caring responsibilities outside work

Take advantage of developments in technology
It is now simple and cost-effective for employees to be able to access their employers online and other networked systems, and to communicate digitally with colleagues

Improved customer service
Flexible working makes it easier for businesses to offer extended opening hours, for example

Whilst there any many advantages to flexible working, it is not always simple or appropriate to introduce it. Amongst the concerns that employers often raise about flexible working are:

Additional administrative work and "red-tape" involved in setting up and running flexible working
Inability to substitute for certain skills if certain employees are absent
Managers finding it difficult to manage or administer the flexibility

Getting the Mix Right Between Financial and Non-Financial Rewards

- Most businesses employ a mix of financial & non-financial rewards
- The "market" largely determines the base financial rewards paid for most jobs & skills
- Offering employees some flexibility in choosing which rewards they get often works well
- Ultimately, financial rewards are closely influenced by what a business can afford

Topic: Leadership

Theme 1: Section 1.4 Managing People

What You Need to Know

- Leadership:
- The distinction between management and leadership
- Types of leadership style:
- Autocratic
- Paternalistic
- Democratic
- Laissez-faire
- From Entrepreneur to Leader

What is Leadership?

Leadership is the way in which one person influences the behaviour or actions of other people.

The role of leadership in modern business is changing. Traditionally leadership has been associated with the need to **command and control** a business and to take decisions. However, in modern business the role of leadership is increasingly about:

- Inspiring employees
- Creating a vision – a clear sense of the purpose and direction of the business
- Shaping the core values & culture of the business
- Building effective teams

Why Leadership is Increasingly Important in Business

The need for effective leadership within a business is becoming increasingly vital, particularly because of:

- **Changing organisational structures**
  - Flatter hierarchies + greater use of delegation
  - Increasing emphasis on teamwork + focus on quality assurance
  - Coaching, support & empowerment
- **Rapid Change**
  - Change is becoming a constant feature of business life
  - Soft skills of leadership & management increasingly important

How Leadership Compares with Management

The two concepts of leadership and management are closely linked. However, there is an important distinction between the two. In summary:

Leaders	Managers
Set the strategy and objectives	Implement the strategy
Inspire people	Coordinate resources
Build relationships	Use their authority to take decisions
Take risks	Manage risks
Have followers	Have subordinates

Topic: Leadership

Theme 1: Section 1.4 Managing People

The Three Key Levels of Management in a Business

The management structure of a business will vary depending on several factors, in particular the scale and complexity of the firm as well as its organisational culture. However, traditionally, management takes place at three core levels in a business:

1. Senior Management

- E.g. Board of Directors
- Set corporate objectives & strategic direction
- Board is responsible to shareholders; led by the CEO

2. Middle Management

- Accountable to senior management
- Run business functions and departments

3. Junior Management

- Supervisory role, accountable to middle management
- Monitor & control day-to-day tasks, and manage teams of workers

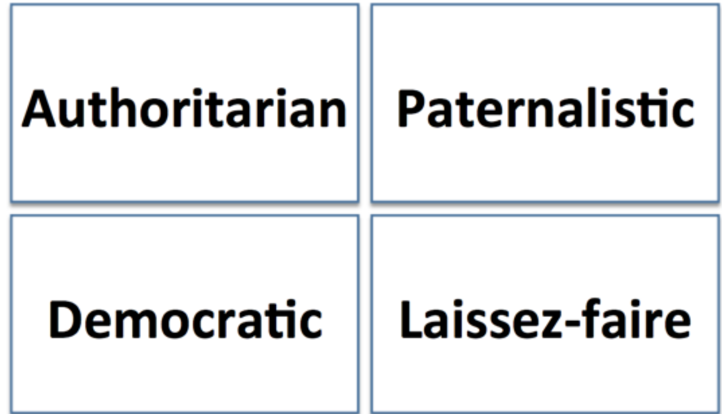
Leadership Styles

A leadership style is determined by:

- The way that the functions of leadership are carried out
- How a leader behaves

The leadership styles of successful business people (and others in non business roles) have been scrutinised in great detail by academics – all searching for that precious insight about what makes an effective leadership style.

The four traditional classifications of leadership style are:



The perceived features of the four traditional leadership styles are:

Authoritarian	**Paternalistic**
Focus of power is with the manager Communication is top-down & one-way Formal systems of command & control Use of rewards & penalties Very little delegation Consistent with McGregor Theory X	Leader decides what is best for employees Links with Mayo (motivation) – addressing employee needs Akin to a parent/child relationship Still little delegation A softer form of authoritarian leadership

approach	
Democratic	**Laissez-faire**
Focus of power is more with the group as a whole Leadership functions are shared within the group Employees have greater involvement in decision-making Emphasis on delegation and consultation A trade-off between speed of decision-making and better motivation and morale?	Leader has little input into day-to-day decision-making Conscious decision to delegate power Managers / employees have freedom to do what they think is best Effective when staff are ready and willing to take on responsibility Not the same as abdication – but not far off!

As a general observation, the use of autocratic leadership styles is increasingly viewed as out-dated in the modern business. There will always be circumstances where autocratic leadership may be effective and desirable (e.g. where a business is facing failure and requires painful restructuring). However, the following factors suggest a move away from autocratic leadership:

- Changes in society's values
- Better-educated workforce
- Focus on need for soft HR skills
- Changing workplace organisation
- Greater workplace legislation
- Pressure for greater employee involvement

From Entrepreneur to Leader

- Successful entrepreneurs have distinctive characteristics not always suitable for leading a bigger business
- As a business grows and becomes more complex, delegation is much more important
- Organisational design and leadership style needs to change as a business matures
- Many entrepreneurs become ineffective "bosses" – it is often best if they stand aside to let their business develop into the next stage

Key Terms

Leadership style	The manner and approach of providing direction, implementing plans, and motivating people
Management	Management is the art of getting things done through people (source: Drucker)

Topic: Role of an Entrepreneur

Theme 1: Section 1.5 Entrepreneurs and Leaders

What You Need to Know

- Creating and setting up a business
- Running and expanding/developing a business
- Innovation within a business (intrapreneurship)
- Barriers to entrepreneurship
- Anticipating risk and uncertainty in the business environment

What is a Business?

To understand the role of enterprise and entrepreneurship, it is first important to understand what a business is – and why they exist.

A business is an organisation that exists to provide goods and services on a commercial basis to customers.

There are two broad types of product that a business can provide:

Goods	Services
Goods are physical products: e.g. consumer electronics, industrial components, cars	Services are intangible products: e.g. insurance, dental services, cleaning

Benefits of Business to Society

The relationship between business and society is a two-way one. Businesses need society (for example to provide a legal framework and infrastructure). Society also needs business. For example, businesses benefit society because they:

- Create Employment & Develop Human Capital
- Drive Innovation through R&D and New Products
- Pay Taxes on profits earned & collect taxes for Government
- Create Wealth by providing returns on investment

Topic: Role of an Entrepreneur

Theme 1: Section 1.5 Entrepreneurs and Leaders

Entrepreneurs and Start-ups
A start-up is a new business enterprise, formed by one or more entrepreneurs.

Entrepreneurs are the driving force behind the formation of hundreds of thousands of new business enterprises in the UK each year. Not all, in fact relatively few, will succeed. That is the nature of enterprise – taking risks, including the risk of failure.

Number of new enterprises in the United Kingdom (UK) from 2004 to 2013

New enterprises
400,000
350,000
300,000
250,000
200,000
150,000
100,000
50,000
0
2004: 280,080
2005: 274,855
2006: 255,530
2007: 280,730
2008: 267,445
2009: 236,030
2010: 235,145
2011: 261,370
2012: 269,565
2013: 346,485

Despite the large number of business start-ups, there remain some important barriers to entrepreneurship:

- Support and finance
- Lack of a viable business idea
- Gender – women still under-represented as entrepreneurs in the UK

The role of the entrepreneur is to:

- Spot business opportunities
- Take (calculated) risks in order to gain possible future returns
- Act a catalyst for the creation & growth of new business enterprises

Business Ideas
A business idea is the foundation of a start-up. It explains why a business has been formed and what the new business is trying to achieve. Good business ideas:

- Solve a problem
- Offer a better, cheaper alternative than existing products
- Are ideally simple & practicable
- Can be delivered quickly
- Have a clear focus
- Anticipate trends & exploit growing markets
- Can be implemented profitably

Topic: Role of an Entrepreneur

Theme 1: Section 1.5 Entrepreneurs and Leaders

Popular and effective sources of good business ideas for a start-up include:

- **Business experience (of the entrepreneur)**
  - A good way of getting insights into what works + more realistic business plan
  - Less need for market research
- **Personal experience (as a customer)**
  - Day-to-day activities, interests & hobbies
  - Bad experiences or frustrations
- **Observations & research**
  - Watching closely what happens to customers (including in other markets)
  - Look for poor customer service as evidence of where an opportunity might lie

Intrapreneurship

Established businesses often wish their employees and management were more "entrepreneurial". In other words, they want people within an existing, established business to display the characteristics and traits associated with entrepreneurs.

Intrapreneurship involves people within a business creating or discovering new business opportunities, which leads to the creation of new parts of the business or even new businesses.

An intrapreneur is someone within a business that takes risks in an effort to solve a given problem. Two famous examples of products that were the result of intrapreneurial activity are:

Gmail	Employees at Google are allowed time for personal projects. Some of Google's best projects come out of their 20 percent time policy. One of these was Gmail, launched on 1 April 2004.
PlayStation	Ken Kutaragi, a relatively junior Sony Employee, spent hours tinkering with his daughters Nintendo to make it more powerful and user friendly. What came from his work turned into one of the world's most recognisable brands - the Sony PlayStation

Potential business benefits of intrapreneurship

In addition to identifying and executing new business opportunities, intrapreneurs can help drive innovation within businesses. In a similar role to that of entrepreneurs, intrapreneurs seek to provide solutions to problems – for example low productivity, excess waste, poor quality.

What can a business do to encourage intrapreneurship?

- Look out for – and encourage - entrepreneurial activity
- Give employees ownership of projects
- Make risk-taking and failure acceptable
- Train employees in innovation
- Give employees time outside the confines of their job description
- Encourage networking & collaboration
- Reward entrepreneurial thinking and activity

Topic: Role of an Entrepreneur

Theme 1: Section 1.5 Entrepreneurs and Leaders

How Entrepreneurs Handle Risk

Being entrepreneurial involves taking risks. What are these risks? They include:

- The probability that things will not go as well as planned
- The chance that money invested in the business will be lost
- The possibility that the entrepreneur will be personally liable for the debts a business incurs
- Risk of not getting another job or having to face the stigma of "failure"

Successful entrepreneurs embrace the concept of risk, but also manage it effectively by:

- Taking calculated risks (i.e. understand risk) rather than gamble
- Spreading risk by diversifying (don't put "all eggs in one basket")
- Looking for higher returns to take account of the risks
- Keeping going despite adversity – persistence is a key quality of an entrepreneur

Rewards for Enterprise

Rewards are the returns for taking risks. For an entrepreneur these include one or more of the following:

- Profits (made by the business)
- Capital gains (made by selling the business)
- Self-esteem
- Personal development
- Sense of control
- Satisfaction from building something

Key Terms

Entrepreneur	A person who organizes, operates, and assumes the risk for a business venture
Intrapreneurship	Entrepreneurial activity by people within a business creating or discovering opportunities, which lead to the creation of new parts of the business or even new businesses

Topic: Entrepreneurial Motives & Characteristics

Theme 1: Section 1.5 Entrepreneurs and Leaders

What You Need to Know

- Characteristics and skills required
- Reasons why people set up businesses:
- Financial motives: profit maximisation and profit satisficing
- Non-financial motives: ethical stance, social entrepreneurship, independence and home working

Introduction to Enterprise and Entrepreneurs

What is enterprise? It can be defined as:

- **"The skills and abilities to take risks and create profits"**
- **"The creation of a business to meet the needs and wants of customers"**

Entrepreneurs demonstrate enterprise. An entrepreneur is:

- **"A person who organizes, operates, and assumes the risk for a business venture"**
- **"A person who takes the risk in starting a new business"**

Whilst there are many characteristics of effective and successful entrepreneurs (and this area has been researched extensively), the following are commonly thought to be important: successful entrepreneurs are…

- **Passionate & Visionary**
- **Energetic, driven & resilient**
- **Self-starting and decisive**
- **Calculated risk-taker**
- **Focused**
- **Results-orientated**

Financial Motives for Starting a Business

The two key financial motives for an entrepreneur starting a business are:

Profit Maximisation	Profit Satisficing
• Desire to earn substantial rewards is a strong entrepreneurial motivation • Long-term profit maximisation consistent with building valuable business • Initially, entrepreneur may need to accept losses as business is established	• A sufficient profit to enable a satisfactory standard of living • Here, the entrepreneur will take fewer risks. • The trade-off is lower returns • Associated with "lifestyle' businesses

Topic: Entrepreneurial Motives & Characteristics

Theme 1: Section 1.5 Entrepreneurs and Leaders

Non-financial Motives for Starting a Business

A wide variety of non-financial motives can be behind a decision to start a new business enterprise. Often more than one of the following factors applies for the entrepreneur/s concerned:

- More control over working life
- Need for flexible working
- Frustration with unfulfilled potential
- Escape an uninteresting job or career
- Pursue an interest or hobby
- Want to be the boss
- Satisfaction from building something
- Want rewards from effort
- Dislike bureaucracy of hierarchy
- Change in personal circumstances – e.g. redundancy

The Drawbacks of Being an Entrepreneur

Being entrepreneurial is a challenging and often costly activity. The potential drawbacks include:

- Occasional loneliness and isolation.
- Higher responsibility: can't blame others when things go wrong
- Financial pressure
- Hard work
- Strain on family and social life
- Higher stress levels
- Needs to multi-tasking
- Difficult to take a "sickie" when you work for yourself!
- Roller-coaster of emotions

Social Enterprises

Social enterprises are the most common form of "not-for-profit" enterprises.

Social enterprises are defined as:

"Businesses with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or community, rather than being driven by the need to maximise profit for shareholders and owners'.

In other words, a social enterprise is a **proper business** that makes its money in a **socially responsible** way. These ventures are not necessarily formed to reinvest all profits into the communities. Social entrepreneurs can make a good profit themselves. However, their business model is also designed to benefit others.

Social enterprises complete alongside other businesses in the same marketplace, but use business principles to achieve social aims. A few things all social enterprises have in common are:

- They are directly involved in producing goods or providing services
- They have social aims and ethical values

- They are self-sustaining, and do not rely on donations to survive (i.e. they are not charities)
- Well known examples of social enterprises include Divine Chocolate, the Eden Project and fair-trade coffee company Cafedirect.

Key Terms

Entrepreneur	A person who organizes, operates, and assumes the risk for a business venture
Social enterprise	A business that operates for a social purpose

Topic: Business Objectives
Theme 1: Section 1.5 Business Objectives

What You Need to Know
- What are business objectives?
- Survival
- Profit maximisation
- Other objectives:
- *sales maximisation*
- *market share*
- *cost efficiency*
- *employee welfare*
- *customer satisfaction*
- *social objectives*

Introduction: Purpose of Business Objectives
Business objectives are:
- The specific intended outcomes of business strategy
- The anticipated end results of a programme of activities
- Targets that the business adopts in order to achieve its primary aims

The main purposes of business objectives are to:
- Make a clear statement of what needs to be achieved
- Provide a focus for all business activity
- Aid and inform management decision-making
- Help set targets for individual and group achievement
- Provide a means of measuring performance

The Hierarchy of Business Objectives
Objectives are set at various levels in business. A useful way to visualise this is to think of a hierarchy of objectives, as shown in the diagram below:

- The objectives cascade down from the mission getting progressively more specific
- Overall objectives are translated into more specific objectives for different parts of the business

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- The hierarchy ensures that at each level the objectives are consistent with the objectives that are above them in the hierarchy

SMART Business Objectives
It is often thought that for business objectives to be used effectively, they should comply with the acronym **SMART** – which stands for:

Specific	The objective should state exactly what is to be achieved
Measurable	An objective should be capable of measurement – so that it is possible to determine whether (or how far) it has been achieved
Achievable	The objective should be realistic given the circumstances in which it is set and the resources available to the business
Relevant	Objectives should be relevant to the people responsible for achieving them
Time Bound	Objectives should be set with a time frame in mind. These deadlines also need to be realistic

Mission Statements
The mission of a business is the over-riding goal of the business and the reason for its existence. A mission provides a strategic perspective for the business and a vision for the future. An effective mission statement:
- Differentiates the business from its competitors
- Defines the markets or business in which the business wants to operate
- Is relevant to all major stakeholders - not just shareholders and managers
- Excites, inspires, motivates & guides – particularly important for employees

Mission statements are often criticised because they are:
- Not always supported by actions of the business
- Often too vague and general or merely statements of the obvious
- Viewed as a public relations exercise
- Sometimes regarded cynically by employees
- Not supported wholeheartedly by senior management

The Relationship between Corporate and Functional Objectives

Corporate objectives are what a business as a whole wants to achieve. Functional objectives are set for the individual functions of a business and are designed to support (and be consistent with) corporate objectives.

Specific corporate objectives are usually set in terms of key performance measures for a business, including:

- Profit (value, margin)
- Return on investment
- Growth (revenues, profit)

- Market share
- Cash flow
- Business value (market capitalisation)
- Corporate image & reputation

Examples of how functional objectives can be set to support corporate objectives are shown in the table below:

Corporate Objective	Example Functional Objective
Increase sales	Successfully launch five new products in the next two years (**marketing**)
Reduce costs	Increase factory productivity by 10% by 2018 (**operations**)
Increase cash flow	Reduce the average time taken by customers to pay invoices from 75 to 60 days (**finance**)
Improve customer satisfaction	Achieve a 95% level of high customer service (**people**)

Themes & Direction for Corporate Objectives
The overall direction for a business setting corporate objectives helps determine which specific objectives are set. Common themes for such objectives are summarised below.

Corporate Objective: Survival
- A priority for new businesses since a large proportion of start-ups fail in the first few years
- Survival also a common objective for:
  - Established but loss-making businesses
  - Firms struggling to handle a shock in the external environment (e.g. economic downturn)
  - Business hit by competitive pressures or by loss of a major customer

Corporate Objectives: Revenues
Revenues (or sales) are a crucial indicator of the performance of a business. Common revenue objectives include:

Revenue Objective	Example
Revenue growth (percentage or value)	Aiming to grow total revenues by 10% Reach £1million in sales during a year
Sales maximisation	Aim to maximise total sales – regardless of whether those sales are profitable
Market share	Grow market share to 20% (will involve faster revenue growth than market competitors)

Topic: Business Objectives
Theme 1: Section 1.5 Business Objectives

Corporate Objective: Cost Efficiency or Cost Minimisation
Cost efficiency aims to achieve the most cost-effective way of delivering goods and services to the required level of quality. The main benefits of achieving cost efficiency are:
- Lower unit costs (competitiveness)
- Higher gross profit margin
- Higher operating profits
- Improved cash flow
- Higher Return on Investment

Corporate Objectives: Profits and Profitability
Revenue and cost objectives are often set in order to support profit objectives. The most common profit objectives are:

Profit Objective	Example
Specific level of profit (in absolute terms)	Achieve an operating profit of £1m
Rate of profitability (as a % of revenues)	Achieve an operating profit margin of 10% of revenues
Profit maximisation	Maximise the total profit for the year
Exceed Industry or Market profit margins	Achieve a higher gross or operating profit margin than key competitors

Corporate Objectives: Employee Welfare
Employee-related objectives tend to be functional in nature (rather than corporate). However, successful services businesses place great emphasis on employee-related corporate objectives, in particular relating to staff retention and the quality of customer service.

Corporate Objectives: Customer Satisfaction
Customer satisfaction is usually at the heart of what successful businesses strive for. But it is rarely a specific corporate objective. Customer satisfaction is loosely linked with functional objectives relating to customer service and quality.

Corporate Objectives: Social
Corporate social responsibility ("CSR") is becoming increasingly important and, as a result, CSR is increasingly integrating into mission statements and vision. However, it is still unusual to see social objectives at the top of the objective hierarchy.

