

Mark Fisher, Medi Houghton  
and Veenu Jain

Cambridge IGCSE®  
and O Level

# Business Studies

Coursebook

Revised third edition

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**Mark Fisher, Medi Houghton and Veenu Jain**

**Cambridge IGCSE<sup>®</sup> and O Level**

# **Business Studies**

## **Coursebook**

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# Introduction

This book has been specifically written to support the latest Cambridge IGCSE® (0450 and 0986) and O Level (7115) Business Studies syllabuses for examination from 2020. It may also prove useful for students following other courses covering similar topics.

Written in clear and accessible language, it will enable you to gain the knowledge, understanding and skills required to study successfully at this level.

## Syllabuses and assessment

The Cambridge IGCSE and O Level syllabuses have the same assessment model, consisting of two separately examined papers. You must take both papers in order to be awarded the qualification. Paper 1 consists of short answer and data response questions, while Paper 2 is a case study.

The book provides thorough support to help you study the course. Exam-style short answer and data response questions are included at the end of each chapter, with an exam-style case study at the end of each section.

In addition, Chapter 27 will help you to consider the skills that you have developed during your course and explore ways in which you could demonstrate these skills when answering assessment questions. It also includes advice on revision techniques. Therefore, you may wish to read this chapter before attempting the practice questions at the end of each chapter/section.

## How to use this book

The book is designed to be a practical guide using questions and case studies to help develop understanding, and assumes no prior knowledge of the topics. The structure of the book is aligned to the syllabus order with sections and chapters within the book following syllabus headings to aid learning. However, chapters do not need to be studied in this order.

Each chapter has a similar structure. The content is introduced in a way that is relevant to real life, and learning objectives set out the aims of the chapter. The main features are as follows:

### KEY TERM

Key terms help you identify and understand important concepts. A glossary of all the key terms and their definitions is included at the end of the book.

### ACTIVITY 1.3

Activities build key skills required by the learning objectives – application, analysis and evaluation – and will help to consolidate learning. Many of the activities include a case study-style scenario, followed by questions.

### CASE STUDY

Case studies from around the world put the topic into a real-life context.



Fast forward / rewind show where concepts appear elsewhere in the book, providing students with a handy link to support their learning.



Top tips offer guidance and advice on key points.



Explore! provides ideas for extra activities to broaden understanding of the topic.



Test yourself questions aid self-assessment and reinforce knowledge.



Example boxes put theory into context by providing worked examples.

### Revision checklist

Summary points at the end of the chapter consolidate learning.

### Exam-style practice questions

Exam-style practice questions will help you to familiarise yourself with the style of questions seen in examination, and assess your own understanding and skills to answer them.

### Exam-style case study

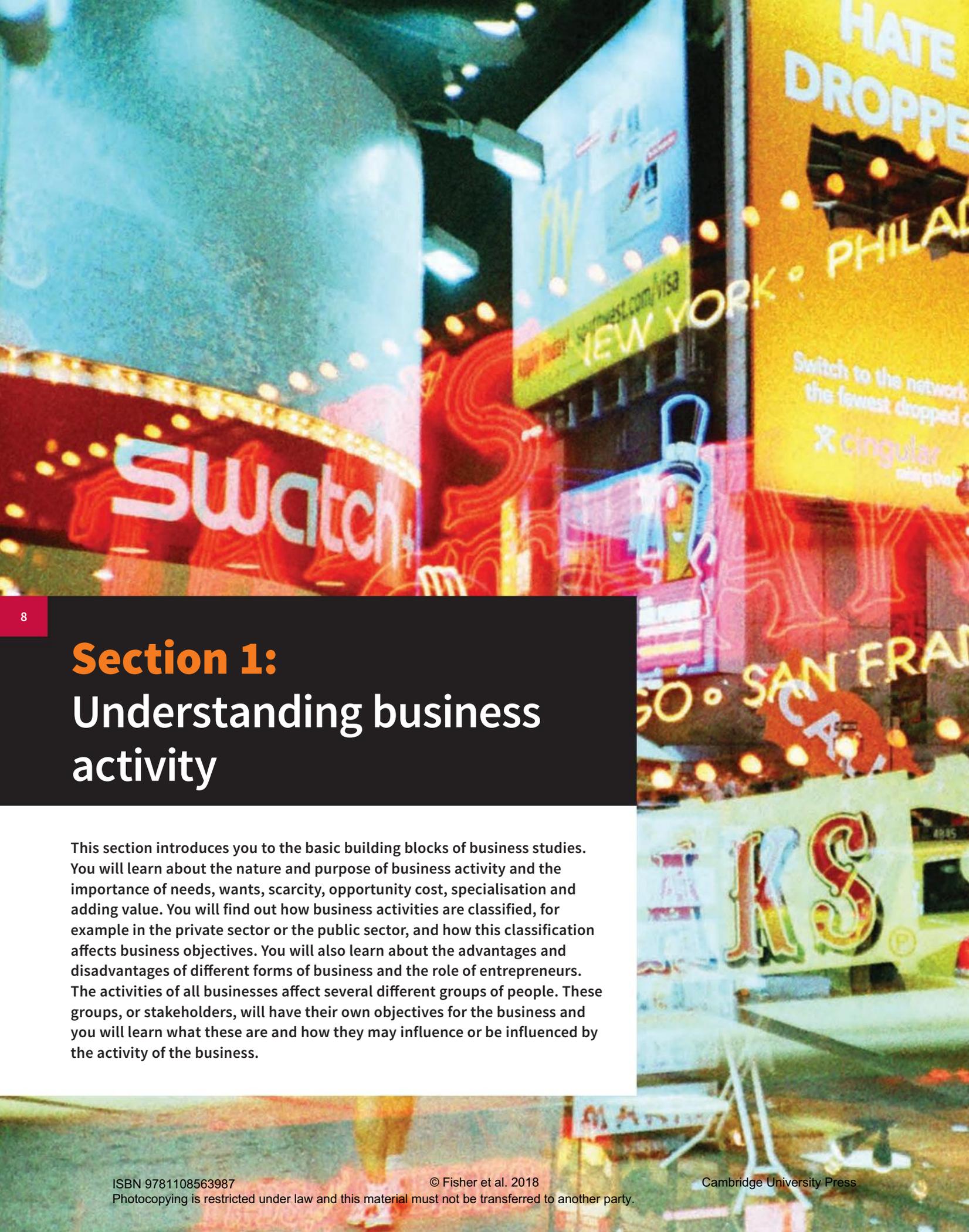
Case study questions at the end of each unit offer extensive help to practise answering case study-style questions.

## Additional resources

Additional resources to help consolidate key concepts and check understanding are available at [www.cambridge.org/9781108563987](http://www.cambridge.org/9781108563987). These include:

- mind maps
- revision questions
- multiple choice questions
- crosswords, word searches and other fun activities.

If your coursebook includes access to the Cambridge Elevate enhanced edition, these materials are available for download within the resource.



## Section 1: Understanding business activity

This section introduces you to the basic building blocks of business studies. You will learn about the nature and purpose of business activity and the importance of needs, wants, scarcity, opportunity cost, specialisation and adding value. You will find out how business activities are classified, for example in the private sector or the public sector, and how this classification affects business objectives. You will also learn about the advantages and disadvantages of different forms of business and the role of entrepreneurs. The activities of all businesses affect several different groups of people. These groups, or stakeholders, will have their own objectives for the business and you will learn what these are and how they may influence or be influenced by the activity of the business.

# 1

## Objectives

*In this chapter you will learn about:*

- needs, wants, scarcity and opportunity cost
- the importance of specialisation to businesses and consumers
- the purpose of business activity
- what is meant by 'added value'
- how a business adds value.



### KEY TERMS

**Business activity:** the process of producing goods and services to satisfy consumer demand.

**Need:** a good or service which is essential to living.

**Want:** a good or service which people would like, but is not essential for living.



### TOP TIP

It is important to learn key terms. Not only are they important when answering questions, but many in this chapter will also help you to understand topics in later chapters.

# Business activity

## Introduction

The business world is all around us. From the minute we get up in the morning to when we go to bed at night, we are using things made by businesses around the world. Think about the food you eat, the clothes you wear, the bus or train you came to school on this morning, the music CDs you listen to, even this book – all these were made by businesses.

Businesses provide us – consumers – with all the goods and services that we need and would like to have. In this chapter you will learn about the purpose of business. You will look at how businesses turn resources into goods and services to meet all our needs and wants.