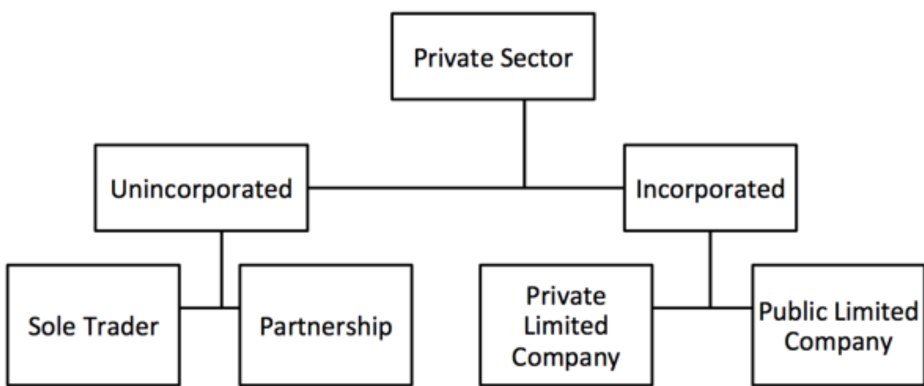
Key Terms

Corporate objective	The specific (SMART) targets that the business as a whole wants to achieve
Functional objectives	The specific objectives set for the individual functional areas of a business, designed to support the achievement of corporate objectives

Topic: Understanding Different Forms of Business
Theme 1: Section 1.5 Entrepreneurs and Leaders

What You Need to Know
- Unincorporated and incorporated businesses (sole traders & limited companies)
- Importance of limited liability
- Private & public sector
- Public limited companies
- Other categories of business:
- *Franchising*
- *Social enterprise*
- *Lifestyle businesses*

Overview of Key Business Forms
We'll look first at the key forms of business in the private sector – which represents the vast majority of businesses in the UK.



Unincorporated and Incorporated Businesses
A key distinction needs to be made between businesses formed as a company (incorporated) and those that are not!

Unincorporated:
- The owner is the business - no legal difference
- Owner has unlimited liability for business actions (including debts)
- Most unincorporated businesses operate as sole traders

Incorporated:
- There is a legal difference between the business (company) and the owners
- The company has a separate legal identity
- Owners (shareholders) have limited liability
- Most incorporated businesses operate as private limited companies

Unlimited Liability
- Unlimited liability is a crucially important characteristic of unincorporated businesses.
- Business owner/s is personally responsible for the debts and liability of the business
- If the unincorporated business fails, the owners are liable for the amounts owed

Topic: Understanding Different Forms of Business

Theme 1: Section 1.5 Entrepreneurs and Leaders

Sole Traders (Unincorporated)

Operating as a sole trader is the most common type of business form. A sole trader is just an individual owning the business on his/her own. Remember that a sole trader can also employ people – but those employees don't share in the ownership of the business. The sole trader owns all the business assets personally and is personally responsible for the business debts. **Crucially - a sole trader has unlimited liability.** The main benefits and drawbacks of operating as a sole trader include:

Advantages	Disadvantages
Quick & easy to set up – business can always be transferred to a limited company once launched Simple to run – owner has complete control over decision-making Minimal paperwork Easy to close / shut down	Full personal liability – "unlimited liability" Harder to raise finance – sole traders often have limited funds of their own and security against which to raise loans The business is the owner – the business suffers if the owner becomes ill, loses interest etc. Can pay a higher tax rate than a company

Partnerships (Unincorporated)

Partnerships arise where a business is started and owned by more than one person. The legal partnership agreement sets out how the partnership is run, covering areas such as:

- How profits are to be shared
- What the partners have to invest into the business
- How decisions are taken
- What happens if a partner wants to leave or dies

The partners between them own all the business assets and owe all business liabilities. Partners, therefore, also have unlimited liability

Advantages	Disadvantages
Quite simple – certainly the simplest way for two or more people to form a business together Minimal paperwork once Partnership agreement set up Business benefits from the expertise and efforts of more than one owner Partners can provide specialist skills Greater potential to raise finance – partners each provide the investment	Full personal liability – "unlimited liability" A poor decision by one partner damages the interests of the other partners Harder to raise finance than a company Partners are bound to honour decisions of others Complicated to sell or close

Topic: Understanding Different Forms of Business

Theme 1: Section 1.5 Entrepreneurs and Leaders

Incorporation and the Importance of Limited Liability

The concept of limited liability is an important protection for shareholders in a company. What this means is that shareholders can only lose (are therefore liable for) the value of their investment in the share capital of the company. However limited liability does not protect against wrongful or fraudulent trading or when directors give personal guarantees.

The reason why limited liability arises for shareholders is because the company has a separate legal identity. The shareholders are not the same as the business.

Main Features of a Limited Company

- Limited companies are separate legal entities to the founders. A legal entity can own things itself (assets), can sue and be sued;
- Companies are owned by their shareholders and run by directors. The shareholders appoint the directors (often the same people) who run the company in the interests of the shareholders;
- Shareholders own a share of the company, but they do not own the assets of the company and they are not liable for the debts of the company;
- The company owns the assets and pays the debts. If the company becomes insolvent (i.e. it cannot pay its debts), then the company is closed;
- Shareholders are not liable for any debts owed by the company that cannot be settled. That is the importance of limited liability;
- By far the most common form is a private limited company. Private means that the shares of the company are not traded publicly on a stock exchange
- By contrast, a public limited company ("plc" after its name) tends to have a larger value of share capital invested and its shares may be traded publicly.

The main benefits and drawbacks of operating as a limited company are, therefore:

Advantages	Disadvantages
Limited liability – protects the shareholders (the big advantage) Easier to raise finance – both through the sale of shares and also easier to raise debt Stable form of structure – business continues to exist even when shareholders change	Greater administration costs Public disclosure of company information Directors' legal duties

Public Limited Companies

- A public company is simply a more specialist type of limited company
- Shares may be quoted and traded on a public stock market (but don't have to be)
- When traded on a stock market, public companies have substantially more shareholders
- Public companies are subject to significantly greater regulation in terms of public disclosure of financial and other information

Topic: Understanding Different Forms of Business

Theme 1: Section 1.5 Entrepreneurs and Leaders

Brief Introduction to Public Sector Organisations and Not-for-Profit Businesses

A relatively small number of companies are owned or controlled by the Government Examples include the bank RBS (nationalised during the banking crisis) and Network Rail.

There are many more organisations that provide goods and services that are owned and operated by public bodies. These are funded by central & local government, but may still levy charges for some services. Examples include the NHS, the Highways Agency and TeachFirst (which recruits & trains new teachers)

Not-for-profit organisations:

- Not-for-profit organisations are businesses that trade in order to benefit the community. These businesses have social aims as well as trying to make money
- Examples of social aims are job creation and training, providing community services and fair trade with developing countries
- There are many different types of social enterprise, including community development trusts, housing associations, worker-owned co-operatives and even sports clubs

Other Forms of Business

Let's look briefly at three other "forms of business" that you need to be aware of. Strictly speaking they are not a "form" of business. For example, a franchise business is nearly always a private limited company. Lifestyle businesses often operate as unincorporated businesses. However, here are the key points you need to be aware of.

Social Enterprises

- Not-for-profit organisations are businesses that trade in order to benefit the community. These business have social aims as well as trying to make money
- Examples of social aims are job creation and training, providing community services and fair trade with developing countries
- There are many different types of social enterprise, including community development trusts, housing associations, worker-owned co-operatives and even sports clubs

Franchises

A franchise exists where a **franchisor grants a licence (franchise) to another business (franchisee) to allow it trade using the brand / business format.**

For the franchisor (i.e. the business that owns the business format and grants the franchise licence to franchisees) the key benefits of the approach are:

- Can accelerate the growth of a proven service business format
- Enables rapid geographical growth for a minimum investment
- Still have an option to open solus branches
- Can cream-off the "above normal" profits

The relative benefits and drawbacks of franchising for the franchisee are:

Topic: Understanding Different Forms of Business

Theme 1: Section 1.5 Entrepreneurs and Leaders

Benefits for Franchisee	Drawbacks for Franchisee
• Still your own business • Tested & developed format & brand • Advice, support, training • Easier to raise finance • No industry expertise required • Buying power of franchisor • Lower risk method of market entry + lower failure rate	• Not cheap! Initial fees + royalties & commission • Restrictions on actions, including selling • Problems selling business on • Long-term rewards for hard work c/w going it alone? • What happens if franchisor fails?

Lifestyle Businesses

- Not a form of business as such
- Used to describe a business that generates a “living” for the owners – but no more
- Most often operated as an unincorporated business
- Business objectives tend to be less important – provided the business allows the owners to maintain their lifestyle

Key Terms

Limited liability	Where shareholders in a company are only liable for the amount they have invested in the share capital
Unlimited liability	Where the owners of the business are legally inseparable from the business they run, making them liable for the debts of the business

Topic: Business Choices

Theme 1: Section 1.5 Entrepreneurs and Leaders

What You Need to Know
- Opportunity cost
- Choices and potential trade-offs

Opportunity Cost

All businesses have to make choices - and those choices have implications.

In business, resources are usually scarce or limited. Decisions are made under circumstances of uncertainty and taking one course of action or decision may affect business ability to take an alternative action.

Opportunity cost measures the **cost of a choice made in terms of the next best alternative foregone or sacrificed.**

Examples of Opportunity Cost in the Business & Economic Environment

Work-leisure choices

The opportunity cost of deciding not to work an extra ten hours a week is the lost wages given up.

Government spending priorities

The opportunity cost of the government spending an extra £10 billion on investment in National Health Service might be that £10 billion less is available for spending on education or defence equipment.

Investing today for consumption tomorrow

The opportunity cost of an economy investing resources in new capital goods is the production of consumer goods given up for today.

Use of scarce farming land

The opportunity cost of using farmland to grow wheat for bio-fuel means that there is less wheat available for food production, causing food prices to rise

Topic: Business Choices

Theme 1: Section 1.5 Entrepreneurs and Leaders

Trade-offs

A trade-off arises where having more of one thing potentially results in having less of another.

The table below lists some examples of how trade-offs often arise in business - as a result of resource scarcity.

Choice	Potential Trade-Off
Less market research (lower cost)	Less successful new product launch (lower sales)
Higher quality standards to build reputation	More quality control & assurance costs
Higher advertising online	Reduced advertising on TV
Choose lower risk investments	Gain lower rewards

Key Terms

Opportunity cost	The cost of a choice made in terms of the next best alternative foregone or sacrificed.
Trade-off	A decision between two choices arising from scarcity of resources, where having more of one thing potentially results in having less of another

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Topic: Sources of Finance

Theme 2: Section 2.1 Raising Finance

What You Need to Know

- Internal and external sources of finance
- Benefits and drawbacks of different sources of finance
- Criteria in choosing a source of finance

Introduction

There are a wide variety of potential sources of finance for a business. The key sources are summarised in the table below:

Long-term	**Medium-term**	**Short-term**
Finances the whole business over many years	*Finances major projects or assets with a long-life*	*Finances day-to-day trading of the business*
Examples:	***Examples:***	***Examples:***
Share capital Retained profits Venture capital Mortgages Long-term bank loans	Bank loans Leasing Hire purchase Government grants	Bank overdraft Trade creditors Short-term bank loans Factoring

Factors Influencing the Choice and Amount of Finance Required

- What is the finance required for?
  - E.g. is it to finance long-term assets like a new factory) or a short-term increase in stocks?
- The cost of the finance
  - Bank finance incurs interest costs
  - Share capital also has a cost – the dividends (returns) required by shareholders
- The flexibility of the finance
  - What repayments might be required (and when)
- The business organisational structure
  - E.g. limited companies normally find it easier to raise finance than sole traders

Sources of Finance for a New (Start-up) Business

A new (or start-up) business normally finds it hard to raise finance. It is not surprising – the business is new and unproven and therefore much higher risk to potential finance-providers.

The main sources of finance used by new businesses tend to be:

Topic: Sources of Finance
Theme 2: Section 2.1 Raising Finance

Internal Sources	External Sources
Founder finance (various personal sources of the entrepreneur) Retained profits Friends & family	Business angels Loans & grants Crowdfunding Bank loan Bank overdraft

Founder finance is particularly popular and important for start-ups: this can involve some or all of the following:

- Cash and investments
- Redundancy payments
- Inheritances
- Personal credit cards
- Re-mortgaging
- Putting time into the business for free

Personal sources like the above provide some important benefits for a new business; for example:

- They are cheap (e.g. compared with a bank loan)
- The entrepreneur keeps more control over the business
- The more the founder puts in, the more others will invest (added confidence)
- Little red tape or delay
- Focuses the mind!

Sources of Finance for Established Businesses
A wider range of mainstream sources of finance is available for established businesses:

Internal Sources	External Sources
Retained profits Working capital Asset disposals	Share issues Bank loans and overdrafts Peer-to-peer lending Debentures Venture capital Supplier finance

Let's explore these in a little more detail, highlighting the key features of each and their respective benefits and drawbacks as a source of finance.

Topic: Sources of Finance

Theme 2: Section 2.1 Raising Finance

Retained Profits

By some distance the most important sources of finance for a profitable business.

Benefits of Retained Profits	Drawbacks of Retained Profits
• Cheap (though not free) • The "cost " of retained profits is the opportunity cost for shareholders of leaving profits in the business • Very flexible - management control how they are reinvested • Shareholders control the proportion retained • Do not dilute the ownership of the company - unlike the issue of new share capital	• A danger of hoarding cash • Shareholders may prefer dividends if the business is not achieving sufficiently high returns on investment • High profits and cash flows would suggest the business could afford debt (higher gearing)

Working Capital

The effective management of working capital is an important part of cash flow management. Key points to remember are:

- Cash inflow arise from reducing working capital
  - This is a one-off source of finance
  - However, the question is can it be sustained?
- Finance often wasted in excess stocks and trade debtors
- Look for very low inventory turnover ratio or high debtor days – for businesses that ought to be able to release cash tied up in working capital

Asset Disposals

- Potentially another one-off boost to finance
- Good examples: spare land, surplus equipment
- Note – not all businesses have spare assets
- Often occurs after acquisitions

Share Issues

You cover the detail of this when looking at shares and share prices. The key points to remember are:

Benefits of Share Issues	Drawbacks of Share Issues
Able to raise substantial funds if the business has good prospects	Can be costly and time-consuming (particularly flotations)
Broader base of shareholders	Existing shareholders' holdings may be diluted
Equity rather than debt = lower risk finance structure	Equity has a cost of capital that is higher than debt

Topic: Sources of Finance
Theme 2: Section 2.1 Raising Finance

Bank Loans and Bank Overdrafts
Bank loans are a common source of finance for established businesses. However banks have been criticised in recent years for making their lending criteria more demanding, which has resulted in less bank lending to some sectors:

Key points to note about bank loans:

- Medium or long-term finance (depending on the term of the loan)
  - Loan provided over fixed period
  - Rate of interest either fixed or variable
  - Timing and amount of repayments are set
- Good for financing investment in fixed assets
- Generally at a lower rate of interest that a bank overdraft
- However, bank loans don't provide much flexibility

Bank overdrafts are the classic source of short-term finance, widely used by businesses of all sizes.

Key points to remember about bank overdrafts:

- An overdraft is really a **loan facility** – the bank lets the business "owe it money" when the bank balance goes below zero, in return for charging a high rate of interest
- A **flexible** source of finance, in the sense that it is only used when needed
- Bank overdrafts are excellent for helping a business handle seasonal fluctuations in cash flow or when the business runs into short-term cash flow problems (e.g. a major customer fails to pay on time).

The relative benefits and drawbacks of bank finance are:

Bank Overdraft	**Bank Loan**
Advantages	
Relatively easy to arrange	Greater certainty of funding, provided terms of loan complied with
Flexible – use as cash flow requires	Lower interest rate than a bank overdraft
Interest – only paid on the amount borrowed under the facility	Appropriate method of financing fixed assets
Not secured on assets of business	
Disadvantages	
Can be withdrawn at short notice	Requires security (collateral)
Interest charge varies with changes in interest rate	Interest paid on full amount outstanding
Higher interest rate than a bank loan	Harder to arrange

Topic: Sources of Finance
Theme 2: Section 2.1 Raising Finance

Debentures
A debenture is a form of bond or long-term loan issued by the company, usually with a fixed rate of interest.

An increasing number of larger businesses have raised finance using debentures in recent years in preference to taking on bank debt.

Key points to remember about debentures are:

- Long-term: often 10-20 years
- Issued by the company (not a bank)
- Fixed rate of interest
- Usually secured against the assets of the company (provides some protection for debenture holders)
- Can be traded

Venture Capital (also known as Private Equity)
For the right business, venture capital is a highly useful source of external equity finance.

- Specialist investors in private companies
- Often back management buy-outs (MBOs)
- They manage investment funds designed to achieve high rates of returns
- Tend to focus on larger investments (>£1m) than business angels
- Will seek a large share of the share capital (equity) + representation on the Board
- Look to sell ("exit") their investment in the medium-term (e.g. 5-7 years)

Advantages of Venture Capital	**Disadvantages of Venture Capital**
Can raise substantial amounts	Venture capitalist requires a high rate of return
Business benefits from specialist investor support	Investment often supported by a high level of bank debt in business
Brings better discipline to business management & strategy	Not a long-term investment – venture capitalist will aim to sell within 5-7 years
Helps original business owners realise their investment	Loss of control – venture capitalist may take a majority share in company

Supplier Finance
As we have seen in our study of working capital management, the availability of trade credit from suppliers can be a significant source of short-term finance.

- Suppliers provide goods and services in advance of payment = trade creditors
- As a business expands, the amount owed to suppliers at any one time also grows
- If a business has a strong relationship with its suppliers, then it may be able to obtain better (i.e. longer) payment terms

Peer-to-Peer Lending (P2P)
Peer-to-peer (P2P) lending is a fast-growing way for businesses to raise loan finance without having to use the traditional banking sector.

P2P lending involves raising a loan from a group of individuals or institutions and is a very flexible source of borrowing, with the minimum loan amount ranging from £5000 to £50,000 and terms ranging from 6 months to 5 years.

Most P2P lending is unsecured, so the borrowers do not have to commit personal or business assets as security. However, most P2P lenders will not deal with start-ups and very young companies, so this source of funding is best suited to businesses that have been trading for several years and need loan capital to support expand.

P2P loans do not involve surrendering any control of the business but they usually involve directors signing a Personal Guarantee, which commits the directors of the company to guarantee the loan if the business fails to repay.

Key points to remember about peer-to-peer lending
- Connects businesses looking for finance with individuals willing to invest or loan
- Managed by online intermediaries
- Effectively cuts out the role traditionally played by banks
- Increasingly popular, particularly for fast-growing, established businesses with a good credit track record

Crowdfunding

Crowdfunding is a specialist example of peer-to-peer funding.

Crowdfunding is an alternative method of raising equity finance for a business, project or idea.

Unlike business angel investment, in which one person typically takes a larger stake in a small business, with crowdfunding an entrepreneur or business can attract a 'crowd' of investors – each of whom takes a small stake by contributing towards an online fundraising target.

Topic: Planning and Cash Flow

Theme 2: Section 2.1 Raising Finance

What You Need to Know
- Relevance of a business plan in obtaining finance
- Interpretation of a simple cash-flow forecast and calculations based on changes in the cash-flow variables
- Use and limitations of a cash-flow forecast

The Role of a Business Plan in Raising Finance

Business plans play a crucial role in a business raising finance at various stages – from starting up to financing the growth of an established business.

A suitable business plan:
- Helps finance-providers assess the business model
- Provides a structured assessment of the opportunities and risks
- Encourages analysis of the competitive position of the business and the market attractiveness
- Provides a benchmark against which progress can be measured
- Helps determine the amount and type of finance required

The key contents of a business plan that is designed to raise finance (rather than one that is solely for the internal use of business management) include

- Business model
- Product & market positioning
- Management team
- Market assessment (competitors, market size, growth)
- Financial forecasts (including cash flows) & scenarios
- Key opportunities and threats
- Investment requirement

Introduction to Cash Flow

Cash flow is hugely important in business:

- Cash flow is a dynamic and unpredictable part of life for most businesses (particularly start-ups and small businesses)
- Cash flow problems are the main reason why a business fails
- Regular and reliable cash flow forecasting can address many of the problems

As a result, cash flow forecasting is also a very important part of financial management:

- Cash is king – it is the lifeblood of a business
- If a business runs out of cash it will almost certainly fail
- Few businesses have unlimited finance – cash is limited, so it needs to be managed carefully

It follows that a carefully -prepared cash flow forecast can provide a variety of benefits:

- Advanced warning of cash shortages

- Make sure that the business can afford to pay suppliers and employees
- Spot problems with customer payments
- As an important part of financial control
- Provide reassurance to investors and lenders that the business is being managed properly

Constructing the Cash Flow Forecast

The cash flow forecast starts by making sure all cash inflows and outflows into a business are identified:

Main Cash Inflows	Main Cash Outflows
Cash sales	Payments to suppliers
Receipts from trade debtors	Wages and salaries
Sale of fixed assets	Payments for fixed assets
Interest on bank balances	Tax on profits
Grants	Interest on loans & overdrafts
Loans from bank	Dividends paid to shareholders
Share capital invested	Repayment of loans

The key to cash flow management is having **good information.** A good cash flow forecast:

- Is updated regularly
- Makes sensible assumptions
- Allows for unexpected changes

An example of a cash flow forecast is provided below:

	Jan	Feb	Mar	Total
CASH INFLOWS				
Investment	10,000			10,000
Sales	2,500	10,000	15,000	27,500
Total inflows	**12,500**	**10,000**	**15,000**	**37,500**
CASH OUTFLOWS				
Raw materials	4,000	5,000	5,000	14,000
Wages & salaries	3,500	4,000	4,000	11,500
Marketing	2,500	1,000	2,000	5,500
Set-up costs	3,000	1,000	0	4,000
Other costs	2,000	1,000	1,000	4,000
Total outflows	**15,000**	**12,000**	**12,000**	**39,000**
NET CASH FLOW	**-2,500**	**-2,000**	**3,000**	**-1,500**
Opening balance	0	-2,500	-4,500	
Closing balance	-2,500	-4,500	-1,500	

Topic: Planning and Cash Flow

Theme 2: Section 2.1 Raising Finance

The key points to remember about constructing a cash flow forecast are:

- A forecast is normally produced by month
- Net cash flow is the difference each month between cash inflows and cash outflows
- Opening balance is the amount the business starts with each month
- Closing balance = opening balance + net cash flow
- Negative closing balance suggests business needs bank overdraft or additional financing

Common Issues with Cash Flow Forecasts

Like all forecasting (e.g. sales forecasts and budgets) forecasting is inherently uncertain since it involves making estimates and assumptions. Real-life never turns out exactly how you expect! Common issues with cash flow forecasts include:

- **Sales prove lower than expected**
  - Easy to be over-optimistic about sales potential
  - Market research may have gaps
- **Customers do not pay up on time**
  - A notorious problem for businesses, particularly small ones
- **Costs prove higher than expected**
  - Perhaps because purchase prices turn out higher
  - Maybe also because the business is inefficient
  - A common problem for a start-up
  - Unexpected costs always arise – often significant

Key Terms

Cash flow forecast	An analysis of estimated cash inflows and cash outflows over a future period and the resulting impact on cash balances

Topic: Sales Forecasting

Theme 2: Section 2.2 Financial Planning

What You Need to Know

- Purpose of sales forecasts
- Factors affecting sales forecasts:
- *Consumer trends*
- *Economic variables*
- *Actions of competitors*
- Difficulties of sales forecasting

Why Try to Forecast Sales?

Sales forecasting is a crucial part of business planning:

- The sales forecast forms the basis for most other common parts of business planning:
  - Human resource plan: how many people we need linked with expected output
  - Production / capacity plans
  - Cash flow forecasts
  - Profit forecasts and budgets
- A very useful part of regular competitor analysis and helps to focus market research

Key Factors Affecting the Accuracy and Reliability of Sales Forecasts

Sales forecasting requires a subjective judgement about an uncertain future. So it is inevitable that actual sales will differ from those forecast. Key factors that create this variability include:

- **Consumer trends**
  - Demand in many markets changes as consumer tastes & fashions change
  - Affects both overall market demand & the market shares of existing competitors
- **Economic variables**
  - Demand often sensitive to changes in variables such as exchange rates, interest rates, taxation etc.
  - Overall strength of the economy (GDP growth) also important
- **Competitor actions**
  - Hard to predict, but often significant reason why sales forecasts prove over-optimistic

Circumstances Where Sales Forecasts Are Likely to be Inaccurate

The situations where actual sales are most likely to be significantly different from the sales forecast include:

- Business is new – a startup (notoriously difficult to forecast sales)
- Market subject to significant disruption from technological change
- Demand is highly sensitive to changes in price and income (elasticity)
- Product is a fashion item
- Significant changes in market share (e.g. new market entrants)
- Management have demonstrated poor sales forecasting ability in the past!

Topic: Sales Forecasting
Theme 2: Section 2.2 Financial Planning

Main Methods of Sales Forecasting

Extrapolation
Extrapolation involves the **use of trends established by historical data to make predictions about future values**.

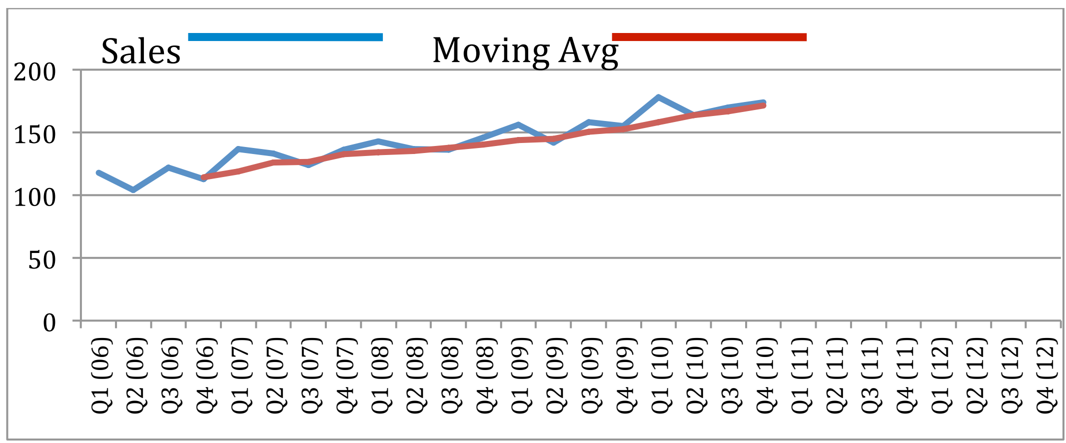
The basic assumption of extrapolation is that the trend / pattern will continue into the future unless evidence suggests otherwise.

The calculation and use of "moving averages" is often used as part of the process of extrapolation.

To understand these techniques further, look at the following chart that shows quarterly sales (£m) for a large business from Q1 Year'06 to Q4 (Year'10):

The blue line shows the actual quarterly sales figure. As you can see the sales total varies quarter by quarter, although you might guess from looking at the data that the overall trend is for a stead increase in sales.

The red line shows the **quarterly moving average.** This is calculated by adding the latest four quarters of sales (e.g. Q1 + Q2 + Q3 + Q4) and then dividing by four. This technique smoothes out the quarterly variations and gives a good indication of the overall trend in quarterly sales.



The moving average helps point out the growth trend (expressed as a percentage growth rate), and it is this which extrapolation would use first to predict the path of future sales. This could be done mathematically using a spreadsheet.

Alternatively, an extrapolated trend can simply be drawn on the chart as a rough estimate, as shown below:

Topic: Sales Forecasting
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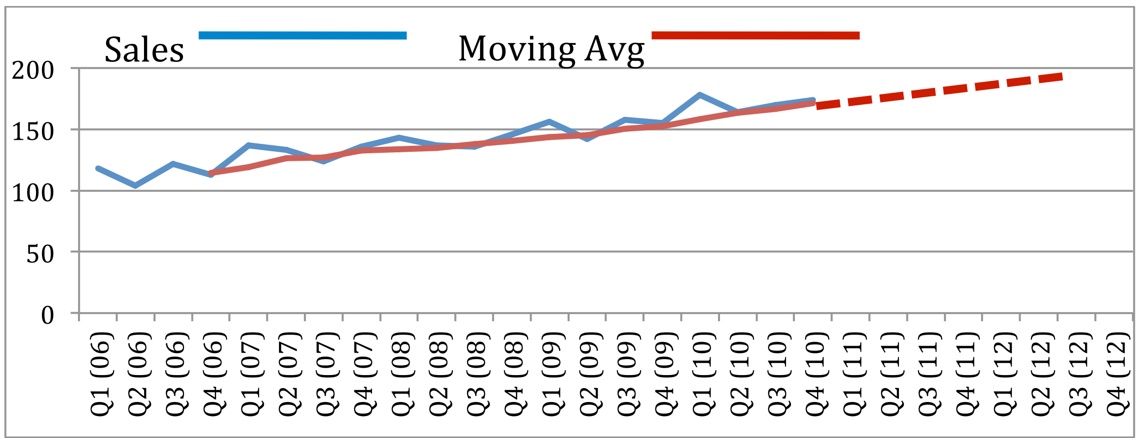


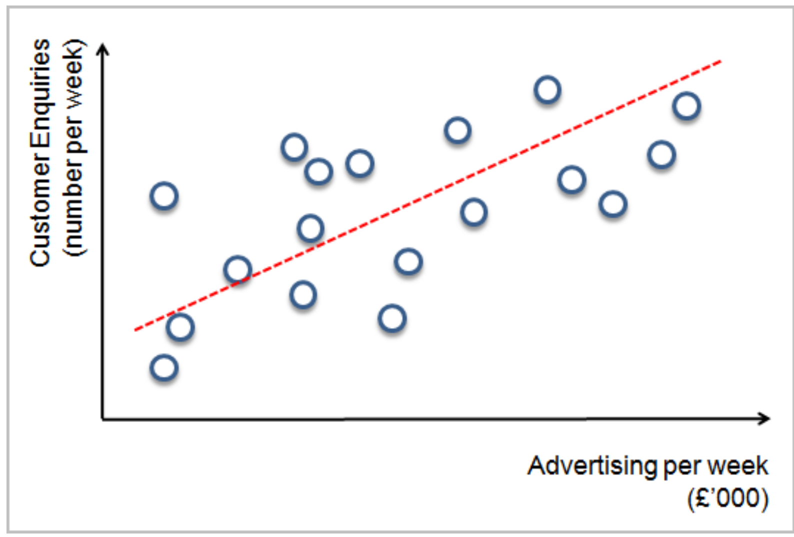
How useful is extrapolation? The main benefits and drawbacks are summarised below:

Benefits of Extrapolation	Drawbacks of Using Extrapolation
A simple method of forecasting	Unreliable if there are significant fluctuations in historical data
Not much data required	Assumes past trend will continue into the future – unlikely in many competitive business environments
Quick and cheap	Ignores qualitative factors (e.g. changes in tastes & fashions)

Correlation

Correlation is another method of **sales forecasting**. Correlation looks at the **strength of a relationship** between two variables.

For marketing, it might be useful to know that there is a predictable relationship between sales and factors such as advertising, weather, consumer income etc. Correlation is usually measured by using a scatter diagram, on which data points are plotted. For example, a data point might measure the number of customer enquiries that are generated per week (x-axis) against the amount spent on advertising (y-axis). This is illustrated below:



It is normal convention to show the:

- **Independent variable** (the factor that causes the other variable to change) on the x-axis
- **Dependent variable** (the variable being influenced by the independent variable) on the y-axis

How might the marketing department make sense and use of all the data points once they have been plotted on the scatter diagram?

The answer is a **"line of best fit" (the regression line)** which attempts to plot the mathematical relationship between the variables based on the data points. This can be drawn by hand or using an Excel spreadsheet or specialist marketing software.

There are three kinds of possible correlation:

Positive correlation	A positive relationship exists where as the independent variable increases in value, so does the dependent variable
Negative correlation	A negative relationship exists where as the independent variable increases in value, the dependent variable falls in value
No correlation	There is no discernible relationship between the independent and dependent variable

The line of best fit indicates the strength of the correlation. Strong correlation means that there is little room between the data points and the line. Weak correlation means that the data points are spread quite wide and far away from the line of best fit.

If the data suggests strong correlation, then the relationship might be used to make marketing predictions.

The big danger with correlation is of believing there is really a **causal link** between two variables when, in fact, they are not related.

It is logical to believe that there is a causal link between the daily temperature and sales by ice-cream vans. However, is there a link between increasing childhood obesity and increasing disposal incomes for households? Both these variables have risen over the long-term, but they are probably not directly related.

Confidence Intervals and Levels

A confidence interval gives the **percentage probability that an estimated range of possible values in fact includes the actual value being estimated**.

Confidence intervals are a useful predictive data tool in business for several reasons:

- Businesses benefit from the use of statistics in estimating or predicting future events

Topic: Sales Forecasting
Theme 2: Section 2.2 Financial Planning

- A confidence interval helps a business evaluate the reliability of a particular estimate
- Because no estimate can be 100% reliable, businesses need to know how confident they should be in their estimates and whether or not to act on them

Here are some examples of how confidence intervals might be used to support business decision-making:

BUSINESS ACTIVITY	HOW CONFIDENCE INTERVALS ARE USED
Quality management	Percentage reliability of machines Chance that quality control samples will detect issues
Market research	Statistical estimates for sales forecasting Reliability of data from customer surveys
Risk management & contingency planning	Risks of sales forecasts not be achieved Scenario planning for competitor actions
Budgeting & forecasting	Likely range of revenues and costs based on key assumptions Sales forecasts to support new product launches

Key Terms

Extrapolation	The use of trends established by historical data to make predictions about future values.
Correlation	A method of forecasting that looks at the strength of a relationship between two variables
Confidence intervals	The percentage probability that an estimated range of possible values in fact includes the actual value being estimated.

Topic: Sales, Revenue & Costs

Theme 2: Section 2.2 Financial Planning

What You Need to Know

- Calculation of sales volume and sales revenue
- Calculation of fixed and variable costs

Introduction to Sales (Revenues) and Demand

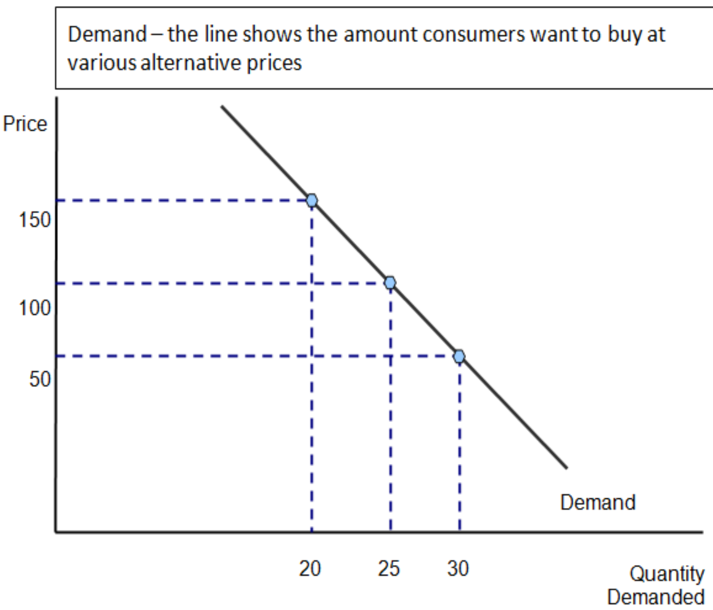
A business generates revenues by satisfying demand from customers. In other words, revenues flow from customer demand – but only if a business has a product that meets the customer needs and expectations:

Revenues	• The amount (value) of a product that customers actually buy from a business
Demand	• The amount of a product that customers are prepared to buy • Can be measured in terms of **volume** (quantity bought) and/or **value** (£ value of sales)

Various factors will affect the level of demand:

- Prices & Incomes (you look at this in more detail when considering **elasticity of demand**)
- Tastes & fashions
- Competitor actions
- Social & demographic change
- Seasonal changes
- Changing technology
- Government decisions

The relationship between quantity demanded and price can be shown graphically by drawing a demand curve, as illustrated below:



Revenue

Topic: Sales, Revenue & Costs

Theme 2: Section 2.2 Financial Planning

There are various different names for the same thing – the value of what a business sells!

- Sales
- Revenues
- Income
- Turnover
- Takings

They all mean the same thing - revenue arises through the trading activities of a business.

The value of revenue achieved in a given period is a function of the quantity of product sold multiplied by the price that customers paid. So revenues can be calculated using the following important formula:

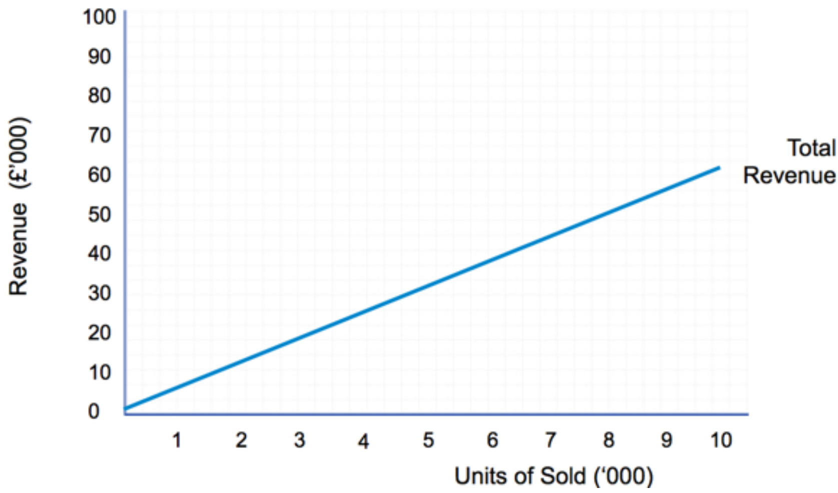
Total revenue = volume sold x average selling price

An example of this calculation is shown in the table below:

Product	Quantity (Q)	Price (P)	Revenue (P x Q)
		£ / unit	£
Blue	5,000	£10	£50,000
Red	2,500	£12	£30,000
Pink	8,000	£11	£88,000
Purple	4,000	£10	£40,000
Total	19,500		£208,000

Using the revenue formula, you can chart the value of total revenue. Revenues rise as higher quantities are sold.

In the chart below, we assume that each unit of product is sold for the same price (£6). E.g. 10,000 units sold at £6 per unit = total revenues of £60,000



Using the revenue calculation formula, you can see that there are two main ways of increasing revenues:

Increase quantity (amount) sold

- Perhaps by cutting the price or offering volume-related incentives (e.g. 2 for price of 1)
- Key issues - is demand sensitive to price?

Achieve a higher selling price

- Best to add value rather than simply increase price
- Does market research suggest that prices are high enough or too low?

Introduction to Costs

Costs are amounts that a business incurs in order to make goods and/or provide services.

Costs are important to business because they:

- Are the thing that **drains away the profits** made by a business
- Are the difference between making a good and a poor **profit margin**
- Are the **main cause of cash flow problems** in business
- **Change as the output or activity of a business changes**

Variable and Fixed Costs

An important distinction needs to be made between variable and fixed costs. This is summarised below:

VARIABLE COSTS	FIXED COSTS
• Costs which change as output varies • Lower risk for a start-up: no sales = no variable costs	• Costs which do not change when output varies • Fixed costs increase the breakeven output
Examples: • Raw materials • Bought-in stocks • Wages based on hours worked or amount produced • Marketing costs based on sales (e.g. % commission)	***Examples:*** • Rent & rates • Salaries • Advertising • Insurance, banking & legal fees • Software • Research and development

Calculating Total Costs

The total costs of a business can be calculated using this formula:

Total costs (TC) = Fixed costs (FC) + Variable costs (VC)

Let's look at a simple example of how total costs can be calculated using the following example data:

Topic: Sales, Revenue & Costs
Theme 2: Section 2.2 Financial Planning

Graham's Van Repairs Business *Forecasts for March*	
Variable costs per job	£75
Garage rent & rates	£500
Wages	£1,500
Advertising	£100
Other fixed costs	£400
Expected number of jobs for month	100

What would Graham's costs be in March if his forecasts prove correct?