## The purpose and nature of business activity

### Needs and wants

The purpose of **business activity** is to provide consumers – that's you and me – with goods and services that meet our needs and wants. But what are **needs**? How are they different from **wants**?

A need is any good or service which people must have to be able to live. Water, food, shelter and clothing are essential needs for living.

Wants are different. They are any goods or services which people would like to have. They are not essential for living. Mobile phones, cars and holidays are good examples.



Customers in a shop

**ACTIVITY 1.1**

- 1 Make a list of your ten most important 'wants'.
- 2 Do you own any of these items? If not, why not?
- 3 If you are lucky enough to own all of these items, does this mean that you no longer have any wants?

You have probably identified things that you still want. The main reason you may have given for not having all of your wants is you may not have enough money to buy them. Even if you are able to buy these wants in the future, you may have other wants. This is because our wants are unlimited.

Throughout the world there are many people who are so poor that they cannot afford to buy the things they need for living, let alone afford their wants. So, some people cannot afford to buy their basic needs. Others, who can afford their basic needs, cannot afford to buy what they want. Surely, then, the cause of these problems is that consumers do not have enough money! Let's see if this is the case.

**ACTIVITY 1.2**

A very small island country has the following supplies of the four groups of goods and services identified as basic needs.

Basic need	Quantity available
Water	50 000 litres
Food	10 000 kilos
Clothing	8 000 units
Housing	400

The country has a population of 500 families. Each family unit must have the following quantities of each basic need for essential living.

Basic need	Quantity needed per family unit
Water	100 litres
Food	25 kilos
Clothing	20 units
Housing	1

In small groups:

- 1 Using the information in the tables, calculate whether there is enough supply of basic needs in this country to support the essential living of all the families.
- 2 If 100 people in the country had a much higher income than the rest of the population, what might happen?

## KEY TERMS

**Economic problem:** unlimited wants cannot be met because there are limited factors of production. This creates scarcity.

**Factors of production:** the resources needed to produce goods and services – land, labour, capital and enterprise.



## TOP TIP

The term 'capital' has several meanings in business. Make sure you understand its meaning as a factor of production.

## Scarcity and opportunity cost

In Activity 1.2, you may have worked out that money alone cannot solve the problem. There are just not enough goods and services to meet the needs and unlimited wants of all consumers – this is known as the **economic problem**. If this is the case, then the answer is simple – produce more goods and services! Unfortunately, the answer is not so simple. To understand why not, first we need to look at **factors of production**.

The production of goods and services requires four factors of production:

- **Land** is all natural resources such as minerals, ores, fields, oil and forests.
- **Labour** is the number of people available to work.
- **Capital** is machinery, equipment and finance needed for production of goods and services.
- **Enterprise** is people prepared to take the risk of setting up businesses – they are known as entrepreneurs.

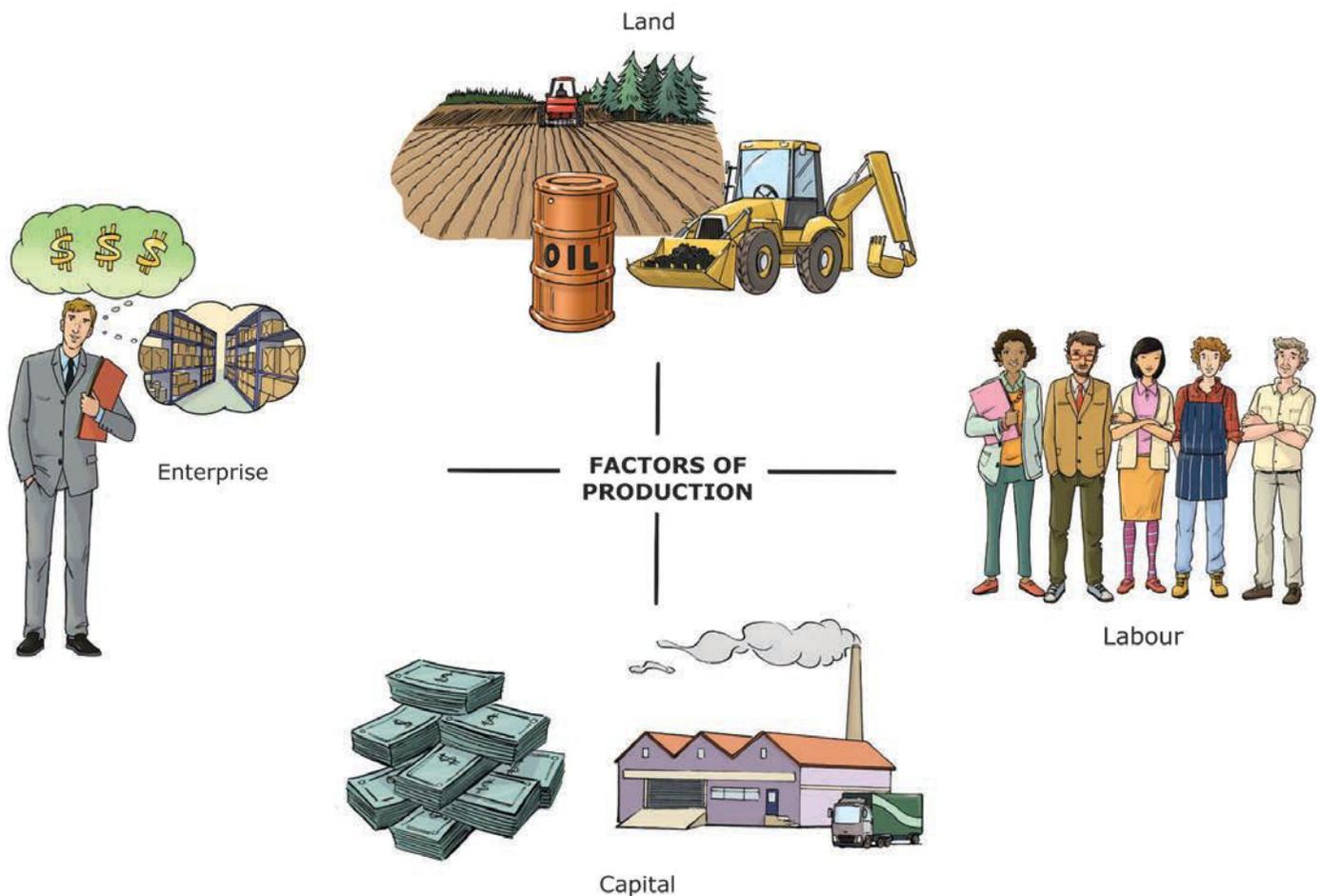
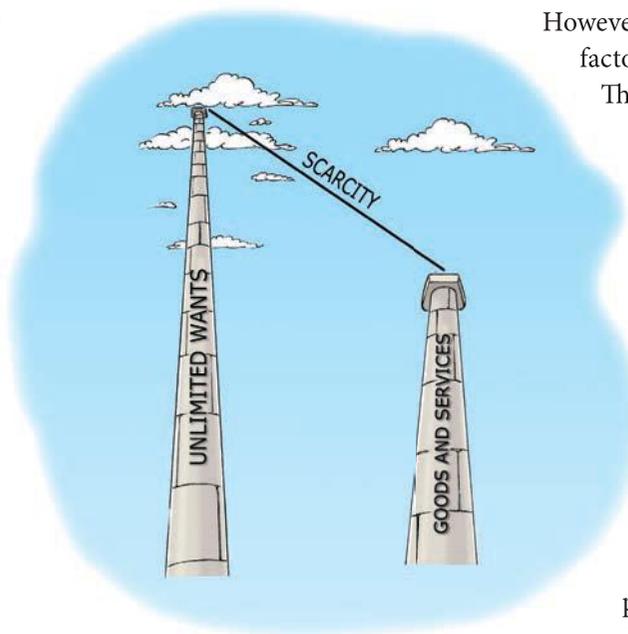


Figure 1.1 Factors of production

Figure 1.2 Scarcity



However, there are not enough of these factors of production in the world.

This means that it is not possible to make all the goods and services needed or wanted by the world's population. In other words, the unlimited wants of consumers cannot be satisfied because the factors of production required to produce the goods and services to meet those wants are limited. This is the problem of **scarcity**.

We have seen that there are not enough resources to produce all the goods and services needed to meet consumers' wants. So, choices have to be made.

We all make choices in our everyday lives. Do you choose to go to the cinema with friends or spend the money on a new computer game? Perhaps you have enough money to buy the latest CD release from your favourite pop star, or you can use the money to buy a Business Studies revision textbook. Whichever decision you make will mean that you will have to give up the chance of having the other. When making the choice you need to make sure that the product or service you choose is worth more to you than the one you give up. The next best alternative you give up is known as the **opportunity cost** of your decision.



## KEY TERMS

**Scarcity:** there are not enough goods and services to meet the wants of the population.

**Opportunity cost:** the benefit that could have been gained from an alternative use of the same resource.

## ACTIVITY 1.3

Fatima works in a bakery and earns \$120 per week. Fatima's grandfather has given her \$5000. Fatima is going to use this money to start her own business. She is going to make cakes for special occasions such as birthdays, weddings and religious festivals.

- 1 Give an example for each of the four factors of production Fatima will use in her new business.
- 2 What is the 'opportunity cost' to Fatima of her decision to start her own business?
- 3 Is Fatima's business meeting consumer 'needs' or consumer 'wants'? Justify your answer.



## EXPLORE!

Use newspapers, library resources or the internet to research the things that your government spends money on.

Have a class discussion about the opportunity cost of these spending decisions. If you were a member of the government would you spend the money differently?

It is not only consumers like you who have to make choices about how to use scarce resources. Businesses and governments also have limited resources and must choose between alternative uses of those resources. For example, a business might have to choose between using resources on an advertising campaign, or on a training programme for its employees. A government might have to choose between building a new school or a new hospital.

## Importance of specialisation

We have seen how consumers, businesses and governments must make choices. They must do this because of the scarcity of goods and services which results from limited factors of production. For this reason, it is very important that the



Figure 1.3 A single employee and the production process

factors of production are not wasted on the production of goods and services that consumers do not need or want.

Most goods and services are produced by more than one person. The production process often uses machinery and equipment which has been specially designed to produce a specific good. This is very different from the production that would have taken place hundreds of years ago. Then a product would have been produced by just one person using machinery and equipment which was far less specialised.

The increasing **specialisation** of factors of production has meant that businesses are far more efficient than they once were. Specialisation reduces the costs of production. This benefits consumers by providing more goods and services at lower prices than before specialisation took place. A good example of specialisation in business is Microsoft, which develops and produces computer software.



#### KEY TERM

**Specialisation:** people and businesses concentrate on what they are best at.

## Making footballs

Global Sports manufactures sports equipment. Its most popular product is footballs.

To make one football requires five employees. Each employee completes a separate task, usually with the aid of specialised machinery.

The five stages in making a football are:

- 1 Panels are cut out of sheets of leather.
- 2 A design and logo are stamped on the panels.
- 3 The panels are stitched together into the shape of a football.
- 4 The bladder is inserted into the ball.
- 5 The ball is moulded into the correct shape and inflated to the correct pressure.



Making a football

#### TASK

- a Identify an example of the factor of production 'capital'.
- b Use the information here to explain 'division of labour'.
- c Identify **two** reasons why Global Sports benefits from specialisation.
- d Explain **one** benefit to Global Sports and **one** benefit to its customers of specialisation.



**Labour productivity:** see Chapter 15, page 204.

**KEY TERM**

**Division of labour:** production is divided into separate tasks and each employee does just one of those tasks.

**EXPLORE!**

Use the internet, newspapers and other resources to research businesses in your country which produce or supply only one type of product. For example, look at farmers to see if they grow only one type of cereal, or rear only one type of animal. Are there any retailers or professionals who supply only one type of good or service?

What do you think are the benefits and limitations to these businesses of specialising in the production or supply of just one type of good?

Specialisation of labour is now commonplace in the workplace. Instead of employees producing one product from start to finish, they focus on just one skill. The production of a product now requires several employees, each using their skill. This is an example of the **division of labour**. Since each employee is now specialising in just one skill, they become far more efficient and this increases the productivity of labour.

In the past, most products were made by employees with only basic tools and equipment. The development of machinery and advances in technology have changed the production process. Machinery and equipment have become far more specialised and this has greatly increased the efficiency of capital.

Even entrepreneurs have realised the benefits of specialisation. There are many examples of businesses that specialise in the production or supply of just one type of product.

### Purpose of business activity

We have already learnt that businesses take scarce resources – factors of production – and use these to produce the goods and services demanded by consumers. Without the activity of business there would be no products and services.



Figure 1.4 The purpose of business activity

Businesses produce different types of goods and services. These are known as:

- consumer goods
- consumer services
- capital goods.

#### Consumer goods

**Consumer goods** are those goods which are sold to the public that they can see (physical goods) and touch (tangible goods). These can be divided into durable and non-durable consumer goods:

- Durable consumer goods can be used over and over again, for example televisions, computers, cars, tables and chairs.
- Non-durable consumer goods can only be used once, for example food and drink.

**KEY TERM**

**Consumer goods:** products which are sold to the final consumer. They can be seen and touched, for example computers and food.



Figure 1.5 Consumer goods



## KEY TERMS

**Consumer services:** non-tangible products such as insurance services, transport.

**Capital goods:** physical goods, such as machinery and delivery vehicles, used by other businesses to help produce other goods and services.

### Consumer services

**Consumer services** are products which are also sold to the public, but they cannot be seen or touched (intangible), for example insurance, banking and bus journeys. You can see and touch the buildings where insurance and banking services take place and you can obviously see and touch a bus, but you are not buying these items, you are using a service which they provide and this service cannot be seen or touched.



Figure 1.6 Consumer service

### Capital goods

**Capital goods** are products which are sold to other businesses to help them in their production process. These are physical goods such as machines, computers and delivery vehicles.

## CASE STUDY

RT Products (RTP) is a manufacturer of printers. It also manufactures replacement ink cartridges for its printers. Each employee assembles all of the different components into making one computer. The Operations Director is considering introducing division of labour into the production of computers.

RTP has recently invested in new computer-controlled equipment to help manufacture printer cartridges. Last year it produced 600 000 printer cartridges. RTP will be able to produce 30% more cartridges this year.

RTP sells its printers to businesses and private individuals for use with their computers at home.

### TASK

- Calculate the number of printer cartridges RTP will be able to produce this year.
- Use the information here to explain the difference between 'consumer goods' and 'capital goods'.
- Do you think the Operations Director should introduce division of labour into the production of printers? Justify your answer.

## Adding value

Whatever good or service a business produces, it will try to add value at every stage of the production process. It does this by taking raw materials and turning them into a good or service which it sells to customers at a price greater than the cost of the raw materials used in their production. Added value is one of the most important objectives of business. Figure 1.7 shows how value is added in the production of a cake.

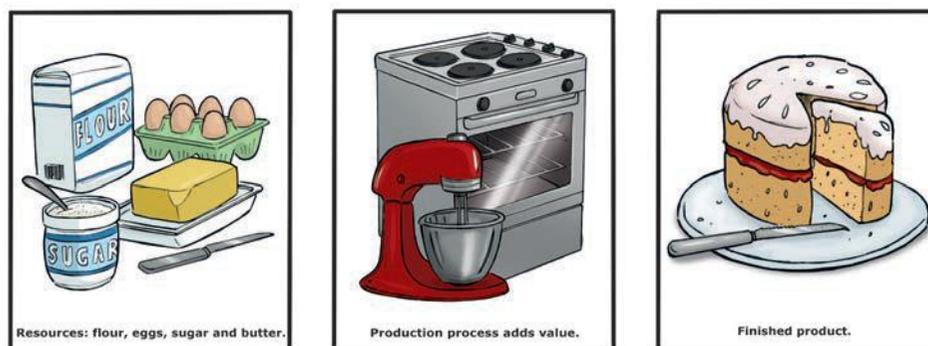


Figure 1.7 Adding value

## How businesses increase added value

Added value is not the same as profit. You will learn later how a business calculates profit. All you need to know now is that other costs such as employees' wages and energy costs must be deducted from the added value to calculate profit.

Profit will increase if a business is able to increase its added value without increasing its costs. In practice, it is difficult to increase value without increasing costs. If the increase in added value is greater than the costs of achieving it, profits will rise.

There are a number of different ways a business can increase its added value.

### Branding

Have you ever wondered why Coca-Cola, Sony and other well-known companies spend huge sums of money on advertising and other promotional activities? They do this to build and then maintain their brand. The products produced by each of these companies all have close substitutes – that means you can buy other brands of drink and electronic goods. However, these companies are able to charge a higher price than their competitors, even though the costs of production are likely to be quite similar. Branding increases added value because people want to or feel they should buy the item from this particular company.