Stage 1: calculate variable costs: = £75 x 100 = £7,500
Stage 2: add together the fixed costs = £2,500 (i.e. £500 + £1,500 + £100 + £400)
Stage 3: add variable to fixed costs: total costs are £10,000 (£7,500 + £2,500)

The costs incurred by a business are often relatively easy to estimate. You know how much salary someone is paid or what price your supplier is charging. However, this is not always the case – some costs are uncertain:

- Raw materials – affected by wastage
- Product returns or refunds – affected by quality
- Where a business or entrepreneur does not have detailed experience of a market

How Costs Change with Output
As output rises, total costs can be expected to increase. However, as output rises, fixed costs are spread over more units produced, which usually results in lower unit costs. The table below illustrates how unit costs (cost per unit) change as output increases:

Output	Fixed Costs	Total Variable Costs	Total Costs	Cost per Unit
Units	£	£	£	£
50	10,000	5,000	15,000	300
100	10,000	10,000	20,000	200
150	10,000	15,000	25,000	166
200	10,000	20,000	30,000	150
250	10,000	25,000	35,000	140

[note: in the above example it is assumed that fixed costs are £10,000 & variable costs are £100 per unit]

Key Formulae

Revenues (Sales)	Selling price per unit x Quantity sold
Costs	Fixed costs + variable costs
Profit	Total revenues less total costs

Topic: Breakeven Analysis

Theme 2: Section 2.2 Financial Planning

What You Need to Know

- Contribution: selling price – variable cost per unit
- Break-even point
- Using contribution to calculate the break-even point
- Margin of safety
- Interpretation of break-even charts
- Limitations of break-even analysis

Introduction

Understanding the breakeven position is key to understanding what a business needs to do to operate profitably.

Calculating contribution and breakeven output is an important analytical method that is used in every type of business – large and small

However, breakeven analysis makes certain assumptions, so be aware of its limitations!

Contribution

Contribution is one of the most important concepts in business and it is essential that you understand it!

- Contribution looks at the profit made on individual products
- It is used in calculating how many items need to be sold to cover all the business' total costs (variable and fixed)
- Contribution is the difference between sales and variable costs of production

In terms of calculating contribution, there are several different formulae:

Contribution = total sales less total variable costs

Contribution per unit = selling price per unit less variable costs per unit

Total contribution can also be calculated as:

Contribution per unit x number of units sold

Finally,

Profit = Contribution less Fixed Costs

Example Calculation of Contribution

Using the following data, let's calculate contribution:

Data

Quantity sold: 5,000 units
Selling price per unit: £10
Variable cost per unit: £5
Fixed costs: £10,000

Contribution per unit = £10 less £5 = £5
Total Sales = 5,000 x £10 = £50,000
Total Variable Costs = 5,000 x £5 = £25,000
Total Contribution = £50,000 - £25,000 = £25,000

Introduction to Breakeven
A business is said to "breakeven" when it is earning enough sales to cover all its costs.

The breakeven point (breakeven output) happens when total sales = total costs.

In other words, at the break-even point, the business isn't making a profit, but it isn't making a loss either!

When we look at breakeven, we are concerned with the following key issues:

- At what level of production (output) does break-even take place?
- What is the effect on break-even of changes in the business?
- What business decisions can be taken which affect break-even and which will help improve profits?

There are three alternative ways of calculating the breakeven point:

- A table (or spreadsheet) showing sales and costs over different levels of output
- A formula which you can use to calculate break-even output
- A graph which charts sales and costs

For each approach, we have to make some important assumptions:

- Selling price per unit stays the same, regardless of the amount produced
- Variable costs vary in direct proportion to output – i.e. variable cost per unit is the same
- All output is sold
- Fixed costs do not vary with output – they stay the same

Using a table to calculate break-even output

Here is a table showing the sales, variable costs, fixed costs and profits from various levels of output for a one-product business:

The product is sold for £10 per unit. The variable cost per unit is £4. Fixed costs are £40,000 (the same at each level of output).

Topic: Breakeven Analysis
Theme 2: Section 2.2 Financial Planning

Output	Sales	Variable Costs	Fixed Costs	Total Costs	Profit
'000	£'000	£'000	£'000	£'000	£'000
0	0	0	40	40	-40
1	10	4	40	44	-34
2	20	8	40	48	-28
3	30	12	40	52	-22
4	40	16	40	56	-16
5	50	20	40	60	-10
6	**60**	**24**	**40**	**64**	**-4**
7	**70**	**28**	**40**	**68**	**2**
8	80	32	40	72	8
9	90	36	40	76	14
10	100	40	40	80	20

Using the table, you can see that the break-even output is somewhere between 6,000 and 7,000 units. At 6,000 units, the business makes a loss of £4,000. At 7,000 units, the business makes a profit of £2,000.

Using a formula to calculate break-even output
Let's use the same information as above to show how a formula can be used to quickly calculate the break-even output.

Remember contribution per unit? Here is a reminder of this crucial and really useful formula:

Contribution per unit = selling price per unit less variable cost per unit

In our example, contribution per unit = **£10 less £4 = £6 per unit**

Here comes the clever bit – the formula
Break-even output (units) = Fixed costs (£) / Contribution per unit (£)

So, break-even output = £40,000 divided by £6 = 6,666

Note: break-even output is always expressed in terms of units

So break-even output = 6,666 units

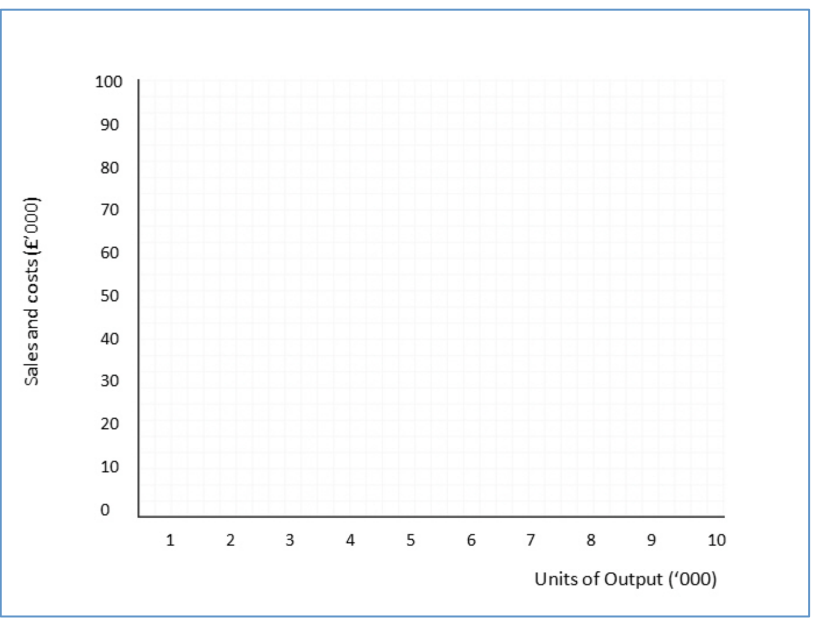
If the information is available, it is always quicker and easier to use this formula rather than use a table or draw a chart.

Using a chart to calculate break-even output
Using graph paper, it is possible to chart the financial data that allows the break-even output to be measured. We'll use the same example data one last time!

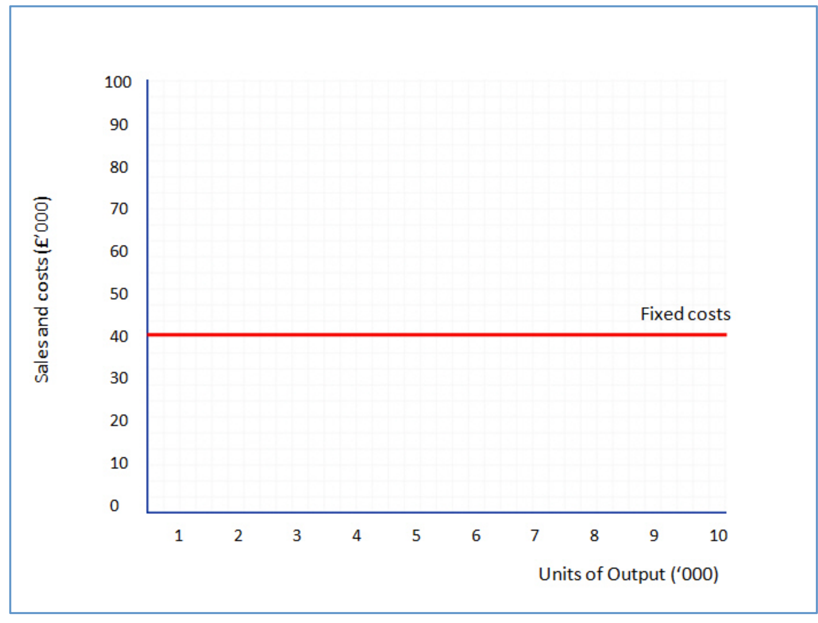
Topic: Breakeven Analysis
Theme 2: Section 2.2 Financial Planning

Step 1
The first step is to produce two axes:
- The vertical axis shows the value of sales & costs
- The horizontal axis shows the output

So here is what the blank chart would look like:

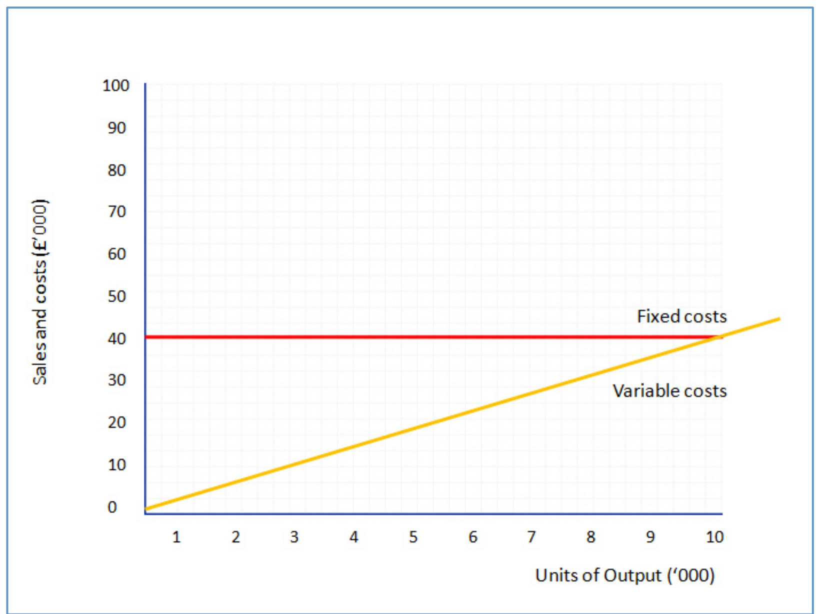


Step 2
The next step is to add the fixed cost line. Remember that we assume fixed costs don't change with the level of output. So the fixed cost line (in red below) is a horizontal line, showing £40,000.



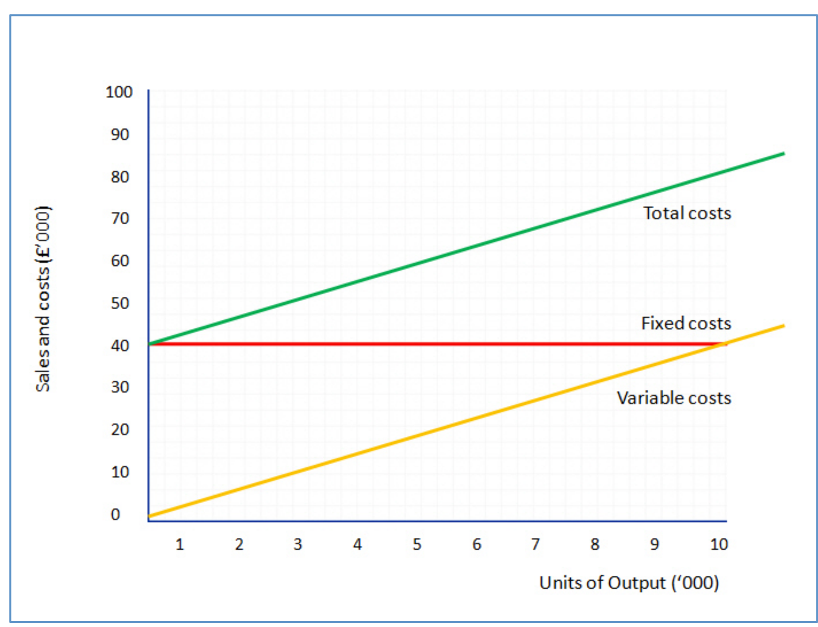
Step 3
Next we add the variable costs. We assume that variable costs vary directly with output. In our example, the variable cost per unit is £4. So variable costs for 1,000

units will be £4,000, and at 5,000 units they will be £20,000. Remember that you only need to plot a couple of points to be able to draw the straight line (in yellow below).



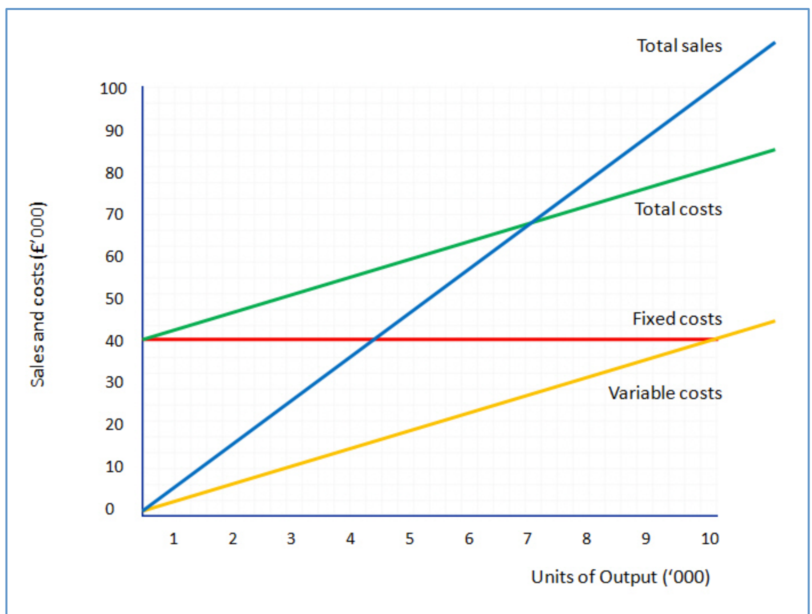
Step 4

Next step is to add the variable costs to the fixed costs for each level of output. This is important. Remember that to calculate break-even we need to know total costs. The total cost line is shown in green on the chart.



Step 5

Having dealt with costs, we can now draw the line for total sales. Remember that we assume that all output is sold for the same selling price (in this case - £10 per unit). So total sales for 2,000 units will be £20,000; 10,000 units will make £100,000 of sales. The total sales line is drawn in blue below.



Step 6

Almost there! The last step is to use these lines to identify certain information from the chart.

First, the break-even output. Remember this is the point where total sales = total costs. So the output is the point where the total sales line crosses the total costs line (e.g. where the blue line crosses the green line). Find this point on the chart and then follow a vertical line down to the output (horizontal) axis. You can see this brings us to 6,666 (approximately, since our chart isn't drawn perfectly to scale!).

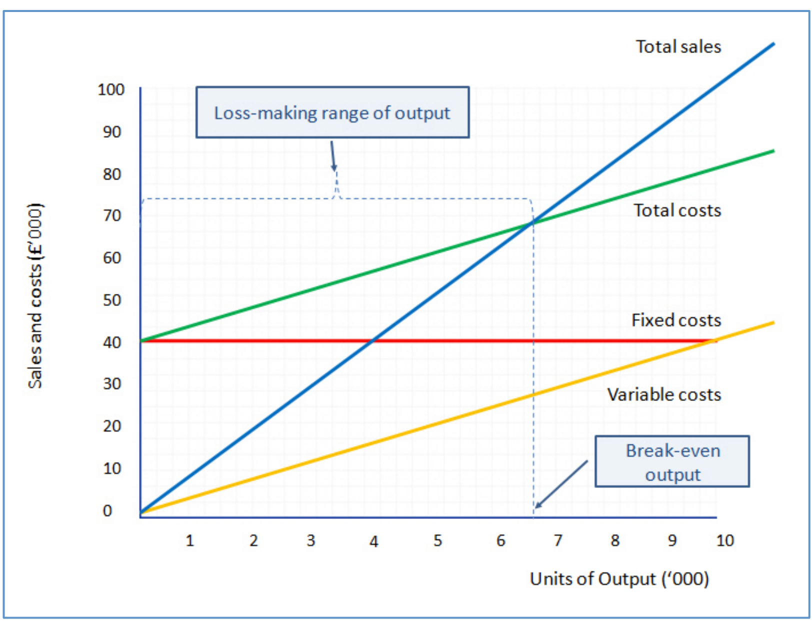
Another thing you can notice from the chart is the over a range of output, total costs are higher than total sales (green line higher than the blue line). That means that in this range, the business is making losses. This is the **loss-making range of output**.

If the actual output is more than the break-even output, the business will be making a profit. In our example, any output more than 6,666 units will mean profits are earned.

The difference between the actual output and the break-even output is known as the **"margin of safety".** For example, if actual output were 8,000 units, then the margin of safety = 8,000 units less 6,666 units = 1,334 units.

Topic: Breakeven Analysis

Theme 2: Section 2.2 Financial Planning



More on the Margin of Safety

The margin of safety is an important concept in breakeven analysis. The margin of safety is the difference between actual output and the breakeven output. A worked example of how it is calculated is shown below.

	DATA
Selling price per unit	£10
Variable cost per unit	£4
Contribution per unit	**£6**
Fixed costs per period	£12,000
Actual output	3,500 units
Breakeven output	**2,000 units**
MARGIN OF SAFETY	**1,500 units**

Changes to Breakeven

We have looked at three approaches to calculating break-even output using the same information. The next stage is to consider what happens to break-even if the data changes. The best way to see the effect of these changes is to work through some calculations. However, here is a simple summary you might find helpful:

Change	Effect on Contribution per Unit	Effect on Breakeven Output
Higher selling price	Higher	Lower
Lower selling price	Lower	Higher
Higher variable cost per unit	Lower	Higher
Lower variable cost per unit	Higher	Lower
Increase in fixed costs	No change	Higher
Decrease in fixed costs	No change	Lower

Topic: Breakeven Analysis

Theme 2: Section 2.2 Financial Planning

Strengths and Limitations of Breakeven Analysis

These can be summarised as follows:

Strengths	Limitations
Focuses on what output is required before a business reaches profitability	Unrealistic assumptions – products are not sold at the same price at different levels of output; fixed costs do vary when output changes
Helps management & finance-providers better understand the viability and risk of a business or business idea	Sales are unlikely to be the same as output – there may be some build up of stocks or wasted output too
Margin of safety calculation shows how much a sales forecast can prove over-optimistic before losses are incurred	Variable costs do not always stay the same. For example, as output rises, the business may benefit from being able to buy inputs at lower prices (buying power)
Illustrates the importance of keeping fixed costs down to a minimum	Most businesses sell more than one product
Calculations are quick and (relatively) easy	A planning aid rather than a decision-making tool

Key Terms

Contribution	The difference between total revenues and total variable costs
Contribution per unit	The difference between selling price per unit and variable cost per unit
Margin of safety	The difference between actual output and breakeven output
Breakeven output	The output at which total revenues = total costs

Topic: Budgeting

Theme 2: Section 2.2 Financial Planning

What You Need to Know

- Purpose of budgets
- Types of budget:
- Historical figures
- Zero based
- Variance analysis
- Difficulties of budgeting

Introduction

A budget is **financial plan for the future concerning the revenues and costs of a business.**

The preparation of budgets is an important business process:

- The process by which financial control is exercised in a business
- Budgets for revenues and costs are prepared in advance and then compared with actual performance to establish any variances
- Managers are responsible for controllable costs within their budgets
- Managers take remedial action if the adverse variances are regarded as excessive

Budgets of various kinds have many uses in business, particularly as the business grows, becomes more complex and the organisational structure becomes more complicated. Some key uses of budgets in business include:

Establish priorities & set targets	Delegate without loss of control
Turn objectives into practical reality	Motivate staff
Provide direction and co-ordination	Improve efficiency
Assign responsibilities	Forecast outcomes
Allocate resources	Monitor performance
Communicate targets	Control income and expenditure

Principles of Effective Budgeting

For budgeting to work effectively as a management process, the following principles need to apply:

- Managerial responsibilities are clearly defined
- Managers have a responsibility to adhere to their budgets
- Performance is monitored against the budget
- Corrective action is taken if results differ significantly from the budget
- Unaccounted for variances are investigated
- Departures from budgets are permitted only after approval from senior management

Two Main Approaches to Budgeting

There are traditionally two main approaches to budgeting – historical and zero-based. These are summarised below.

Topic: Budgeting

Theme 2: Section 2.2 Financial Planning

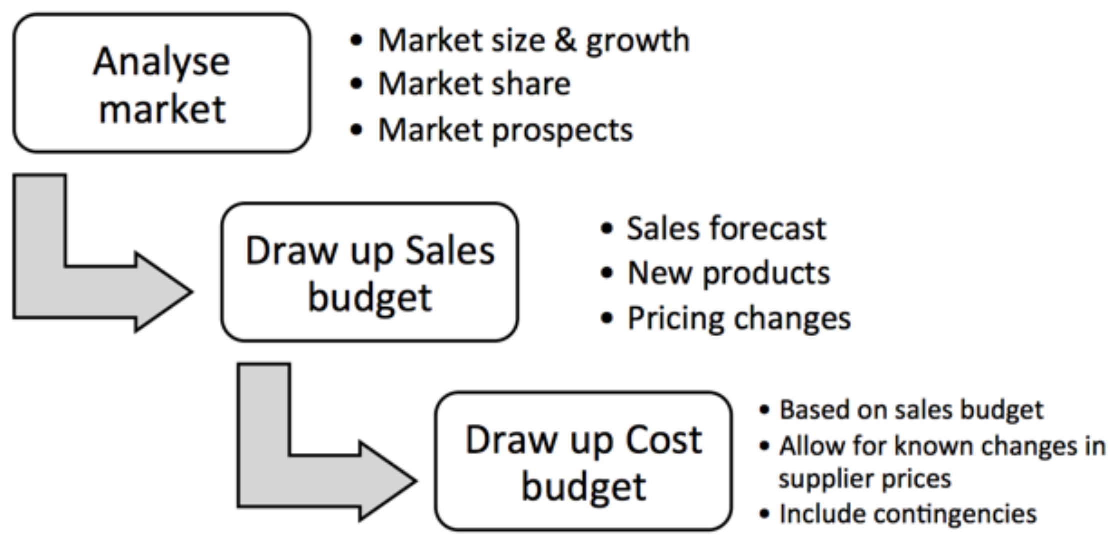
HISTORICAL BUDGETING	ZERO BUDGETING
• Use last year's figures as the basis for the budget • Realistic in that it is based on actual results • However, circumstances may have changed (e.g. new products, lost customers, credit crunch) • Does not encourage efficiency	• Budgeted costs & revenues are set to zero • Budget is based on new proposals for sales and costs – i.e. built from the bottom-up • Makes budgeting more complicated and time-consuming, but potentially more realistic

Three Main Types of Budget

The three most common types of budget in business are the revenue, cost and profit budgets. These are summarised below:

Type of Budget	What is Included
Revenue (or income) budget	Expected revenues & sales Broken down into more detail (products, locations, etc.)
Cost (or expenditure) budget	Expected costs based on sales budget Overheads and other fixed costs
Profit budget	Based on the combined sales and cost budgets Of great interest to stakeholders May form basis for performance bonuses

The diagram below illustrates how the profit budget is produced. Importantly it needs to be based on an informed analysis of the competitive (market) position of the business. The profit budget then flows from the revenue and cost budgets.



Topic: Budgeting

Theme 2: Section 2.2 Financial Planning

Budgetary Accuracy

A budget is only as accurate and useful as the quality of the information used to produce it!

Various sources of information are typically used to inform the budgeting process: for example;

- **Financial performance in previous periods**
  - Particularly for established businesses
  - Lots of relevant data likely to be available
- **Market research**
  - Trends in market size, growth, segmentation, product life cycles
  - Competitor activity
  - Customer feedback

The main difficulties in budgeting accurately usually arise because of the challenges of forecasting revenues and costs:

Sales Forecasting	Costs
• Harder when market experiences rapid change (e.g. new technology) • Start-up firms find it hard to estimate likely sales and revenues • Competitor actions difficult to predict	• Always likely to be unexpected costs • Will vary depending on the sales budget • Changes in external environment will impact costs (e.g. taxes, exchange rates

Variance Analysis

Variance analysis involves calculating and investigating the differences between actual results and the budget.

Variances can be either:

- **Positive/favourable** (better than expected) or
- **Adverse/unfavourable** (worse than expected)

A **favourable variance** might mean that:

- Costs were lower than expected in the budget, or
- Revenue/profits were higher than expected

By contrast, an **adverse variance** might arise because:

- Costs were higher than expected
- Revenue/profits were lower than expected

Should variances be a matter of concern to management? After all, a budget is just an estimate of what is going to happen rather than reality. The answer is – it depends. The significance of a variance will depend on factors such as:

- Whether it is positive or negative – adverse variances (negative) should be of more concern

- Was it foreseen?
- Was it foreseeable?
- How big was the variance - absolute size (in money terms) and relative size (in percentage terms)?
- The cause
- Whether it is a temporary problem or the result of a long term trend

Example of Variance Analysis
Consider the following budget statement:

	Budget £'000	Actual £'000	Variance £'000	Favourable or Adverse
SALES REVENUE				
Standard product	75	90	15	F
Premium product	30	25	-5	A
Total sales revenue	**105**	**115**	**10**	**F**
COSTS				
Wages	35	38	3	A
Rent	15	17	2	A
Marketing	20	14	-6	F
Other overheads	27	35	8	A
Total costs	**97**	**104**	**7**	**A**
Profit	**8**	**11**	**3**	**F**

What do the numbers in the budget statement tell us?

- Looking at the sales revenue section, you can see that actual sales of standard product were £15k higher than budget – this is a positive (favourable) variance.
- Turning to the costs section, actual wages were £3k higher than budget – i.e. an adverse (negative) variance.
- Overall, the profit variance was positive (favourable) – i.e. better than budget

Problems and Limitations of Using Budgets
Whilst budgets are widely used to in business, you should appreciate that they have some important limitations. In particular, budgets

- Are only as good as the data being used to create them. Inaccurate or unreasonable assumptions can quickly make a budget unrealistic
- Can lead to inflexibility in decision-making
- Need to be changed as circumstances change
- Can take significant time to prepare – in large businesses, whole departments are sometimes dedicated to budget setting and control
- Can result in short term decisions to keep within the budget rather than the right long term decision which exceeds the budget

- Managers can become too preoccupied with setting and reviewing budgets and forgetting to focus on the real issues of winning customers

Budgets can also create some behavioural challenges in a business
- Budgeting has behavioural implications for the motivation employees
- Budgets are de-motivating if they are imposed rather than negotiated
- Setting unrealistic targets adds to de-motivation
- Budgets contribute to departmental rivalry - battles over budget allocation
- Spending up to budget: it can result in a "use it or lose it" mentality - spend up to the budget to preserve it for next year
- Budgetary slack occurs if targets are set too low
- A "name, blame and shame" culture can develop - but managers should be answerable only for variations that were under their control

Key Terms

Budget	Financial plan for the future concerning the revenues and costs of a business
Variance analysis	Calculating and investigating the differences between actual results and the budget
Historical budget	Budget initially based on the figures from the previous period (year)
Zero-based budget	Budget built entirely from the bottom up with completely new assumptions
Positive variance	Actual result is better than budget
Adverse variance	Actual result is worse than budget

Topic: Profit

Theme 2: Section 2.3 Managing Finance

What You Need to Know

- **Calculation of:**
- *Gross profit*
- *Operating profit*
- *Profit for the year (net profit)*
- **Measuring profitability:**
- *Calculation of gross profit margin, operating profit margin, and profit for the year (net profit) margin*
- Ways to improve profitability
- Distinction between profit and cash

Introduction to Profit

The calculation is profit is straightforward.

Profit = Total Sales less Total Costs

A simple example of this profit calculation formula is shown below:

Sales	Costs	Profit or Loss?
£100,000	£75,000	£25,000 (profit)
£100,000	£125,000	£25,000 (loss)
Total sales > total costs Total costs > total sales Total sales = total costs		= Profit = Loss = Breakeven

An example of how profit can change as revenues grow is shown in the table below:

Total Revenues	Total Costs	Profit or (Loss)
£	**£**	**£**
10,000	15,000	(5,000)
20,000	20,000	Nil
30,000	25,000	5,000
40,000	30,000	10,000
50,000	35,000	15,000

Profit can be measured in both absolute terms (how much) and relative terms (profit as a percentage):

- **Profit in <u>absolute</u> terms**
  - The £ value of profits earned
  - E.g. £50,000 profit made in the year
- **Profit in <u>relative</u> terms**
  - The profit earned as a proportion of sales achieved or investment made
  - E.g. £50,000 profit from £500,000 of sales is a profit margin of 10%
  - E.g. £50,000 profit from an investment of £1 million = a 5% return on investment

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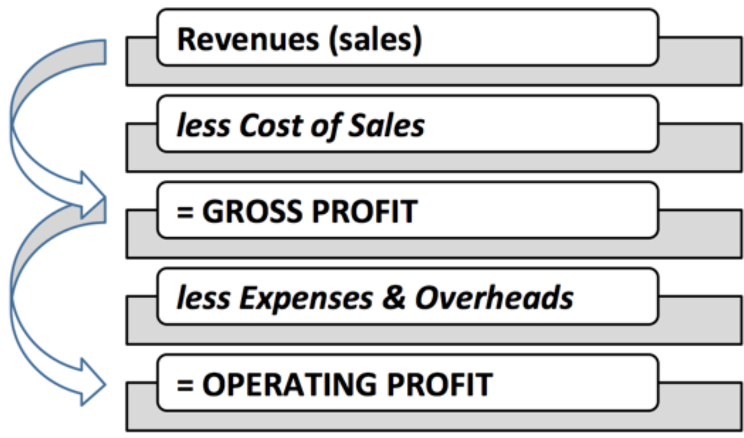
Topic: Profit

Theme 2: Section 2.3 Managing Finance

Investigating Profit in More Detail

The profit that arises from the operations of a business can be analysed in more detail as illustrated in diagram below. We'll explore this breakdown in more detail below.



Introduction to Ratio Analysis

Ratio analysis involves looking at the relationships between financial data to assess the performance of a business. Ratio analysis is particularly useful when it comes to understanding how profitable a business is and how profit might be improved.

Profitability ratios provide some really useful insights into business performance:

- Is the business making a profit? Is profit growing?
- How efficient is the business at turning revenues into profit?
- Is the profit enough to justify investment in the business?
- How does the profit achieved compare with the rest of the industry?

We'll look in more detail at two key profitability ratios:

- Gross profit margin
- Operating profit margin

Gross Profit Margin

The table below illustrates an example of how to calculate gross profit margin:

£'000	**2014**	**2015**	**2016**
Revenue	250	325	400
Cost of Sales	150	186	225
Gross Profit	**100**	**139**	**175**
Gross margin	40.0%	42.8%	43.8%

In the calculations above we use two important formulae:

Topic: Profit

Theme 2: Section 2.3 Managing Finance

Gross profit = revenue less cost of sales

Gross margin (%) = gross profit / revenue

Operating Profit

Operating profit is what is left after all the costs of a business have been taken from its revenues.

The operating profit margin expresses operating profit as a percentage of revenues using the formula:

Operating profit margin (%) = Operating Profit (£) / Total Revenues (£)

An example of this is shown in the table below:

	£'000
Revenues	**150**
Wages	(50)
Energy costs	(25)
Marketing	(15)
Other overheads	(30)
OPERATING PROFIT	**30**
Operating profit margin	*20%*

The operating profit margin (%) is a very useful ratio. It helps tell us:

- How effectively a business turns its sales into profit
- How efficiently a business is run
- Whether a business is able to "add value" during the production process (a high margin business must be doing something right!)

Comparing Operating Profitability with Other Businesses

The operating profit margin of a business can be compared with other competitors in the same market, and over time, to provide useful insights.

Take the following data as an example:

	Company A £'000	**Company B £'000**	**Company C £'000**
Sales	150	250	500
Operating profit	50	25	125
Operating profit margin	20%	10%	25%

In the table above:

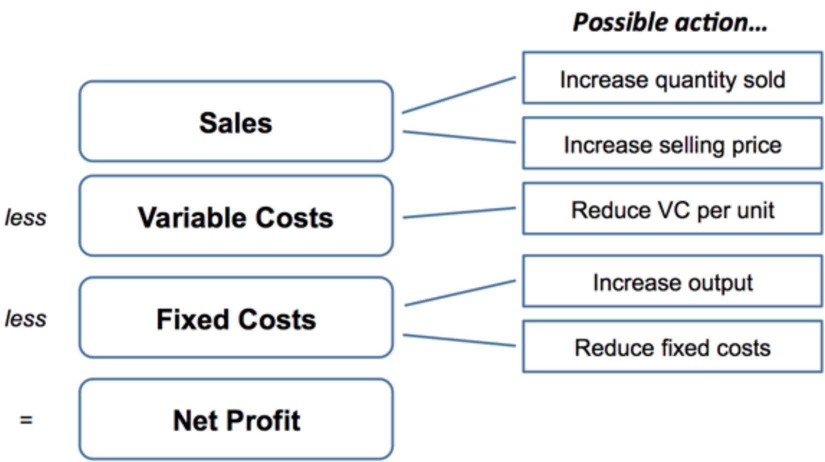
- Company A makes a higher operating profit than Company B even though its sales are lower – because it has a higher operating profit margin
- Company C makes the highest operating profit margin of these three & also the highest sales. So it makes the largest operating profit too!

Topic: Profit

Theme 2: Section 2.3 Managing Finance

How to Improve Profit

A useful way of thinking about the ways a business can improve its profit is by returning to the components of profit. The diagram below illustrates the simple ways profit might be increased:



Let's look at each of these possible actions in turn:

Increase the Quantity Sold (Higher Sales)

Why?	Higher sales volumes = higher sales, assuming that the selling price is not lowered Makes better use of production capacity (i.e. fixed costs should not rise) May result in higher market share
Will it work?	Depends on elasticity of demand Sales value may actually fall if price has to be reduced to achieve higher sales volumes Does business have capacity to sell more?
Why it might not work	Competitors are likely to respond Marketing efforts may fail – e.g. promotional campaign does not generate results Fixed costs might actually rise – e.g. higher marketing

Increase Selling Prices (Higher Sales)

Why?	Higher selling price = higher sales (assuming quantity sold does not fall in response) Maximises value extracted from customers Customers may perceive product as higher quality No need for extra production capacity
Will it work?	Depends on price elasticity of demand Sales value may actually fall price rise is matched by an even bigger fall in quantity sold It will work if customers remain loyal and still perceive product to be good value

Why it might not work	Competitors are likely to respond (e.g. prices lower) Customers may decide to switch to competitors

Reduce Variable Costs per Unit (Lower Cost of Sales = Higher Gross Margin %)

Why?	Increase the value added per unit sold Higher profit margin on each item produced and sold Customers do not notice a change in price
Will it work?	Yes, if suppliers can be persuaded to offer better prices Yes, if quality can be improved through lower wastage Yes, if operations can be organised more efficiently
Why it might not work	Lower input costs might mean lower quality inputs – which can lead to greater wastage Customers may notice a decrease in product quality

Increase Production Output (Spread Fixed Costs over Higher Output)

Why?	Provides greater quantity of product to be sold Enables business to maximise share of market demand Spreads fixed costs over a greater number of units
Will it work?	Yes, if the extra output can be sold (e.g. finding a new market, offering a lower price for a more basic product) Yes, if the business has spare capacity
Why it might not work	A dangerous option – what if the demand is not there? Fixed costs might actually rise (e.g. stepped fixed costs) Production quality might be compromised (lowered) in the rush to produce more

Reduce Fixed Costs (Lower Costs = Higher Profit)

Why?	A drop in fixed costs translates directly into higher profits Reduces the break-even output Often substantial savings to be made by cutting unnecessary overheads
Will it work?	Yes, provided costs cut don't affect quality, customer service or output A business can nearly always find savings in overheads
Why it might not work	Might reduce ability of business to increase sales Intangible costs – e.g. lower morale after making redundancies

More Complex Approaches to Increasing Profit
Two other ways a business might look to improve profit could be:

Reduce product range
- Business often has too many products = complex operations & inefficiency
- Some products may be very low-margin or even loss-making

Outsource non-essential functions
- A way of reducing fixed costs

Topic: Profit

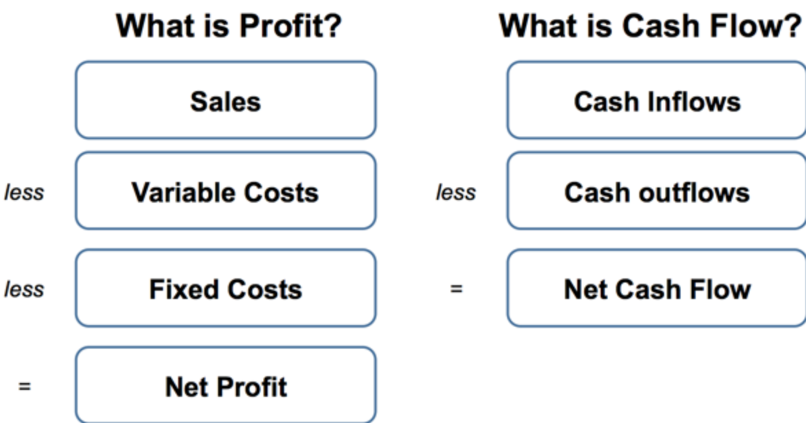
Theme 2: Section 2.3 Managing Finance

- Focus the business on what it is good at
- Areas to outsource: e.g. IT, call handling, finance

The Difference between Profit and Cash Flow

An important distinction needs to be made between profit and cash flow. They are similar concepts – but not quite the same!

Profit	The difference between total revenues and total costs over a period
Cash Flow	The difference between total cash inflows and total cash outflows over a period



Profit and cash flow are linked as follows

- Profits are the main source of funds for an established business
- Revenues eventually turn into cash inflows
- Costs eventually turn into cash outflows

However, cash flow differs from profit in the following ways:

- **Timing differences**
  - Sales to customers made on credit
  - Payments to suppliers
- **The way fixed assets are accounted for**
  - Payment for fixed asset = cash outflow
  - Cost of fixed asset = treated as an asset not a cost
  - Depreciation is charged as cost when the value of fixed assets is reduced
- **Cash flows arising from the way the business is financed**
  - Inflows from shareholders, bank loans, factoring etc.
  - Repayments of amounts loaned
  - Payment of dividends

The table below provides some more detailed examples of how business transactions have different effects on profit and cash flow:

Topic: Profit
Theme 2: Section 2.3 Managing Finance

Transaction Example	What happens to Profit?	What happens to Cash Flow?
Customer buys goods for £50,000 on 60 days credit	Sales of £50,000 are recognised immediately	Cash inflow of £50,000 when the customer actually pays
Marketing campaign costing £10,000 ordered from marketing agency	Cost of £10,000 included in marketing costs	Cash outflow of £10,000 when the marketing agency is paid
New factory machinery bought for £150,000	No effect. £150,000 added to the value of fixed assets	Cash outflow of £150,000 paid to supplier of machinery
Depreciation charge of £100,000 to reflect use of factory fixed assets	Depreciation of £100,000 included as a cost	No effect on cash flow

Key Terms / Formulae

Revenues (Sales)	Selling price per unit x Quantity sold
Costs	Fixed costs + variable costs
Profit	Total revenues less total costs
Gross Profit	Total revenues less cost of sales
Operating Profit	Gross profit less overheads
Profit for the Year	Operating profit less finance costs and taxation

Topic: Liquidity

Theme 2: Section 2.3 Managing Finance

What You Need to Know

- Statement of financial position (balance sheet)
- Measuring liquidity: calculating current ratio and acid test ratio
- Ways to improve liquidity
- Working capital and its management: the importance of cash

Statement of Financial Position

The statement of financial position (also commonly known as the **"balance sheet")** is one of the three main financial statements of a business. These are:

Income statement	This measures the business' **performance** over a given period of time, usually one year. It compares the income of the business against the cost of goods or services and expenses incurred in earning that revenue
Statement of Financial Position	This is a **snapshot** of the business' assets (what it owns or is owed) and its liabilities (what it owes) on a particular day - usually the last day of the financial year
Cash flow statement	This shows how the business has generated and disposed of cash and liquid funds during the period under review.