**How a business calculates profit:** see Chapter 21, page 269.

16



### TOP TIP

Try to read local and national newspapers as often as you can. There are lots of business articles. You may not understand everything, but it will help you to have a better understanding of business, especially in your country. You could cut out any articles or advertisements you think may be useful later in the course. You could bring them into school for your teacher to keep as a resource for future lessons.



**ACTIVITY 1.4**

Name your top ten brands. Then cut out advertisements from newspapers and magazines and make a poster.

**Excellent service quality**

In some industries, providing a high-quality, personalised service can be the difference between being able to charge a high price or one which is much lower. The price of a made-to-measure suit will be higher than the price of a ready-made suit. The cost of the materials used will be very similar, but the personalised service increases the added value.



Personalised service increases the cost of the product

**Product features**

Products that have more features and functions than similar products on the market will allow the producer to charge a higher price. Although these additional features will increase costs, consumers are prepared to pay a much higher price than they would pay for a product with fewer features or functions. The mobile phone market is a very good example of how features and functions are used to increase the product's added value.

**Convenience**

Many consumers lead busy lives and they are often prepared to pay a higher price for goods and services which they can have immediately or which save them time, for example ready meals.

**ACTIVITY 1.5**

Explain how these businesses add value:

- restaurant
- shoe manufacturer
- house builder
- florist.

## Making leather bags and belts in Ethiopia



Leather bags and belts in Ethiopia

The Ethiopian government is encouraging young entrepreneurs to start small businesses in order to reduce the rate of youth unemployment.

In Hawassa City in southern Ethiopia, Mitike Paulos, her younger sister and three friends are producing leather bags and belts in a small workshop.

Mitike and her sister learnt the craft from their brother. They started business in 2011 with a \$2000 loan from a small-loan lender. They used the money to buy equipment and raw materials and to rent their workshop. Today their business employs ten workers and, as they expand production, they also hope to hire more. 'The more we work, the more we grow,' says Mitike.

Adapted from an article by Andualem Sisay, [www.theafricareport.com/East-Horn-Africa/how-a-group-of-young-ethiopians-beat-unemployment.html](http://www.theafricareport.com/East-Horn-Africa/how-a-group-of-young-ethiopians-beat-unemployment.html)

### TASK

- a Identify examples from the case study for each of the four factors of production.
- b Using examples from the case study, define 'business activity'.
- c How is the business helping to satisfy the needs of Mitike's employees?
- d How does this business add value?
- e Explain **two** ways Mitike and her sister could increase their business's added value.

### TEST YOURSELF

- 1 Explain the difference between 'needs' and 'wants'.
- 2 Define 'scarcity'.
- 3 Define 'the economic problem'.
- 4 Identify **two** ways a business might benefit from using specialised machinery.

## Revision checklist

- Business activity combines the factors of production to produce goods and services that meet consumer needs and wants.
- The economic problem and the problem of scarcity are due to unlimited needs and wants of consumers which cannot be met by businesses because they have limited factors of production. Choices must be made and this creates an opportunity cost.
- Specialisation of both labour and capital helps businesses to produce more goods and services at a lower cost.
- Businesses add value by taking raw materials and turning these into goods and services that they can sell to consumers.

## Exam-style practice questions

- 1 Jonah is employed as a joiner by a firm whose main business activity is building houses. The firm also employs bricklayers, plumbers, painters and other skilled tradesmen. Other factors of production are used when building houses. The owner of the firm, Jack, believes that specialisation of labour brings many benefits to the business and its employees.

In his spare time, Jonah makes wooden toys which his sister sells on her stall at the local market. He buys the wood and other resources from a local supplier. The wooden toys have been so successful that Jonah has decided to leave his job as a joiner to set up his own toy-making business.

- a Identify **two** stages of business activity. [2]
- b Define 'opportunity cost'. [2]
- c Identify **four** factors of production. [4]
- d Explain **two** ways Jonah could add value to his toys. [6]
- e Do you agree with Jack that 'specialisation of labour brings many benefits to the business and its employees'? Justify your answer. [6]

- 2 Company X is a manufacturer of pottery products, such as plates and bowls, which are mainly sold to hotels and restaurants. The company employs 50 workers. Each employee receives a good wage and this helps them to meet their needs. Production is broken down into nine processes. Employees specialise in just one process. The marketing manager of Company X has been asked by the directors to look at ways of adding value to the company's products.

- a Identify **two** factors of production. [2]
- b Define 'needs'. [2]
- c Outline how Company X benefits from specialisation. [4]
- d Explain **two** stages of Company X's production process. [6]
- e Suggest **two** ways the marketing manager might increase Company X's added value. Justify your answer. [6]

**Total available marks 40**

# 2

## Objectives

*In this chapter you will learn about:*

- primary, secondary and tertiary sector business activity
- the changing importance of the classification of business activity by sector for developing and developed economies
- how business enterprises are classified in the private sector and the public sector.

# Classification of businesses

## Introduction

In the last chapter you looked at the purpose of business activity. In this chapter you are going to learn how business activity can be used to classify all the businesses in an economy and why it is important to classify businesses in this way.

What is an economy? The country where you live has an economy. It is a measure of all the wealth and resources in your country. It includes the things that your country produces and the goods and services that consumers buy.

## Primary, secondary and tertiary sectors

### How businesses are classified

Businesses produce a wide range of goods and services to meet the needs and wants of consumers. The goods and services they produce can be used to classify all of a country's businesses into one of three different sectors. We call these:

- the primary sector
- the secondary sector
- the tertiary sector.

### Primary sector

**Primary sector** business activity involves extracting or harvesting natural resources from the land or sea. These include agricultural products such as rice, fish, wood, coal and oil. Examples of primary sector business activity are:

- farming
- fishing
- forestry
- mining.

Primary sector business activity often provides raw materials for secondary sector business activity. An example is the extraction of oil which is used to produce petrol or plastics. However, some primary sector business activity produces final products. For example, consumers can buy raw vegetables, fruit and fish.



Harvesting in a rice field



**Needs and wants:** see Chapter 1, page 9.



### KEY TERM

**Primary sector:** firms whose business activity involves the extraction of natural resources.

### ACTIVITY 2.1

Make a list of the primary sector business activities found in your country, including the natural resources they produce.

**KEY TERM**

**Secondary sector:** firms that process and manufacture goods from natural resources.

**Secondary sector**

**Secondary sector** business activity takes the natural resources produced by primary sector activity and turns these raw materials into finished goods. The activities of the secondary sector include:

- refining
- manufacturing
- construction.

Examples of secondary sector business activity include food canning, furniture making, car manufacturing and house building.



A car manufacturing plant

**ACTIVITY 2.2**

Make a list of the secondary sector business activities found in your country, including the products they make.

**KEY TERM**

**Tertiary sector:** firms that supply a service to consumers and other businesses.

**Tertiary sector**

**Tertiary sector** business activity involves providing services to the final consumers or businesses. Examples of tertiary sector businesses include:

- shops
- restaurants
- banks
- cinemas
- airlines.



**TOP TIP**

You must be able to define and give examples of businesses found in each sector. Calculations are also quite common on this topic in examinations, for example calculating the number of employees in a sector.

These businesses provide services such as retailing, finance, entertainment and transport.



Fast food at a cinema

**ACTIVITY 2.3**

Make a list of the tertiary sector business activities found in your country, including the services they provide.



**KEY TERM**

**Chain of production:** the production and supply of goods to the final consumer involves activities from primary, secondary and tertiary sector businesses.

**How the sectors depend on each other**

Although an economy can be divided into primary, secondary and tertiary sectors, the different sectors of business activity are often dependent upon each other. This is known as a **chain of production**. Let's look at oil, for example. Oil is extracted from underground and is a business activity of the primary sector. Once it has been extracted, oil needs to be refined to produce other products such as petrol or gas. This is a process carried out by businesses in the secondary sector. Finally, tertiary sector activity is needed to bring the petrol to your nearest petrol or gas station, for sale to the final consumer.