Measuring Liquidity

Liquidity assesses whether a business has **sufficient cash or equivalent current assets to be able to pay its debts as they fall due.**

There are two commonly used ratios that can help assess the liquidity position of a business:

- Current ratio
- Acid-test ratio

Current ratio

This is calculated from information in the Statement of Financial Position using the following formula:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

For example:

Current assets = £6,945k Current liabilities = £3,750k Current ratio = 1.85

Evaluating the current ratio:

- Interpreting the results

  - Ratio of 1.5-2.0 would suggest efficient management of working capital
  - Low ratio (e.g. below 1) indicates cash problems
  - High ratio: too much working capital?
- Look out for
  - Industry norms (e.g. supermarkets operate with low current ratios because they low debtors)
  - Trend (change in ratio) is perhaps most important

Acid-test ratio

This is also calculated from information in the Statement of Financial Position, using the following formula:

$$\text{Acid-test ratio} = \frac{\text{Current assets less stocks}}{\text{Current liabilities}}$$

For example:

Current assets less stocks = £5,620k Current liabilities = £3,750k Acid test ratio = 1.50

Evaluating the acid-test ratio:

- Interpreting the results
  - A good warning sign of liquidity problems for businesses that usually hold stocks
  - Significantly less than 1 is often bad news
- Look out for
  - Less relevant for business with high stock turnover
  - Trend: significant deterioration in the ratio can indicate a liquidity problem

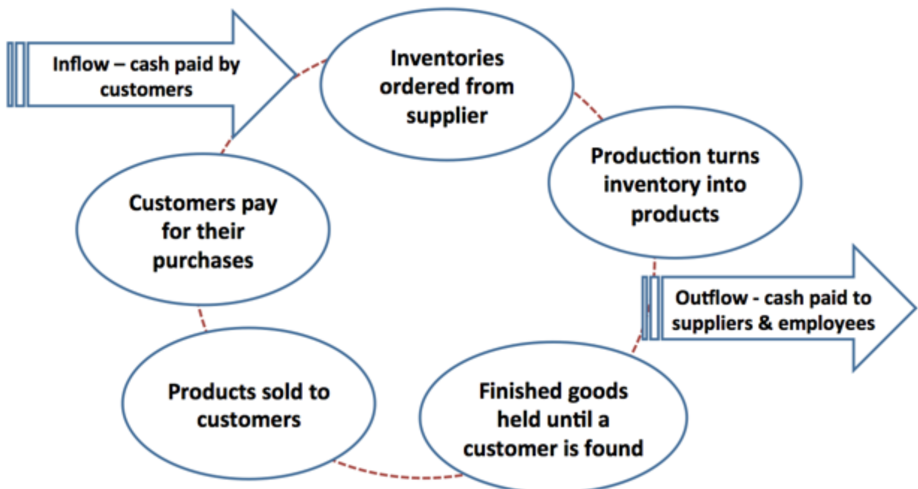
Managing Cash Flow

Producing cash flow forecasts is just one part of effective cash flow management.

Cash flow management is a crucial day-to-day activity for every business, in particular to avoid cash flow problems.

As cash flows around a business (see the diagram below) it is quite common for cash flow problems to arise.

Topic: Liquidity
Theme 2: Section 2.3 Managing Finance



The most common cash flow problems are summarised below:

Cause of Cash Flow Problem	Comments
Low profits or (worse) losses	• The main underlying cause of cash flow problems, particularly over the long-term • Profit is the most important source of finance • Lack of profit is the cause of business failure
Too much production capacity	• Spending too much on fixed assets • Made worse if short-term finance is used (e.g. bank overdraft) • Fixed assets are hard to turn back into cash in the short-term
Excess inventories held	• Excess stocks tie up cash • Increased risk that stocks become obsolete • But... • There needs to be enough stock to meet demand • Bulk buying may mean lower purchase prices
Allowing customers too much credit & too long to pay	• Customers who buy on credit are called "**trade debtors**" • Offer credit = good way of building sales • But... • Late payment is a common problem • Worse still, the debt may go "bad"
Overtrading – growing the business too fast	• Where a business expands too quickly, putting pressure on short-term finance • Classic example – retail chains – Keen to open new outlets – Have to pay rent in advance, pay for shop-fitting, pay for stocks – Large outlay before sales begin in new store • Businesses that rely on long-term contracts also at high risk of overtrading
Seasonal demand	• Where there are predictable changes in demand & cash flow • Production or purchasing usually in advance of seasonal peak in demand = cash outflows before inflows • This can be managed – cash flow forecast should allow for seasonal changes

Topic: Liquidity

Theme 2: Section 2.3 Managing Finance

The key to managing cash flow problems lies in:

- Regular and reliable cash flow forecasting
- Managing working capital
- Having sufficient and suitable sources of finance

You look at sources of finance as a separate topic and we've already looked at cash flow forecasting. So let's now look at **managing working capital.**

Managing Working Capital
Effective management of working capital involves focusing on:

Debtors	Amounts owed by customers
Creditors	Amounts owed to suppliers
Inventories (or stocks)	Cash tied up in raw materials, work in progress and finished goods

Improving Cash Flow from Debtors

Key points to remember are:

Effective Credit control

- Policies on how much credit to give and repayment terms and conditions
- Measures to control doubtful debtors
- Credit checking

Offer cash discounts for prompt payment
Improve record keeping – e.g. accurate and timely invoicing
Potentially use debt factoring

What is debt factoring?

- The selling of debtors (money owned to the business) to a third party
- This generates cash
- It guarantees the firm a percentage of money owed to it
- But will reduce income and profit margin made on sales
- Cost involved in factoring can be high

Improving Cash Flow from Creditors

Key points to remember are:

- Trade credit - amounts owed to suppliers for goods supplied on credit and not yet paid for
- Delayed payment means that a business retains cash longer
- But - have to be careful not to damage firm's credit reputation and rating
- Trade creditors are seen (wrongly) as a "free" source of capital
- Some firms habitually delay payment to creditors in order to enhance their cash flow - a short-sighted policy and raises ethical issues

Topic: Liquidity

Theme 2: Section 2.3 Managing Finance

Improving Cash Flow from Inventory (Stocks)

Key points to remember are:

- Inventory refers to goods purchased and awaiting use or produced and awaiting sale
- Inventories take the form of raw materials, work-in-progress and finished goods
- Stockholding is costly and therefore it is sound business to:
    - keep smaller balances (just in time stocks)
    - computerise ordering to improve efficiency
    - improve stock control
- This will cut down the spending on stock but may leave the business vulnerable to stock outs

Key Terms

Current ratio	A liquidity ratio calculated by dividing current assets by current liabilities
Acid-test ratio	A liquidity ratio calculated by dividing current assets (excluding stocks) by current liabilities
Working capital	The cash tied up by a business in inventories held and amounts owed by customers, less amounts owed to creditors
Credit control	The management of amounts owed on credit by the customers of a business
Debt factoring	Selling the rights to collect amounts owed by customers in order to release cash flow

Topic: Business Failure

Theme 2: Section 2.3 Managing Finance

What You Need to Know
• Internal and external causes of business failure:
• *financial factors*
• *non-financial factors*

High Failure Rate of New Businesses

The highest rate of business failure is amongst new businesses (start-ups). It should be pretty obvious why this is the case:

- Difficult to test a business model without trading
- Easy to be over-optimistic in the business plan
- Competitor response is often aggressive
- Management may lack experience

Among the most common reasons why new businesses fail so frequently are:

- **No demand for the business idea**
  - Poor market research & unrealistic plan
  - Competitor response
  - Just a bad idea – was doomed to fail!
- **Good idea, but poorly executed**
  - Wrong people; poor management
  - Growth is too quick (overtrading) or too slow
  - Failure to manage cash flow
  - A competitor grabs the good idea and does it better
- **External shocks**
  - Economic change
  - Legal & social change

Why Do Established Businesses Fail?

The main reasons why established businesses fail can be grouped into:

Financial Reasons	Non-Financial Reasons
• Poor management of cash flow • Inadequate or inappropriate financing	• Lack of management control • Significant external shock

The key points to remember about each of the four reasons above are:

Evidence of poor management of cash flow:

- Significant increases in stock levels
- Inadequate credit control
- Bad debts incurred
- Poor accounting practices including late invoicing
- Inaccurate forecasting by management
- Failure to plan for significant capital and/or exceptional expenditure

Topic: Business Failure

Theme 2: Section 2.3 Managing Finance

Evidence of inadequate or inappropriate financing:

- Use of short term overdrafts for long term investment or capital spending
- Failure to use debt factoring when sales are substantially increasing
- Inadequate shareholder capital all contribute to cash flow problems
- These problems will become more pronounced when a substantial difficulty such as a major bad debt, loss of a major customer or business interruption occurs

Evidence of lack of management control:

- Failure to develop a credible business plan
- Failure to understand costs, markets and key customers
- Failure to administer the business properly
- Caught be surprise by significant illegality or unethical behaviour leading to substantial business costs
- Excessive marketing expenditure

Evidence of significant external shocks

- Loss of important / major customer (particularly if costs cannot be reduced)
- Sudden decline in market demand
- Change in legislation impacting demand or increasing costs

Key Terms

Management control	The systems and processes that enable a business to be effectively managed, such as decision-making, management authority and financial planning
External shock	A change in the external business environment that significantly impacts a business

Topic: Production, Productivity & Efficiency

Theme 2: Section 2.4 Resource Management

What You Need to Know
- **Methods of production:**
- *Job, Batch, Flow, Cell*
- **Productivity:**
- *Output per unit of input per time period:*
- *Factors influencing productivity*
- *Link between productivity and competitiveness*
- **Efficiency:**
- *Production at minimum average cost:*
- *Factors influencing efficiency*
- *Distinction between labour and capital intensive production*

Methods of Production

There are several methods of production, each with their own suitability, benefits and drawbacks. The methods we'll cover briefly here are:

- Job production
- Batch production
- Flow production
- Cell production

The key points you need to remember for each method are summarised below.

Job Production

Key features:

- One-off or small number of items produced
- Normally made to customers specifications (e.g. wedding cake or building project)
- Often undertaken by small, specialist businesses
- Examples:
  - Architects
  - Plumbers
  - Ship builders
  - Road builders

Advantages of Job Production	Disadvantages of Job Production
Customer requirements and changes can be handled	Individual cost of one unit may be high
Associated with higher quality	Often labour-intensive = high labour costs
Employees can be better motivated – more job satisfaction	Requires close consultation with the client
A flexible production method	Usually reliant on high skills

Batch Production

Key features:

- What is involved
  - Similar items are produced together
  - Each batch goes through one stage of production process before moving onto next stage
- Aims
  - Concentrate skills
  - Achieve better use of equipment and so produce good quality products more economically than manufacturing them individually

Advantages of Batch Production	Disadvantages of Batch Production
Cost savings can be achieved by buying in bulk	Takes time to switch production of one batch to another
Still allows customers some choice	Requires the business to maintain higher stocks of raw materials and work-in-progress
Products can be worked on by specialist staff or equipment at each stage	Tasks may become boring (repetitive) – reducing motivation
Allows a firm to handle unexpected orders	Size of batch dependent on capacity allocated

Flow Production

Key features:

- Associated with making high volumes of the same product
- Product moves continuously through production process
- When one task is finished next task must start immediately
- Therefore, time taken on each task must be same

Advantages of Flow Production	Disadvantages of Flow Production
Costs per unit of production reduced through improved work and material flow	Very long set up time & reliant on high quality machinery
Suitable for manufacture of large quantities	High raw materials and finished stocks unless lean production used
Capital intensive which means it can work constantly	Goods are mass produced – less differentiation for the customer
Less need for training & skills	Production is shut down if flow is stopped

Cell Production

Key features:

- Work is organised into teams who work together in a cell
- Teams are given responsibility of doing a part of production process as product moves through assembly line.
- Cell production often leads to improved productivity due to:

- Increased motivation (team spirit and added responsibility)
- Specialisation

Which Method of Production is Best for a Growing Firm?
Don't assume that flow production is best for a growing or large firm. It depends on factors such as:

- **Target market** – e.g. does customer demand product options?
- **Technology** – can some or all production be automated?
- **Resources** – does the business have finance & people to be able to use flow production?
- **Standards** – what quality is required?

How Do We Measure Productive Efficiency in a Business?
Three approaches to assessing how efficiently a business operates are to look at:

- **Productivity**
    - This measures the relationship between inputs into the production process and the resultant outputs.
    - Examples:
        - Output per worker or hour of labour
        - Output per hour / day / week
        - Output per machine
- **Unit costs**
    - As we'll see below to get unit costs, divide total costs by the number of units produced. A falling ratio would indicate that efficiency was improving
- **Non-productive ("idle") resources**
    - Which resources are used by a business? Are employees often left with nothing to do? Are machines only used for part of available time? Too many idle resources are a common sign of inefficiency in production

Unit Costs as a Measure of Efficiency and Productivity
Unit costs are a key indicator of the efficiency and productivity of a business. They are also critical to the profitability and competitiveness of many businesses.

The unit cost measures the **average cost per unit produced,** as measured over a particular time period (e.g. month, year).

Unit costs will vary over time and as the scale of a business' operation changes. Unit costs are particularly sensitive to the effect of significant operational scale and to the relationship between fixed and variable costs for a business.

Calculating Unit Costs
Average (or unit cost) is calculated using this formula:

$$\frac{\text{Total production costs in period (£)}}{\text{Total output in period (units)}}$$

Looking at an example of this calculation, the table below illustrates how unit costs (cost per unit) change as output increases. In the data used, it is assumed that fixed costs are £10,000 and variable costs are £100 per unit:

Output	Fixed Costs	Total Variable Costs	Total Costs	Cost per Unit
Units	£	£	£	£
50	10,000	5,000	15,000	300
100	10,000	10,000	20,000	200
150	10,000	15,000	25,000	166
200	10,000	20,000	30,000	150
250	10,000	25,000	35,000	140

Understanding how unit costs change as output changes – and over time – is very useful for a business.

So too is understanding how unit costs compare with the competition, since we know that unit costs are an important component of competitiveness.

In the exam table below, the unit costs of different businesses are shown. Business D has the lowest unit costs, perhaps because it operates at higher output – potentially benefitting from economies of scale.

Business	Output Units	Total Costs £	Unit Costs £
A	10,000	£50,000	£5
B	20,000	£80,000	£4
C	5,000	£30,000	£6
D	25,000	£75,000	£3
E	15,000	£75,000	£5

Economies of Scale

How you every wondered how IKEA can profitably sell flat-pack furniture at what seem impossibly low prices? The answer is – **economies of scale.** Scale economies have brought down the unit costs of production and have fed through to lower prices for consumers.

Most firms find that, as their production output increases, they can achieve lower costs per unit. This can be illustrated as follows:

Topic: Production, Productivity & Efficiency

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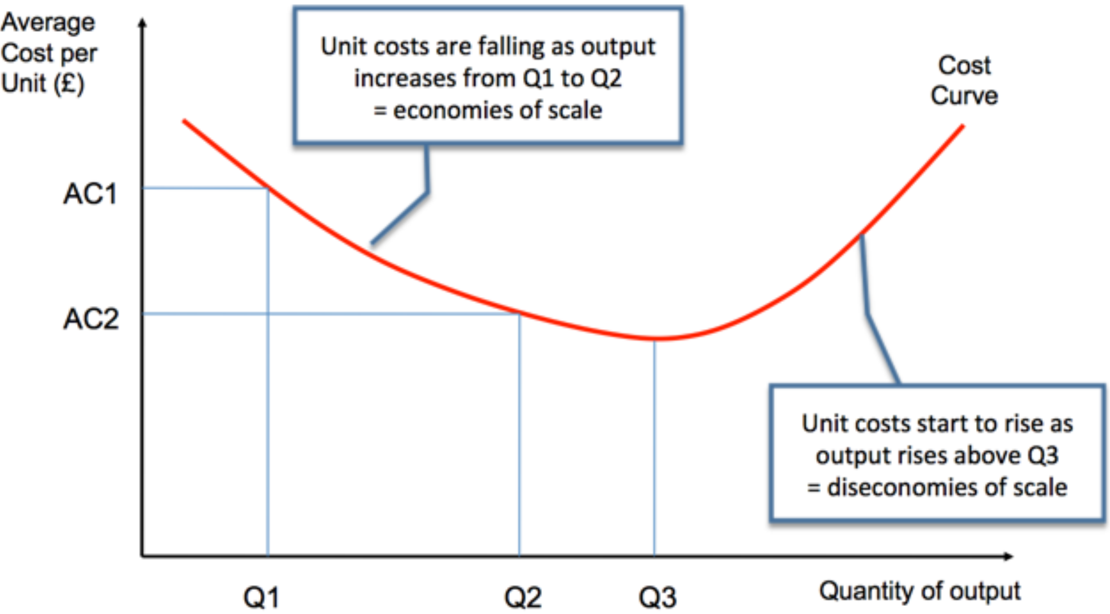

In the diagram above, you can see that unit costs fall from AC1 to AC2 when output increases from Q1 to Q2. That illustrates the effect of economies of scale – so what are they?

Economies of scale are the **cost advantages** that a business can exploit by expanding their scale of production. The effect of economies of scale is to reduce the average (unit) costs of production. There are many different types of economy of scale and depending on the particular characteristics of an industry, some are more important than others.

Internal economies of scale

Internal economies of scale arise from the growth of the business itself. Examples include:

Technical economies of scale

Large-scale businesses can afford to invest in expensive and specialist capital machinery. For example, a supermarket chain such as Tesco or Sainsbury's can invest in technology that improves stock control. It might not, however, be viable or cost-efficient for a small corner shop to buy this technology.

Specialisation of the workforce

Larger businesses split complex production processes into separate tasks to boost productivity. By specialising in certain tasks or processes, the workforce is able to produce more output in the same time.

Marketing economies of scale

A large business can spread its advertising and marketing budget over a large output and it can purchase its inputs in bulk at negotiated discounted prices if it has sufficient negotiation power in the market. A good example is the major grocery retailers who use their buying power when purchasing supplies from farmers and other suppliers.

Managerial economies of scale

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Large-scale manufacturers employ specialists to supervise production systems, manage marketing systems and oversee human resources.

External economies of scale
External economies of scale occur within an industry. Examples of external economies of scale include:

- Development of research and development facilities in local universities that several businesses in an area can benefit from
- Spending by a local authority on improving the transport network for a local town or city
- Relocation of component suppliers and other support businesses close to the main centre of manufacturing are also an external cost saving

Unit Costs and Resource Intensity
Unit costs are closely linked to the relationship between labour and capital in operations.

A **labour–intensive business** has a relatively high proportion of it costs related to the employment of people. By contrast, a **capital-intensive business** has relatively low labour costs, but high costs arising from the extensive use of equipment (e.g. machinery). Some examples of labour and capital intensive operations are:

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Labour intensive	Capital intensive
Food processing	Oil extraction & refining
Hotels & restaurants	Car manufacturing
Fruit farming	Web hosting
Hairdressing	Intensive arable farming
Coal mining	Transport infrastructure

The key implications for unit costs of labour and capital intensity can be summarised as follows:

Labour Intensive	Capital Intensive
Labour costs higher than capital costs	Capital costs higher than labour costs
Costs are mainly variable = lower breakeven output	Costs are mainly fixed = higher breakeven output
Firms benefit from access to sources of low-cost labour	Firms benefit from access to low-cost, long-term financing

The respective benefits and drawbacks of labour and capital intensity include:

Benefits of Labour Intensity	Drawbacks of Labour Intensity
Unit costs may still be low in low-wage locations	Greater risk of problems with employee/employer relationship
Labour is a flexible resource – through multi-skilling and training	Potentially high costs of labour turnover (recruitment etc.)
Labour at the heart of the production process – can help continuous improvement	Need for continuous investment in training

Benefits of Capital Intensity	Drawbacks of Capital Intensity
Greater opportunities for economies of scale	Significant investment
Potential for significantly better productivity	Potential for loss competitiveness due to obsolescence
Better quality & speed (depending on product)	May generate resistance to change from labour force
Lower labour costs	

Key Terms

Unit cost	The average cost per unit produced, as measured over a particular time period
Economy of scale	The effect of unit costs falling as output rises

Topic: Capacity Utilisation

Theme 2: Section 2.4 Resource Management

What You Need to Know
Meaning & importance of capacity
Calculation and interpretation of capacity utilisation
How to use capacity efficiently

Introduction to Capacity

The **capacity** of a business is a measure of how much **output** it can achieve in a given period. For example:

- A fast-food outlet may be able to **serve 1,000 customers per hour**
- A call-centre may be able to **handle 10,000 calls per day**
- A football stadium could seat no more than **45,000 fans at each match**
- A car production line may be able to complete **50,000 cars per year**

Capacity is therefore a measure of "potential" output. Of course, not every business will be able to operate to full potential; and sometimes a business will find demand so high that it does not have sufficient capacity.