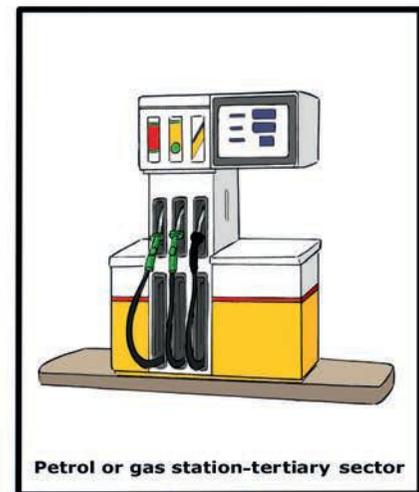
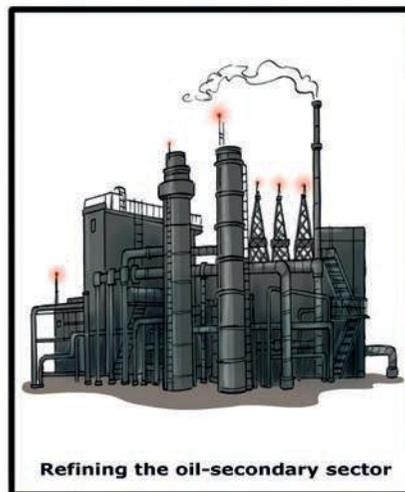
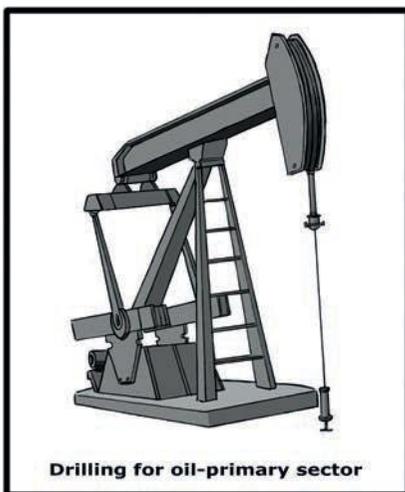


Figure 2.1 Primary, secondary and tertiary sectors

## Diamonds in South Africa

Petra Diamonds is a leading independent mining group in South Africa. It has eight producing mines in Africa and is exploring for diamonds in Botswana.

Source: [www.petradiamonds.com](http://www.petradiamonds.com)

For over 28 years, Mark Solomon has been manufacturing beautiful pieces of diamond jewellery. Breathtakingly beautiful South African diamonds are set in designs ranging from stunning individually crafted diamond engagement rings through to highly prized tanzanite jewellery.

Source: [www.marksolomonjewellers.co.za](http://www.marksolomonjewellers.co.za)

Browns are a leading South African jewellery store. They sell a wide range of diamond rings, bracelets, necklaces and earrings.

Source: [www.brownsjewellers.com](http://www.brownsjewellers.com)

### TASK

- a Using the information contained in the three articles above, define:
  - i primary sector business activity
  - ii secondary sector business activity
  - iii tertiary sector business activity.
- b Explain how the three businesses form a 'chain of production'.
- c Mark Solomon is also a retailer of diamond jewellery and Browns is also a manufacturer of diamond jewellery. What do you think are the benefits to both businesses of being both manufacturers and retailers?

### Changing importance of business classification

Countries are often described as developing or developed. A developing country, or less developed country (LDC), often has a small industrial sector and a lower standard of living compared to other countries. A developed country, or more developed country (MDC), has high levels of industrialisation and its people have higher average incomes and enjoy a higher standard of living compared to less developed countries.

The classification of business activity by sector is not used to class a country as developing or developed. However, the size of a country's different sectors of business activity often indicates if it has a developing or developed economy.

## ACTIVITY 2.4

The data below shows countries which are currently classified as having developing or developed economies.

## Country data for business activity by sector

	Primary sector as a % of the total economy	Secondary sector as a % of the total economy	Tertiary sector as a % of the total economy
<b>Developing economies</b>			
Rwanda	33.3	13.9	52.9
Vietnam	21.5	40.7	37.7
Zimbabwe	20.3	25.1	54.6
<b>Developed economies</b>			
Bermuda	0.7	7.0	92.3
Japan	1.2	27.5	71.4
Norway	2.7	41.5	55.7

- 1 Which country has the lowest percentage of activity in the primary sector, but the highest percentage of business activity in the tertiary sector?
- 2 Which country has the smallest percentage difference between primary business activity and secondary business activity?
- 3 Using data from the table to support your answer, is it true to say that countries whose tertiary sector is larger than their other two sectors of business activity are always developed economies?
- 4 What does the data in the table tell you about the relationship between primary business activity and developing and developed economies?

The importance of business classification has changed for many countries. There are two main reasons for this:

- **Industrialisation** – the growing importance of secondary sector business activity and the reduced importance of primary sector business activity. The emerging economies of both China and India are good examples.
- **De-industrialisation** – the growing importance of the tertiary sector and the reduced importance of the secondary sector. The UK and the USA are good examples of this type of economic activity.

However, the changing importance of business classification may also be due to the following:

- A change in consumer behaviour as a result of both industrialisation and de-industrialisation:
  - Higher incomes – consumers demand better quality and a wider choice of products.
  - Better education – consumers expect better products and know that they can buy goods from suppliers in a different region or country through e-commerce.
  - More leisure time – consumers work fewer hours than they used to. The demand for leisure activities, such as cinemas, restaurants and holidays, has increased.

- A change in business behaviour resulting from:
  - the need for finance to fund expansion so that businesses can compete in global markets
  - the need to be able to communicate internally and externally quickly and as cheaply as possible to take advantage of the opportunities of wider markets
  - the need to provide better services for employees, for example canteens; this in turn increases business demand for the goods and services of other businesses.

### TEST YOURSELF

- 1 Give **one example** of primary, secondary and tertiary sector business activity.
- 2 Explain the difference between primary sector and tertiary sector business activity.
- 3 Define 'secondary sector business activity'.
- 4 Using an example, explain the relationship between business activities in the primary, secondary and tertiary sectors.
- 5 How might the classification of business activity by sector be used to tell the difference between a developing and a developed economy?

## Business enterprises in the private and public sectors

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### KEY TERMS

**Mixed economy:** an economy where the resources are owned and controlled by both the private and the public sectors.

**Private sector:** the part of the economy that is owned and controlled by individuals and companies for profit.

**Public sector:** the part of the economy that is controlled by the state or government.

Most countries in the world have **mixed economies**. These are economies that have both **private sector** and **public sector** organisations.

In the private sector, businesses are owned and controlled by individuals or groups of individuals, for example Sony, Tata Corporation and Apple.

In the public sector, organisations are owned by the country as a whole and controlled by the state or government; for example, most countries have publicly owned television and radio broadcasting services such as SABC in South Africa. Figure 2.2 shows the main types of organisations found in a mixed economy.

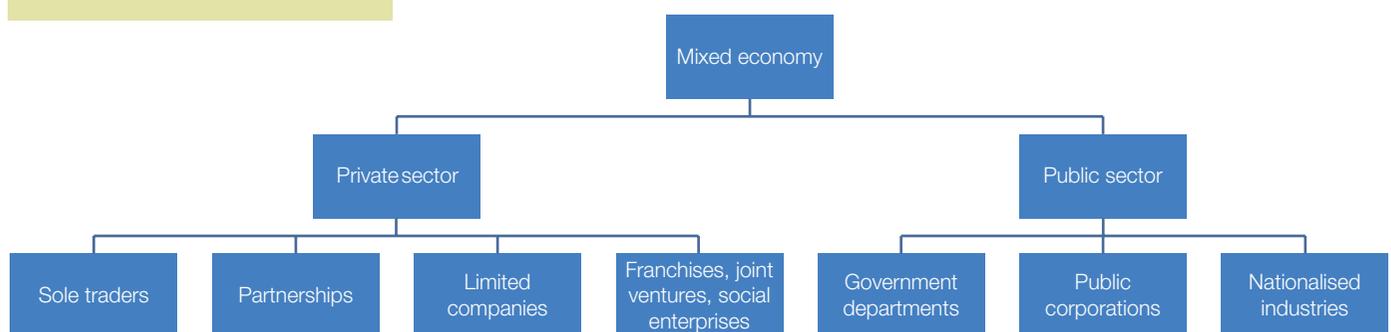


Figure 2.2 Organisations in a mixed economy



**Sole traders, partnerships, private and public limited companies, franchises and joint ventures:** see Chapter 4, page 45.



**EXPLORE!**

Use newspapers, library resources or the internet to research the private and public sectors in your country. Draw bar charts or pie charts showing how important each sector is to your country's economy, for example how many people are employed in each sector.

Identify the different organisations in the public sector of your country and the products they provide. Which of these products are provided 'free' to the population and which ones do consumers have to pay for? Are there any products which are provided by both the private sector and the public sector? Why do you think both sectors provide these products?



**TOP TIP**

Knowing your own country's economy, and the businesses within it, will help you to better understand many of the key terms and concepts you will study in this and later chapters.

In a mixed economy, decisions about **what** to produce, **how to** produce and **for whom** to produce are made by both the private sector and the public sector – see Table 2.1.

	Private sector	Public sector
What to produce	Consumer choices	The government decides
How to produce	Firms want to make profit	The government decides
For whom to produce	Customers' buying power	The government decides

Table 2.1 Choices in the private and public sectors

**Private sector decisions**

In the private sector, consumers want to buy certain goods and services. Consumer choices help businesses to decide what they produce.

Businesses only produce the goods and services that consumers want if they can make a profit from doing so. Businesses decide the best way of producing their products. This is at the lowest cost so that they can make a profit when the products are sold.

The goods and services produced by private sector businesses will only be bought by people who have enough money to pay the price charged. Some consumers will not be able to buy products they want because they do not have enough money.

**Public sector decisions**

The decisions about what, how and for whom to produce in the public sector are all made by government.

The public sector in many countries produces goods and services that all people in the population need, for example electricity, roads, education and health care.

Government departments make decisions about how to produce these goods and services. The decisions are based on providing good-quality services to the public rather than making profit.

Some of the goods and services provided by the public sector are provided free at the point of use, for example primary and secondary education and hospital treatment. Other goods and services are sold to consumers. If some consumers do not have enough money to buy these goods and services, the government might sell them at a lower price, or provide them free of charge.



A secondary school classroom

**TEST YOURSELF**

- 1 State **four** forms of private sector business organisation.
- 2 Explain the role of **four** public sector organisations in your country.
- 3 Explain **two** differences between the private sector and the public sector.
- 4 Define 'mixed economy'.
- 5 In a mixed economy how is the decision made about 'what' to produce?

## Revision checklist

- Businesses in every country can be classified, according to their activities, into primary, secondary and tertiary.
- The primary, secondary and tertiary sector businesses are linked because one provides the resources required by another.
- The classification of businesses by activity is often used to classify the economies of countries into developing or developed.
- Most economies have a private sector and a public sector.

## Exam-style practice questions

- 1 Paul owns a fishing boat with his father John. They have been in business together for over 15 years. Paul is thinking of investing money in his friend's fish canning company – Pisces Products (PP).
- PP sells most of its canned products to local supermarkets, but about 10% of the output is sold to public sector organisations such as schools and hospitals.
- Identify **two** forms of business organisation (other than supermarkets and fish canning) found in the private sector. [2]
  - Define 'public sector'. [2]
  - Outline how the decisions about 'what to produce' and 'how to produce' are made in the private sector of a mixed economy. [4]
  - Explain **two** differences between primary sector and secondary sector business activity. Use the information in the question to help with your explanation. [6]
  - Do you think Paul should invest in his friend's fish canning company? Justify your answer. [6]
- 2 Consider the following data for two countries, X and Y.

Sectors	Country X – size of business activity by sector	Country Y – size of business activity by sector
Primary	61%	3%
Secondary	24%	32%
Tertiary	15%	56%

	Country X	Country Y
Size of private sector	28	49
Size of public sector	72	51

- Country X has a working population of 40 million. How many people work in the tertiary sector? [2]
- Define 'primary sector'. [2]
- Outline **two** differences between the public sector and the private sector. [4]
- Using data from the tables, explain **two** differences between Country X and Country Y. [6]
- The people who live in Country Y are likely to have a higher income and a better standard of living than people who live in Country X. Do you agree? Justify your answer. [6]

# 3

## Objectives

*In this chapter you will learn about:*

- entrepreneurs and enterprise
- business plans
- how to measure business size
- why some businesses grow
- why some businesses fail.

# Enterprise, business growth and size

## Introduction

Do you know anyone who has their own business? Maybe a member of your family or a friend? Many businesses start from small beginnings. A person has an idea for a business. A bank or members of their family loan them some money to get started. Before they know it, the business is growing fast, and they need to employ other people to help them. In this way, both large and small businesses play an important part in the economy of a country.

In this chapter you will learn about the people who are responsible for business start-ups and the importance of these to the economies of the world. You will also look at why and how governments, including your country's government, support business start-ups through a variety of different financial and non-financial schemes.

Once a business exists, how do we work out its size? The next part of this chapter looks at how to measure the size of a business, and the problems involved. Some businesses decide to remain small. Other businesses set growth as an objective. You will learn how businesses achieve their growth objective, the advantages and drawbacks of growth and why some businesses fail.



### KEY TERM

**Entrepreneur:** an individual who has an idea for a new business and takes the financial risk of starting up and managing it.



### EXPLORE!

Working in small groups, use newspapers, magazines, library resources or the internet to research an entrepreneur from your country, or one who your group thinks has had a big influence on business activity in your country. Make sure all groups are researching a different entrepreneur, then prepare a short presentation to the rest of your class about your chosen entrepreneur.

What is their name? What qualifications and work experience did they have before going into business? How did they start in business? What business did they start? What is the history of this business? These are just some of the things you could include in your presentation.

## Enterprise and entrepreneurship

New businesses are started by people called **entrepreneurs**. They include people such as Ekta Kapoor from India, Kagiso Mmusi from Botswana, Mo Ibrahim from the Sudan, Richard Branson from the UK and Pan Shiyi from China.

Although the ideas for a business are often different, entrepreneurs usually:

- have an idea for a new business
- are prepared to invest their own savings
- accept the risks of failure
- want to make all the decisions about the management of the business.

The idea for an enterprise – meaning a project or business – may be any of the following:

- a new idea for a good or service
- offering an existing good or service in a way that has not been offered before
- offering an existing good or service in a new location.



UK entrepreneur Richard Branson, founder of the Virgin Group



Figure 3.1 An entrepreneur needs certain skills and qualities



#### KEY TERMS

**Business plan:** a detailed written document outlining the purpose and aims of a business which is often used to persuade lenders or investors to finance a business proposal.

**Revenue:** the amount a business earns from the sale of its products.



**Market research:** see Chapter 11, page 153.

**Cash-flow forecast:** see Chapter 20, page 259.



**Business (SMART) objectives:** see Chapter 5, page 57.

## Characteristics of successful entrepreneurs

Entrepreneurs come in all shapes and sizes, young and old, male and female, quiet and showy. There is no such thing as a typical entrepreneur! All successful entrepreneurs have the ability to take an idea and turn it into a good or service which can be sold for profit. Successful entrepreneurs share similar characteristics.

- **Innovative** – they are good at thinking up new ideas for goods and services or new ways of presenting existing goods and services.
- **Self-motivated and determined** – they have the drive to keep going, even when things get difficult.
- **Self-confident** – they have a strong belief in their own ability and ideas.
- **Multi-skilled** – they have the ability to see an idea through from development to profitable sales. This requires a good understanding of the functions of finance, operations, human resources and marketing.
- **Strong leadership qualities** – they have good communication skills, the ability to motivate others and are good decision-makers.
- **Initiative** – they not only have good ideas, but are also able to develop a good plan for achieving the business's objectives.
- **Results driven** – they are focused on achieving results and make sure products are sold for profit.
- **Risk-taker** – they are prepared to take risks, knowing that failure is a possibility. They see failure as a positive experience to be learnt from.
- **Good at networking** – they are prepared to learn from others.

These skills and qualities help to turn ideas into a real and profitable business.

## Contents of a business plan

A **business plan** describes:

- the business – this part of the plan includes details of the entrepreneur, the idea for the business and information about the skills and expertise of managers or employees who need to be recruited
- the business opportunity – here you will find information about the product and why the entrepreneur believes customers will buy it; this part of the plan includes market research
- the market – the current size, the potential for growth and the product's main competitors
- the objectives of the business – this is what the business hopes to achieve
- financial forecasts – a cash-flow forecast and projected sales, **revenue** and profit for at least the first year of trading.

## How business plans assist entrepreneurs

The business plan is important to new (and existing) businesses.

- The information it contains can be used to persuade lenders such as banks and investors to provide finance to the business.
- The plan gives the business a sense of purpose and direction. It sets out the resources required by the business such as finance, the number and skills of employees needed, and how the goods and services will be marketed to consumers.
- The objectives and financial forecasts provide the business with targets to aim at and enable the business to monitor its progress.