Why Capacity is Important

How capacity is managed has a direct effect on the performance of a business. In order for a business to be able to meet **demand** from customers, it needs to have the **capacity** to do so. Having capacity enables orders to be met and revenues generated. However, a lack of capacity can have a damaging effect on business performance. For example, a restaurant will lose sales if customers turn away seeing all the tables full; a factory may lose an order if it is not able to produce the volume required for a possible order.

The Costs of Capacity

Since capacity is all about the **output a business can achieve**, it is easy to see what costs are involved in making that capacity available. The key costs of capacity are:

Equipment: e.g. production line

Facilities: e.g. building rent, insurance

Labour: wages and salaries of employees involved in production or delivering a service

There is an important link between capacity and unit costs, since unit costs are calculated using the actual output during a period. This link is a key concept called **capacity utilisation**.

Capacity Utilisation

Capacity utilisation measures the extent to which capacity is used during a specific period. For example:

- A frozen pizza production line might make 75,000 pizzas in a week compared with its capacity of 100,000 per week
- A beauty salon could complete 300 appointments in a month compared with a potential of 500 appointments per month.

Where both actual and potential output can be measured, capacity utilisation can be calculated and it is **expressed as a simple percentage** using this formula:

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Capacity utilisation = the percentage of total capacity that is actually being achieved in a given period
(Actual output / potential output) x100

Example of Capacity Utilisation Calculation
Kaur Components manufactures printed circuit boards for use in remote monitoring devices. Working a normal two-shift rota, the Kaur factory is capable of producing 150,000 circuit boards per month. In the latest month, actual output was 127,500 units. What was the capacity utilisation for that month?
Actual Output: 127,500 units
Potential Output (Capacity): 150,000 units
Capacity Utilisation = 127,5000 / 150,000 = 85%

Capacity utilisation is an important concept because:

- It is a useful measure of productive efficiency since it measures whether there are idle (unused) resources in the business;
- Average production costs tend to fall as output rises – so higher utilisation can reduce unit costs, making a business more competitive
- Businesses usually aim to produce as close to full capacity (100% utilisation) as possible in order to minimise unit costs
- A high level of capacity utilisation is required if a business has a high break-even output due to significant fixed costs of production

Reasons Why Businesses Operate Below Full Capacity

Most businesses have some **spare capacity** – i.e. they operate at below their capacity (i.e. less than100% capacity utilisation). This happens for a variety of reasons:

Reason	Example
Lower than expected market demand	A change in customer tastes
A loss of market share	Competitors gain customers
Seasonal variations in demand	Weather changes lead to lower demand
Recent increase in capacity	A new production line has been added
Maintenance and repair programmes	Capacity is temporarily unavailable

If a business operates **consistently at a low level of capacity utilisation,** this is likely to indicate potentially serious issues, particularly if production costs are mainly fixed and the business has a high break-even output. Persistently low levels of capacity utilisation are likely to result in the business having higher unit costs than other competitors that may therefore result in the business being less competitive.

Drawbacks of High Capacity Utilisation

Although there are benefits of operating at a high level of capacity utilisation, there are also possible drawbacks. Possible issues include:

- There is less time for productive equipment and facilities to be maintained and repaired, which may increase the likelihood that they break-down in the future;

- Employees involved in production are out under greater stress and pressure which can be counter-productive if, for example, they become demotivated or it contributes to an increase in absenteeism;
- Customer service may deteriorate if, for example, customers have to wait longer to be served or to receive their product
- A business is less likely to be able to respond to sudden or unexpected increases in demand

Options to Increase Capacity

What happens if a business finds itself with **excess demand** (i.e. it does not have enough capacity to meet demand). In such circumstances, what can it do to operate at higher than 100% normal capacity? Possible options might include:

- Increase workforce hours (e.g. extra shifts; encourage overtime; employ temporary staff)
- Sub-contract some production activities (e.g. assembly of components)
- Reduce time spent maintaining production equipment

Key Terms

Capacity	The potential output of a business measured in terms of units of output over a specific period
Capacity utilisation	The proportion (percentage) of a business' capacity that is actually being used over a specific period
Spare (excess) capacity	Where actual output is less than capacity
Excess demand	Where demand for a business' products or services is greater than the business capacity

Topic: Stock Control

Theme 2: Section 2.4 Resource Management

What You Need to Know
The types of stock held by businesses The need for stock holding and management Factors influencing how much stock is held Stock control charts

Introduction to Stocks

Stocks (also known as stocks) are the raw materials, work-in-progress and finished goods held by a firm to enable production and meet customer demand.

There are three main categories of stock:

Type of Stock	Description
Raw materials & components	Bought from suppliers Used in production process E.g. parts for assembly or ingredients
Work in progress	Semi or part-finished production E.g. construction projects
Finished goods	Completed products ready for sale or distribution E.g. products on supermarket shelves; goods in the ASOS and Amazon warehouses

Why Businesses Hold Stock

Depending on the nature of the business, there are several reasons why a business will want to hold stock:

What Stock Management and Control is Important

Stock management & control is a key part of a business operating efficiently:

- The business damage from stock-outs or having the wrong stock can be significant
- However, it is crucial to manage stock carefully as it often ties up a significant value of capital (cash) that could be used elsewhere in the business
- These days, stock management is much easier due to widely available IT systems

Main Influences on the Quantity of Stock Held

Topic: Stock Control

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How much stock should a business hold? The answer of course is – it depends. Key factors a business needs to consider are:

- **Need to satisfy demand**
  - Failure to have goods available for sale is very costly
  - Demand may be seasonal or unpredictable
- **Need to manage working capital**
  - Holding stocks ties up cash in working capital
  - There is an opportunity cost associated with stock holding
- **Risk of stock losing value**
  - Longer stocks are held, the greater risk that they cannot be used or sold

Costs of Holding Stock

A decision to hold stock involves more than just the cost of the stock itself. The overall cost of stock needs to take account of:

Cost	Explanation
Cost of storage	More stocks require large storage space and possibly extra employees and equipment to control and handle them
Interest costs	Holding stocks means tying up capital (cash) on which the business may be paying interest
Obsolescence risk	The longer stocks are held, the greater is the risk that they will become obsolete (i.e. unusable or not capable of being sold)
Stock out costs	A stock out happens if a business runs out of stock. This can result in: Lost sales & customer goodwill Cost of production stoppages or delays Extra costs of urgent, replacement orders

Stock-out costs can be particularly significant as it results in lost sales that may instead go to a competitor as well as the potential loss of customer goodwill and loyalty.

Stock Control Charts

The overall objective of stock control is to maintain stock levels to that the total costs of holding stocks is minimised. Stock control charts are a popular method of automating this process.

An example of a stock control chart is shown below:

Topic: Stock Control
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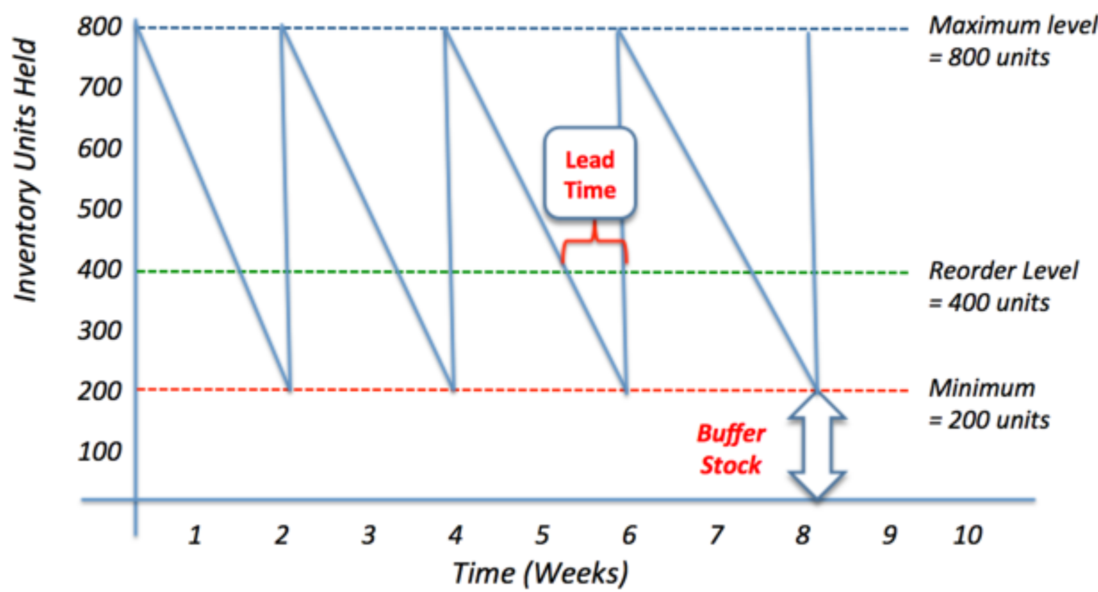

The key elements of a stock control chart are as follows:

Element	Description
Maximum level	Max level of stock a business can or wants to hold Example chart: 800 units
Re-order level	Acts as a trigger point, so that when stock falls to this level, the next supplier order should be placed Example chart: 400 units
Lead time	Amount of time between placing the order and receiving the stock Example chart: just under a week
Minimum stock level	Minimum amount of product the business would want to hold in stock. Assuming the minimum stock level is more than zero, this is known as buffer stock
Buffer stock	An amount of stock held as a contingency in case of unexpected orders so that such orders can be met and in case of any delays from suppliers

Careful consideration is required in deciding when and how much stock to re-order. Key factors to take into account are:

- **Lead-time from the supplier**
    - How long it takes for the supplier to deliver the order
    - Higher lead times may require a higher re-order level
- **Implications of running out (stock-outs)**
    - If stock-outs are very damaging, then have a high re-order level & quantity
- **Demand for the product**
    - Higher demand normally means higher re-order levels

Topic: Stock Control

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Benefits and Drawbacks of Holding Low or High Stock Levels

These can be summarised as follows:

LOW STOCK LEVELS	HIGH STOCK LEVELS
Lower stock holding costs (e.g. storage)	Production fully supplied – no delays
Lower risk of stock obsolescence	Potential for lower unit costs by ordering in bulk / high quantities
Less capital (cash) tied up in working capital – can be used elsewhere in the business	Better able to handle unexpected changes in demand or need for higher output
Consistent with operating "lean"	Less likelihood of "stock-outs"

Key Terms

Stock-out	Where a business is unable to satisfy customer demand due to stock being unavailable
Re-order level	The stock quantity at which a replacement order is triggered
Lead time	The period between placing an order and the receipt of stock
Buffer stock	Stock held as a contingency in case of unexpected orders so that such orders can be met and in case of any delays from suppliers

Topic: Quality Management

Theme 2: Section 2.4 Resource Management

What You Need to Know

- What is meant by quality
- Why quality is increasingly important
- The costs of poor quality
- Approaches to monitoring, assuring and improving quality
- Business benefits of improving quality

What is Quality?

"Quality is about meeting the needs and expectations of customers"

Customers want quality that is appropriate to the price that they are prepared to pay and the level of competition in the market. Key aspects of quality for the customer include:

- Good design – looks and style
- Good functionality – it does the job well
- Reliable – acceptable level of breakdowns or failure
- Consistency
- Durable – lasts as long as it should
- Good after sales service
- Value for money

'Value for money' is especially important, because in most markets there is room for products of different overall levels of quality, and the customer must be satisfied that the price fairly reflects the quality.

For many businesses, good product design is also fundamental, so that the product can be produced efficiently, reliably and at the lowest possible cost.

Why Quality Is important

Quality can determine business success in several ways:

- Customer loyalty: customers return, make repeat purchases and recommend the product or service to others.
- Strong brand reputation for quality
- Retailers and other distributors want to stock the product
- As the product is perceived to be better value for money, it may command a premium price and will become more price inelastic
- Fewer returns and replacements lead to reduced costs
- Attracting and retaining good staff

These points can each help support the *marketing function* in a business. However, businesses have to work hard to maintain and improve their reputation for quality, which can easily be damaged by a news story about a quality failure.

Costs of Poor Quality

You can probably come up with several examples from your own experience of when you have come across poor quality: e.g.

- Product fails – e.g. a breakdown or unexpected wear and tear
- Product does not perform as promised (or what the customer thought was promised!)

- Product is delivered late
- Poor instructions/directions for use make using the product difficult or frustrating
- Unresponsive customer service

Poor quality results in additional business **costs:**

- Lost customers (expensive to replace – and they may tell others about their bad experience)
- Cost of reworking or remaking product
- Costs of replacements or refunds
- Wasted materials

Some recent examples of how costly poor quality can be for a business are listed below:

When	What	Cost
2006	Dell recalls 4 million laptops due to faulty over-heating batteries	$400m
2007	Mattel recalls 19 million toys supplied from China	$30m
2010	Toyota recalls 10 million cars due to a faulty accelerator pedal	$1.2bn
2011 -	UK banks required to pay compensation for mis-selling of PPI (Payment Protection Insurance)	£40bn+
2013	Horsemeat scandal results in slide in sales of red meat in UK	Industry sales down 5%
2015	Alton Towers rollercoaster crash results in compensation claims & lower customer visits	£40m+

Business Benefits from Good Quality

You can see from the list above that poor quality is a likely **source of competitive disadvantage.** If competitors are achieving higher quality, then a business will suffer. The flip side of the above is that a business can benefit by improving its quality.

The key benefits of improved quality are:

- Improved image & reputation, which should result in
- Higher demand, which may in turn mean
- Greater production volumes (possibly providing better economies of scale)
- Lower unit costs because of less waste and rejected output
- Fewer customer complaints (& more satisfied customers)
- Potentially higher selling prices (less need to discount)

Indeed, quality is now seen as a key component of competitiveness:

- Fewer businesses are competing solely on price
- At a similar price, the higher-quality product is likely to win
- Quality can enable a business to differentiate its product from the competition

Topic: Quality Management

Theme 2: Section 2.4 Resource Management

Measuring Quality

There are several tangible and intangible measures of quality:

Tangible	Intangible
Reliability	Brand image
Functions & features	Exclusiveness
Support levels & standards	Market reputation
Cost of ownership (e.g. repairs)	

However, it is important to remember that:

- Quality is **subjective**, it is a matter of personal opinion and what constitutes an acceptable level of quality will vary from one individual to another
- Not all aspects of quality are tangible – for example the degree of assurance given by a firm's name or reputation can be very important even though it is hard to measure.
- Quality is always evolving because of things like improved technology, better materials, new manufacturing techniques and fresh competitors. No business can afford to stand still as far as quality is concerned
- Whilst controlling quality has benefits to the firm, it can also be costly to do, so it is important that the benefits outweigh the costs in the long term

Approaches to Managing Quality

Achieving high quality does not happen by accident. The production process must be properly managed to achieve quality standards.
Quality management is concerned with controlling activities with the aim of ensuring that products and services are fit for their purpose and meet the specifications. There are two alternative approaches to managing quality

Quality Control

Quality control is **the process of inspecting products to ensure that they meet the required quality standards**

This method checks the quality of completed products for faults. Quality inspectors measure or test every product, samples from each batch, or random samples – as appropriate to the kind of product produced.

The **main objective of quality control** is to ensure that the business is achieving the standards it sets for itself.

In almost every business operation, it is not possible to achieve perfection. For example there will always be some variation in terms of materials used, production skills applied, reliability of the finished product etc.

Quality control involves setting standards about how much variation is acceptable. The aim is to ensure that a product is manufactured, or a service is provided, to meet the specifications that ensure customer needs are met.

Topic: Quality Management

Theme 2: Section 2.4 Resource Management

There are several methods of quality control. At its simplest, quality control is achieved through inspection. For example, in a manufacturing business, trained inspectors examine samples of work-in-progress and finished goods to ensure standards are being met.

For businesses that rely on a continuous process, the use of **statistical process control ("SPC")** is common. SPC is the continuous monitoring and charting of a process while it is operating. Data collected is analysed to warn when the process is exceeding predetermined limits

Advantages of Quality Control

- With quality control, inspection is intended to prevent faulty products reaching the customer. This approach means having specially trained inspectors, rather than every individual being responsible for his or her own work. Furthermore, it is thought that inspectors may be better placed to find widespread problems across an organisation.

Disadvantages of Quality Control

- A major problem is that individuals are not necessarily encouraged to take responsibility for the quality of their own work.
- Rejected product is expensive for a firm as it has incurred the full costs of production but cannot be sold as the manufacturer does not want its name associated with substandard product. Some rejected product can be re-worked, but in many industries it has to be scrapped – either way rejects incur more costs,
- A quality control approach can be highly effective at preventing defective products from reaching the customer. However, if defect levels are very high, the company's profitability will suffer unless steps are taken to tackle the root causes of the failures.

Quality Assurance

Quality assurance is about **the processes that ensure production quality meets the requirements of customers.**

This is an approach that aims to achieve quality by organising every process to get the product '**right first time'** and prevent mistakes ever happening. This is also known as a **'zero defect'** approach.

In quality assurance, there is more emphasis on '**self-checking'**, rather than checking by inspectors.

Advantages of quality assurance include:

- Costs are reduced because there is less wastage and re-working of faulty products as the product is checked at every stage
- It can help improve worker motivation as workers have more ownership and recognition for their work (see Herzberg)
- It can help break down 'us and them' barriers between workers and managers as it eliminates the feeling of being checked up on

- With all staff responsible for quality, this can help the firm gain marketing advantages arising from its consistent level of quality

Total Quality Management ("TQM")
This is a specific approach to quality assurance that aims to develop a quality culture throughout the firm. In TQM, organisations consist of 'quality chains' in which each person or team treats the receiver of their work as if they were an external customer and adopts a target of 'right first time' or zero defects.

Which is Best: Quality Control or Quality Assurance?
Which approach to managing quality is best? Here is a summary of the main considerations:

Quality Assurance	**Quality Control**
A medium to long-term process; cannot be implemented quickly	Can be implemented at short-notice
Focus on processes – how things are made or delivered	Focus on outputs – work-in-progress and finished goods
Achieved by improving production processes	Achieved by sampling & checking (inspection)
Targeted at the whole organisation	Targeted at production activities
Emphasises the customer	Emphasises required standards
Quality is built into the product	Defect products are inspected out

Key Terms

Quality control	An approach to managing quality by inspecting production output before it is delivered to the customer
Quality assurance	A series of processes that aim to build quality into the production process

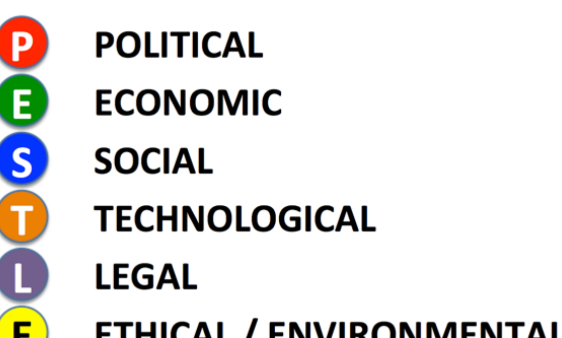
Topic: Economic Influences
Theme 2: Section 2.5 External Influences

What You Need to Know
- **The effect on businesses of changes in:**
- *The business cycle*
- *Interest rates*
- *Exchange rates (appreciation, depreciation)*
- *Inflation (the rate of inflation, the Consumer Prices Index)*
- *Taxation and government spending*

Economic Influences and the External Environment
Economic influences are just one part – though a very important one – of the external environment in which a business operates.

- Businesses must take into account the external environment in which they operate in order to make effective decisions;
- Most businesses are unlikely to have much control (if any) over this environment;
- Businesses need to monitor their environment constantly, in order to react to any changes that occur;
- The most competitive businesses will anticipate change, rather than react to it.