**TOP TIP**

Don't just learn the main features of a business plan. It is important for you to know why the features are important to new and existing businesses.

Preparing a business plan is not just something a business needs to do at start-up. A business plan is also important for the planning and development of existing businesses. An up-to-date business plan may also be needed when a business wants lenders or investors to provide finance for expansion or other long-term projects.

These plans are often known as the corporate plan and are often more long-term than the business plan produced for a new business start-up.

## CASE STUDY

## Mama Meals on Wheels

When Naisiadet Mason moved back to Kenya from working abroad she realised that no-one delivered food from all the restaurants in Nairobi. A few restaurants did have their own delivery service but this was limited to how close customers' homes were to the restaurants.

Naisiadet loves good food, as opposed to 'junk food', and thought that delivering meals from restaurants in Nairobi direct to the homes of customers was a good business idea. She carried out market research and found that only 5% of people in Nairobi could afford the services she was going to offer. These were mostly middle income earners who get home tired after work and do not want to go to the trouble of making their own meals.

Naisiadet set up Mama Meals on Wheels in 2010 using her own savings to buy delivery motorbikes and other start-up costs. The business has been successful and now employs 14 workers. Grocery delivery has been added to the service Mama Meals on Wheels offers to its customers. Naisiadet puts the success of the business down to offering good customer service. 'Quality on time delivery every time' is the business's motto.

However, despite the early success of her business, Naisiadet realised that not having a business plan when she set up her business may have been a mistake.

Source: adapted from <http://www.youtube.com/watch?v=AmR8L0MHxD0> and [www.mamamealsonwheels.com](http://www.mamamealsonwheels.com)

**TASK**

- Mama Meals on Wheels is in the tertiary sector. Identify the other **two** sectors.
- Identify **two** reasons why Naisiadet might be described as an entrepreneur.
- Explain **two** benefits to Naisiadet of researching the market for her proposed business.
- Do you think it was a mistake for Naisiadet not to have a business plan for her business? Justify your answer.

## Why and how governments support business start-ups

Small businesses are important to most economies throughout the world. In the UK, for example, in 2012:

- There were 4.8 million businesses.
- More than 99% of these businesses were small or medium-sized businesses, employing fewer than 250 people.
- There were 4.6 million micro-businesses (96% of all businesses), employing fewer than ten people.

Governments are keen to encourage new start-up businesses because of the benefits they bring to the economy. These benefits include:

- Job creation – although small firms may not individually employ many workers, together they employ a very large percentage of the working population.



An example of a small business

- The entrepreneurs who start up new businesses bring ideas for goods and services that increase the variety of products available. This helps to create a greater consumer choice in the market.
- The more businesses there are in the marketplace, the greater the competition. Competition usually results in lower prices and better quality of goods and services.
- Small businesses often provide specialist goods and services to consumers which larger businesses are less interested in supplying because they are only interested in mass marketing. Also, these smaller businesses often provide the goods and services needed by the larger firms in the industry, for example a small firm that produces electronic components used by large computer manufacturers.

- Start-up businesses begin life as a small business, but some will grow and become the larger businesses of the future. The country will benefit from the advantages larger businesses bring to the economy.
- Some start-up and smaller businesses often have much lower costs than larger businesses and can pass this on to the consumer through lower prices.



#### KEY TERM

**Business start-up:** a newly formed business. They usually start small, but some might grow to become much bigger.

Many governments provide financial and other support to new **business start-ups**. These vary from country to country, and even within a country the support may vary depending on the activity of the business and its location.

The most common types of government support include:

- grants and interest-free or low-interest loans
- lower taxation rates on profits in the early years
- rent-free premises for a certain period of time
- free or subsidised training schemes for employees
- information, advice and support from specialist agencies.

### ACTIVITY 3.1

Use newspapers, magazines, library resources or the internet to research the assistance the government provides to start-up businesses in your country.

Why do you think governments should provide financial and other support to start-up businesses in your country?

### TEST YOURSELF

- 1 Identify **two** characteristics of an entrepreneur.
- 2 Explain **two** features of a business plan.

## Measuring business size

There are several ways of measuring and comparing the size of businesses. The most common methods are shown in Figure 3.2.

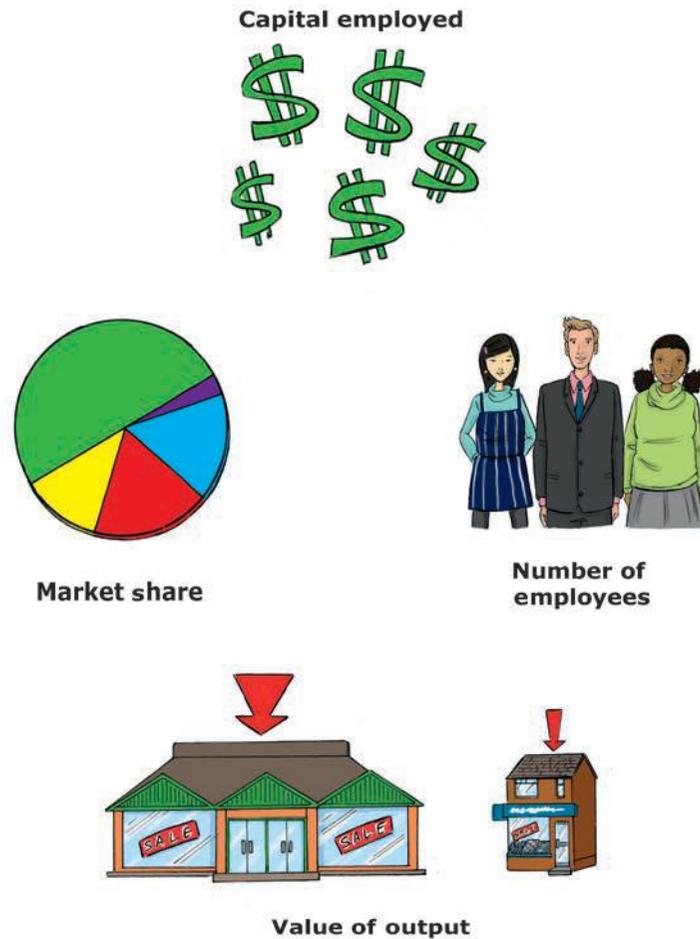


Figure 3.2 Measuring business size

### Capital employed

This is the value of all long-term finance invested in a business. It is used to buy the things that a business needs before it can produce goods and services, for example factory/office buildings, machinery and inventory – these are known as assets.

A small business will invest less capital than a large business in the same industry. For example, a small baker will only need one shop, one food mixer, one oven and a small inventory of raw materials. A large bread manufacturer will need production lines, industrial mixers, large ovens and a large inventory of raw materials.

Using capital employed to compare the size of businesses in different industries is a problem because some industries, such as car manufacturing, need a very large capital investment in factories and machinery. Others, such as computer software design, do not.

**EXAMPLE**

Think about the two businesses below.



Figure 3.3a A window cleaner



Figure 3.3b A helicopter rental business

Both of these businesses are small and have just one owner, but the helicopter rental business requires a much greater capital investment than that needed by a window cleaner.

### Value of output

The amount businesses earn from selling their products is often used to compare the size of businesses in the same industry. A small business will have much lower revenue – earnings from sales – than a larger business. For example, a small general store will have fewer customers than a large supermarket and, therefore, much lower sales and revenue. The larger the market a business serves, the more revenue the business is likely to earn. However, it is not a good measure when comparing businesses in different industries.

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**EXAMPLE**

Think about the two businesses below.



Figure 3.4a A designer dress shop



Figure 3.4b A sweet shop

The designer dress shop sells a high-value product compared to the low-value products sold by the sweet shop. The revenue of the designer dress shop is likely to be much greater than that of the sweet shop.

## Number of employees

Large businesses need to produce a much greater output or provide their services to a much larger market than smaller businesses. They will also have more departments and managers. Therefore, larger businesses usually employ many more employees than smaller businesses in the same industry, for example a local general store and a large national supermarket.

However, this measure may be misleading. Two businesses can produce similar levels of output, but if one business uses more machinery than the other then they are likely to have far fewer employees.

Let's look at the example of two drinks manufacturers. They both produce the same level of output. However, one firm has invested in an automated production process, while the other still uses more traditional methods of production. The firm with automated production will require far fewer employees than the one that is using traditional methods.