PESTLE Analysis provides a useful way to analyse the external environment. The acronym PESTLE stands for:



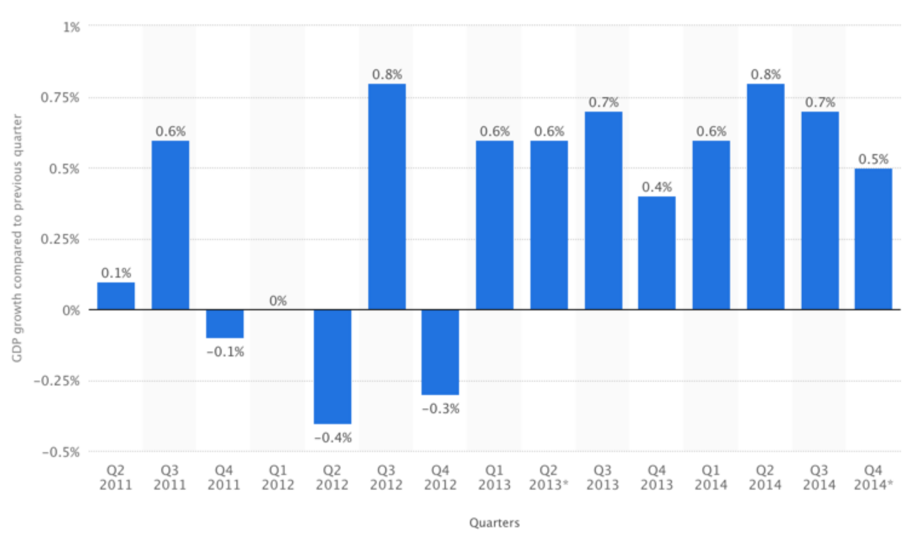
Examples for each element of the PESTLE framework include:

POLITICAL	ECONOMIC	SOCIAL
Competition policy Industry regulation Govt. policies Business policy & incentives	Business cycle Interest rates Inflation Exchange rates Govt. spending & taxation	Demographic change Impact of pressure groups Consumer tastes & fashions Changing lifestyles
TECHNOLOGICAL	**LEGAL**	**ETHICAL / ENVIRONMENT**
Disruptive technologies Adoption of mobile tech New production processes Big data and dynamic pricing	Employment Law Minimum / Living Wage Health & Safety Laws Environmental legislation	Sustainability Tax practices Ethical sourcing (supply chain) Pollution & carbon emissions

Topic: Economic Influences
Theme 2: Section 2.5 External Influences

Business Cycle
The business cycle is all about the rate of change in the value of economic activity. The most common measure of this activity is Gross Domestic Product (GDP).

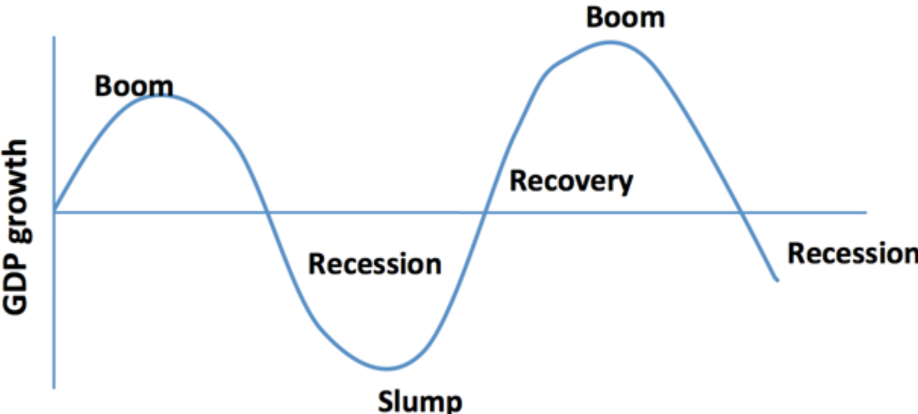
- The level of demand in most markets is influenced by the rate of economic growth
- Economies vary in terms of their "normal" long-term growth rate. A mature economy like the UK has a long-term growth rate of around 2-3%
- GDP growth will vary depending on the stage of the business cycle



The business cycle describes:

- The changes in **GDP** from one quarter to the next
- The traditional sequence of slump, recovery, boom and recession
- The regular pattern of "ups and downs" in the economy

The traditional sequence of the business cycle is usually something like this:



The main stages in the business cycle diagram above can be summarised as follows:

Boom	• High levels of consumer spending, business confidence, profits and investment • Prices and costs also tend to rise faster • Unemployment tends to be low
Recession	• Falling levels of consumer spending and confidence mean lower profits for businesses – which start to cut back on investment • Spare capacity increases + rising unemployment
Slump / depression	• Very weak consumer spending and business investment • Many business failures • Rapidly rising unemployment • Prices may start falling
Recovery	• Things start to get better • Consumers begin to increase spending • Businesses feel a little more confident and start to invest again • But it takes time for unemployment to stop growing

What causes the business cycle?

- Changes in the level of business and consumer confidence
- Alternating periods of stocking (businesses increasing their stocks) and de-stocking (reducing the value of stocks held)
- Changes in the value of consumer spending and business investment
- Changes in government policy which can induce a change in the economy

Interest Rates

An interest rate is the **reward for saving** and the **cost of borrowing** expressed as a percentage of the money saved or borrowed. At any one time there are a variety of different interest rates operating within the external environment; for example:

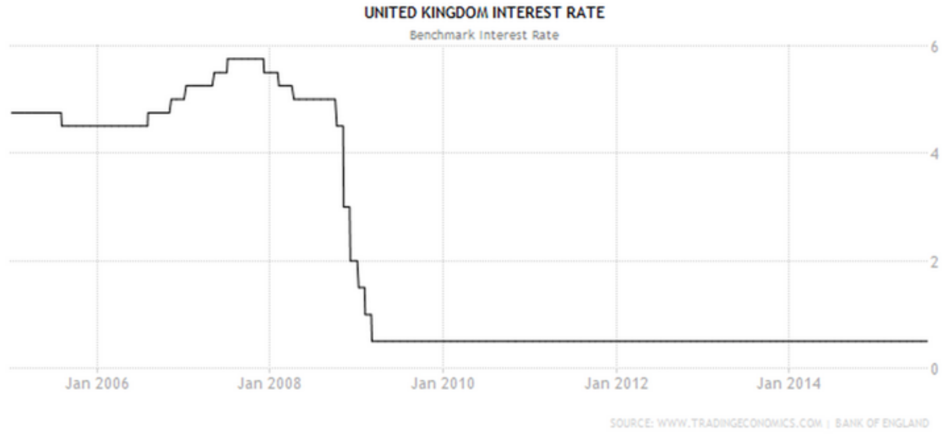
- Interest rates on savings in bank and other accounts
- Borrowing interest rates
- Mortgage interest rates (housing loans)
- Credit card interest rates and pay day loans
- Interest rates on government and corporate bonds

The Bank of England uses policy interest rates to help regulate the economy and meet economic policy objectives.

The Bank of England Base Rate has been very low and stable for several years – at 0.5% since 2010.

Topic: Economic Influences

Theme 2: Section 2.5 External Influences



What might happen if interest rates start to rise? Possible effects might be:

- Cost of servicing loans / debt is reduced – boosting spending power
- Consumer confidence should increase leading to more spending
- Effective disposable income rises – lower mortgage costs
- Business investment should be boosted e.g. prospect of rising demand
- Housing market effects – more demand and higher property prices
- Exchange rate and exports – cheaper currency will increase exports

Exchange Rates

An exchange rate is the **price of one currency expressed in terms of another** currency. The forces of demand and supply in the currency markets determine the price (exchange rate). Just like the commodity markets for oil and coffee, the price of a currency will reflect the amount of the currency that consumers and businesses want to buy (**demand**) and sell (**supply**).

The exchange rate determines how much of one currency has to be given up in order to buy a specific amount of another currency.

For example a £/$ exchange rate might be 1.50. That means, for every £1, you can buy $1.50 US dollars

This is the price of one pound, expressed in dollars i.e. the £/$ exchange rate.

What happens when an exchange rate changes? Let's look at a simple example.

Set out below are two exchange rates for two months:

£1 buys	May	September
US Dollars ($)	$1.60	$1.45
Euros (€)	€1.15	€1.05

In the table above, you can see that in May, £1 would buy $1.60, if you wanted to convert some pounds into US dollars. Alternatively, £1 would buy €1.15 euro.

What happened to the exchange rate for the pound between May and September?

The value of £1 fell against both the US dollar and the Euro. For example, by September, £1 would only buy you $1.45, a fall of $0.15 from May.

That means that the pound **weakened** against the dollar (and the euro).

Putting it another way, the value of the US dollar strengthened against the pound.

If you were holding dollars, you would need less of them to convert into £1.

Factors that determine effect of changing exchange rates on business

Low effect on business	**High effect on business**
No export sales – turnover all in domestic (UK) market	Significant export sales, perhaps in many currencies
All business activities located in UK	Overseas operations, earning profits in foreign currency
Raw materials and other supplies bought in UK	Significant purchases from overseas suppliers
Demand predominantly from domestic (UK) customers	Substantial demand from overseas visitors to UK
Demand is price inelastic	Demand is price elastic
Higher costs can be passed on to customers to maintain margin	Higher costs usually have to be absorbed via a lower margin

Exchange rates and price elasticity of demand
Price elasticity of demand is an important concept for any business where demand may be affected by changing exchange rates

E.g. price elastic demand
- Stronger (higher) exchange rate will increase selling price for export customers (e.g. they have to use more US$ for each £1)
- Likely to result in greater reduction in quantity demanded + overall reduction in export sales

Inflation
Inflation is a **sustained increase in the average price level of an economy**.

The rate of inflation is measured by the **annual percentage change in the level of prices** as measured by the **consumer price index.**

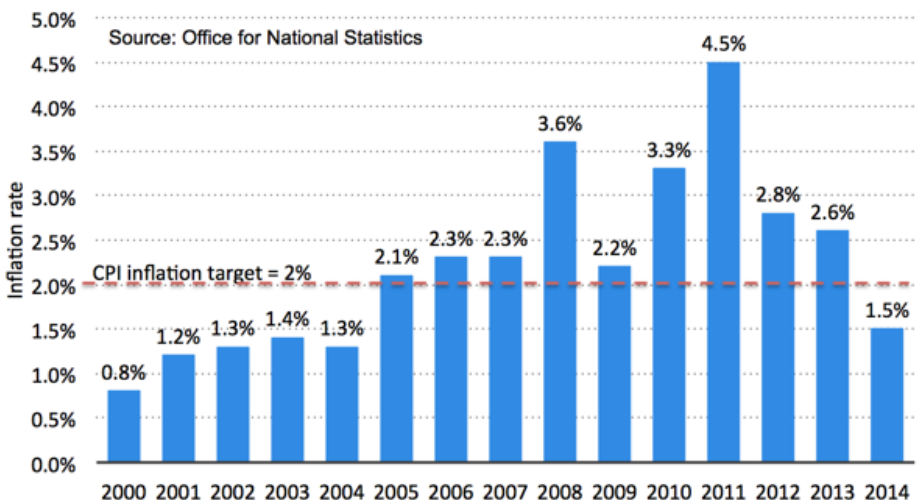
A sustained fall in the general price level is called **deflation** – in this situation, the rate of inflation becomes negative.

The consumer price index is the main measure of inflation for the UK

The government has set the **Bank of England** a target for inflation (using the CPI) of **2%**. The aim of this target is to achieve a sustained period of low and stable inflation. Low inflation is also known as **price stability**

Topic: Economic Influences
Theme 2: Section 2.5 External Influences

The recent level of consumer price inflation in the UK is illustrated in the chart below:



What causes prices to rise? There are two main causes of inflation:

Too much demand	Businesses respond to high demand by raising prices to increase their profit margins Excess demand in the economy or a market is associated with the boom phase of the business cycle
Rising business costs	***Main causes:*** External shocks (e.g. commodity price fluctuations) A depreciation in the exchange rate Faster growth in wages and salaries ***What happens?*** Firms raise prices to protect their profit margins – better able to do this when market demand is price inelastic "Wages often follow prices" A rise in inflation can lead to rising inflationary expectations

The main costs and consequences of inflation:

- Money loses its value and people lose confidence in money as the value of savings is reduced
- Inflation can get out of control - price increases lead to higher wage demands as people try to maintain their living standards. This is known as a wage-price spiral.
- Consumers and businesses on fixed incomes lose out because the their real incomes falls - employees in poor bargaining positions lose out
- Inflation can favour borrowers at the expense of savers – because inflation erodes the real value of existing debts
- Inflation can disrupt business planning and lead to lower capital investment
- Inflation is a possible cause of higher unemployment in the long term – because of a lack of competitiveness

- Rising inflation is associated with higher interest rates - this reduces economic growth and can lead to a recession

Inflation and price elasticity of demand

- Remember that price elasticity of demand refers to the responsiveness of demand to changes in price
- When **demand is elastic**, a price rise leads to a more than proportionate fall off in quantity demanded
- When **demand is inelastic**, a price rise leads to a less than proportionate fall off in quantity demanded
- Businesses with products that have inelastic price elasticity of demand will be **less affected by a rise in inflation**
- Some businesses will be able to absorb price increases by becoming more efficient
- Price inflation will vary from industry to industry – be careful about making generalisations

Government Spending & Taxation – Fiscal Policy

Fiscal policy involves the use of government spending, taxation and borrowing to affect the level and growth of economic activity.

The government taxes in order to:

- Raise revenue – to finance government spending
- Managing aggregate demand – to help meet the government's macroeconomic objectives
- Changing the distribution of income and wealth
- Address market failure and environmental targets

There are two main kinds of taxation: direct and indirect.

Direct Taxation	Indirect Taxation
Levied on income, wealth and profit	Levied on spending by consumers on goods and services
Main examples: • Income Tax • National Insurance Contributions • Corporation Tax • Capital Gains Tax	Main examples: – VAT – Excise duties on fuel and alcohol, car tax, betting tax etc

Government Spending

In the UK government spending takes up around 40% of annual GDP. Three main areas of spending are:

- **Transfer Payments** - welfare payments made to benefit recipients such as the state pension and the Jobseeker's Allowance

- **Current Spending -** spending on state-provided goods & services such as education and health
- **Capital Spending** - infrastructural spending such as spending on new roads, hospitals, motorways and prisons

Why is Government spending so significant?

- Provide welfare support for low income households / the unemployed
- Government spending is also a means of redistributing income within society e.g. to reduce the scale of relative poverty
- Government spending can also be used as a tool to manage aggregate demand (GDP) as part of macroeconomic policy

Topic: Legislation
Theme 2: Section 2.5 External Influences

What You Need to Know
The effects on businesses of:
- ***Employee protection***
- ***Consumer protection***
- ***Environmental protection***
- ***Competition policy***
- ***Health and safety***

Introduction to Legislation
Government legislation is one important part of the overall external environment.

You do not need to be an expert in the areas of legislation covered in this part of the specification. What is needed is more of an overview of the key areas where legislation impacts business activity. The key points for each are set out below.

Main roles of business legislation
Legislation as it relates to business is designed to:

- Regulate the rights and duties of people carrying out business in order to ensure fairness
- Protect people dealing with business from harm caused by defective services
- Ensure the treatment of employees is fair and un-discriminatory
- Protect investors, creditors and consumers
- Regulate dealings between business and its suppliers
- Ensure a level playing field for competing business

Employee protection
The key areas impacting on business are those relating to individual employment (particularly pay and discrimination) and industrial disputes.

Equal pay
The basic rule: men and women are entitled to equal pay for work of equal value
- "Pay" includes everything in the employment contract - bonuses and pension contributions, as well as basic wages or salary
- Workers have the right to ask their employer for information to check equality – using the equal pay questionnaire
- If they believe their pay is unequal, they can take the employer to an **Employment Tribunal**

Minimum wage
- Employers are required by law to ensure they pay their workers at least the national minimum wage (NMW)
- Makes no difference when a worker is paid (monthly, weekly, daily, hourly). The NMW still applies

Discrimination
It is illegal for an employer to discriminate against an employee on the basis of:

- Sex, including pregnancy and maternity

- Marital / civil partnership status
- A person's disability
- Race
- Age
- Sexual orientation
- Religion/belief
- Trade union membership or non-membership
- Status as a fixed-term or part-time worker

Employment rights

Laws provide a variety of "rights" for employees, including:

- Reasonable notice before dismissal
- Right to redundancy
- Right to a written employment contract
- Right to request flexible working
- Right to be paid national minimum wage
- Right to take time off for parenting

Industrial relations

- Protection from unfair dismissal
- Employers must recognise union is >50% of staff are members
- Regulation of procedures for industrial action (e.g. ballots)
- Role / powers of Employment Tribunals
- EU – Works Councils requirements

Consumer Protection

Legislation provides a wide variety of protections to consumers when they transact with businesses. In particular, businesses must ensure that

- **Goods fit their description**
  - E.g. organic wine really must be organic
  - Businesses need to take care with descriptions – avoid inaccurate claims
- **Must be of satisfactory quality**
  - Test is of a "reasonable person"
  - Must work and have no major blemishes
- **Goods are fit for the purpose specified**
  - E.g. a watch should tell the time
  - Businesses should take care when explaining what a product can be used for

Other ways in which consumers are protected by legislation:

- Businesses may not use unfair commercial practices – e.g. misleading advertising
- Customers have a right of return and full refund if goods /services do not comply with law
- Services
  - Must be done at a reasonable price and by the time stated
  - Customer can request that unsatisfactory work be repaired or carried out again at no cost

- Consumers have the right to a "cooling off period"
- Distance selling regulations provide further protection for consumers against online businesses

Distance Selling Regulations	Gives consumers protection when they buy goods or services by mail order, phone or online
The Sale of Goods Act	Requires goods to be as described, fit for their purpose and of satisfactory quality. If they are not, the customer can reject them
Supply of Goods and Services Act	Customers are entitled to work that's carried out with reasonable skill, in a reasonable time, at a reasonable price
Trade Descriptions Act	Required any descriptions of goods and services given to be accurate and not misleading

Environmental Protection
Businesses must comply with a wide variety of environmental laws and regulations. These are set at local, UK and European levels. The key areas of impact are:

- Emissions into the air
- Storage, disposal & recovery of business waste
- Storing and handling hazardous substances
- Packaging
- Discharges of wastewater

Competition Laws
The main aims of laws designed to regulate market competition include:

- Wider consumer choice in markets for goods and services
- Encouraging and protecting innovation
- Effective price competition between suppliers
- Investigating allegations of anti-competitive behaviour within markets which might have a negative effect on consumers

Both UK and EC competition law prohibit agreements, arrangements and concerted business practices which appreciably prevent, restrict or distort competition (or have the intention of so doing)

Examples of prohibited agreements include:

- Agreements which **directly or indirectly fix purchase or selling prices,** or any other trading condition (e.g. discounts or rebates, etc)
- Agreements which limit or control production, markets, technical development or investment (e.g. setting quotas or levels of output)
- Agreements which share markets or sources of supply

Health & Safety Legislation

Topic: Legislation

Theme 2: Section 2.5 External Influences

Health and safety is about **preventing people from being harmed** at work or becoming ill, by **taking the right precautions** and **providing a satisfactory working environment**.

An employer has important responsibilities for health & safety. It is not just about protecting staff – health & safety applies to many people who come into contact with the business; for example:

- Employees working at the business premises, from home, or at another site
- Visitors to the premises such as customers or subcontractors
- People at other premises where the business is working, such as a construction site
- Members of the public - even if they're outside the business premises
- Anyone affected by products and services the business designs, produces or supplies

There are stringent health & safety regulations specific to particular industries too: for example:

- Food processing (hygiene)
- Hotels (guest safety, hygiene)
- Chemical production (dangerous processes, waste disposal)
- Air travel (passenger safety)
- Tour operators (holidaymaker safety)

Topic: Competitive Environment

Theme 2: Section 2.5 External Influences

What You Need to Know
Competition and market size

Introduction

You look at the nature of competition and business strategy in detail later in your studies. This topic provides a brief introduction to some key concepts.

What is Competitiveness?

Competitiveness is the **ability of a business to deliver better value to customers than competitors.**

If a business is able to be more competitive than the rest of the market or industry over a sustained period, it is said to have **competitive advantage:**

- The ability of a business to add more value for its customers than its rivals and attain a position of relative advantage
- A situation where a business has an advantage over its competitors by being able to offer better value, quality and/or service

Competition and Market Structure

The nature of competition in a market is determined by a variety of factors, including:

- The extent of current competition
- The potential for new businesses to enter the market
- The extent to which a business produces a similar product (indistinct from rivals) or a differentiated product (distinct from rivals)

The threat of new businesses entering a market is a particularly important factor influencing the extent of competitive rivalry:

- High profits will tempt newcomers to enter a market and this will drive down prices and profits
- Therefore the maintenance of market power depends upon erecting and maintaining barriers to market entry

Barriers to Market Entry

What can existing competitors in a market do to dissuade new businesses from trying to enter a market?

- **Product differentiation (including brands)**
  - Will act to increase customer loyalty making it difficult for newcomers to gain market share
- **Control access to raw materials and distribution channels**
  - A lack of access will make it difficult for newcomers to enter the market
- **Retaliation by established products**
  - E.g. the threat of price war
  - Will act to discourage newcomers