## Market share

The larger the share of the total market, the larger the business. However, this measure can also be misleading. Look at the data for three firms shown in Table 3.1. Firm A and Firm B are in the same industry. Firm C is in a different industry from A and B.

	Firm A	Firm B	Firm C
Market share %	10	60	6
Total market value \$000s	500	500	850

Table 3.1 Data for firms A, B and C

Firm B is larger than Firm A because its market share is six times bigger. However, can we describe Firm B as a large business? The answer is yes if we use market share as a measure. However, does this mean that Firm C with a market share of just 6% is a small business? The answer lies not in the market share of each business, but in the value of each firm's share of the market:

So, if we work out Firm B's share of the market:

$$60\% \text{ of } \$500\,000 = \$300\,000$$

and Firm C's share of the market:

$$6\% \text{ of } \$850\,000 = \$51\,000$$

We can see that the value of Firm C's market share is much higher than the value of Firm B's market share. Therefore, Firm C is larger than Firm B.

## Limitations of methods of measuring business size

Although all of the above methods can be used to measure and compare the size of businesses, you have seen that it is not quite as straightforward as it first seems. Take care before drawing any conclusions about the size of a business, because different measures can produce different results. Before deciding on how to describe the size of a business it is a good idea to use more than one measure.



### TOP TIP

Profit is **not** an acceptable measure of business size.

## ACTIVITY 3.2

The table below shows data for three companies which are all manufacturers of home entertainment appliances such as televisions and DVD players.

Company data	Company A	Company B	Company C
Revenue	\$280 000	\$380 000	\$410 000
Capital employed	\$200 000	\$500 000	\$350 000
Number of employees	60	35	50

- 1 Each company claims to be the largest in the industry. Why can they do this?
- 2 Why might the number of employees NOT be a good measure of size in this industry?
- 3 Which of the three companies do you think is the largest? Give reasons for your answer.

## TEST YOURSELF

- 1 Identify **three** methods of measuring the size of a business.
- 2 Explain one problem of measuring business size.

## Why some businesses grow and others remain small

Growth is a long-term objective of most, but not all, businesses. Some businesses prefer to remain small, while others wish to expand. For example, a chocolatier making specialist, handmade chocolates may want to stay small, while a chocolate manufacturer who wants to produce chocolates for the mass market will want to grow.



Figure 3.5 Some businesses prefer to remain small, while others will want to grow

### Why owners may want to expand their business

Expanding a business can bring many benefits, including increased profits and a larger share of the market.

### Increase in profits

When a business grows, its profits may increase. Growth must result in an increase in output – goods and services produced. If this output is sold, then sales increase. Increased sales usually increase revenue and, if the business has kept control of its costs during its growth, should also increase profits.

### Increase in market share

An increase in market share may also result from business growth. This benefits the business because its products and brand become more widely known and this makes it easier for the business to continue to grow. Launching new products on to the market is less risky. However, the growth in the value of a business's sales does not automatically increase its market share.

Look at the data for Company Z in Table 3.2.

	Value of annual sales (\$000s)	Value of total market (\$000s)	Market share
2011	100	100 000	$(100/100\,000) \% = 10\%$
2012	120	144 000	$(120/144\,000) \% = 8.5\%$

Table 3.2 Data for Company Z

You can see that Company Z has increased its sales between 2011 and 2012, although its market share has fallen from 10% to 8.5%. This is because the growth in Company Z's market share is less than the growth in the total market.

### Economies of scale

The concept of economies of scale will be studied in a later chapter. For now, all you need to know is that as a business grows it may benefit from reduced average costs as a result of economies of scale. If a business can lower the cost of producing its products, its profits will increase. Instead, it may decide to lower the price of its products and become more competitive – resulting in higher sales.

### Greater power to control the market

Larger businesses in an industry have greater power to control market activities. They have greater control over their own prices and may even be able to set the price for all other businesses in the industry to follow. Large and powerful firms may even be able to influence government policy to their advantage.

### Protection from the risk of takeover

Public limited companies are often at risk of takeover. This is achieved by buying at least 51% of the company's shares. Sometimes the takeover is welcomed by the company's directors and shareholders. However, this is not always the case and a hostile or unwanted takeover might happen. The larger the company, the more difficult and more expensive it is for this to happen because a greater number of shares must be bought.

### Different ways businesses can grow

Businesses can grow in different ways, either through internal growth (also known as organic growth) or through external growth (also known as integration).



**Economies of scale:** see Chapter 16, page 219.



**Public limited companies:** see Chapter 4, page 48.

### Internal growth

Internal growth occurs when a business expands by:

- increasing the number of goods it can produce, for example by buying more or better machinery
- developing new products
- finding new markets for its products.

Although internal growth is often quite slow, it avoids some of the problems of external growth.

## Air India

India's national carrier Air India is poised for significant internal growth.

Air India is currently the only operator of the Boeing 787 Dreamliner aircraft in the Indian sub-continent. The arrival of additional aircraft will enable the Indian flag carrier to look to new markets.

'We are looking to add new flights to a number of new markets in the coming years. These include destinations in Australia, Italy, the US and a second stop in the UK.'

Deepak Brara,  
Commercial Director, Air India



Air India Dreamliner

Air India's existing home market is very large and it is already established as the market leader. It plans to build on its success in this market by operating more efficiently.

*Source:* Adapted from [www.routesonline.com/news/29/breaking-news/189045/air-india-set-for-international-network-growth](http://www.routesonline.com/news/29/breaking-news/189045/air-india-set-for-international-network-growth)

### TASK

- a Explain **two** ways Air India is trying to achieve internal growth.
- b Explain **one** other way Air India could achieve its growth objective.
- c Explain **two** reasons why you think Air India might achieve its plans for growth.

### External growth

External growth takes place when a business merges with or takes over another business in the same or a different industry. The process is known as integration. There are four main types of integration:

- **Horizontal integration** brings together two firms in the same industry who are also in the same sector of business activity, for example two wheat farmers (primary sector), two chocolate manufacturers (secondary sector) or two banks (tertiary sector).
- **Forward vertical integration** brings together two firms in the same industry, but one is a customer of the other, for example a shoe manufacturer and a shoe retailer.
- **Backward vertical integration** brings together two firms in the same industry, but one is a supplier to the other, for example a chocolate manufacturer and a cocoa producer.

- **Conglomerate integration** is the bringing together of two businesses who are in completely different industries, for example a cosmetics manufacturer and a soft drinks manufacturer.

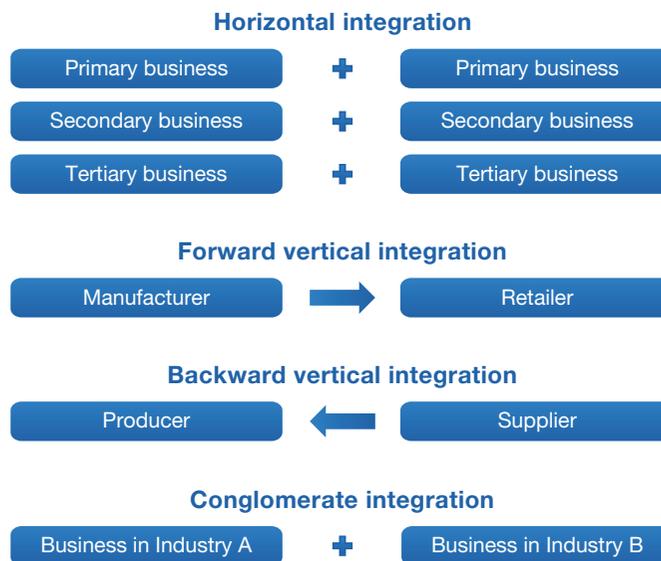


Figure 3.6 Horizontal, forward vertical, backward vertical and conglomerate integration

**ACTIVITY 3.3**

1 Copy and complete the table below.

Form of integration	Business activity	Business activity
Forward vertical	Oil refining	
Conglomerate		Restaurant
	Large car manufacturer	Small car manufacturer
Backward vertical		Fruit canning
	Fast food outlet	Supermarket
	Overseas holidays	Travel agency

- 2 Explain the main advantage to the fruit canning business of backward vertical integration.
- 3 What do you think is the main advantage of conglomerate integration?
- 4 What is the advantage to the overseas holiday business of integration with a travel agency?
- 5 Discuss the advantages to both the large and the small car manufacturers of their integration.

**Problems linked to business growth**

Although businesses benefit from growth, there may also be problems.

- Internal growth is usually slow. There is a risk that other businesses, using an external growth strategy, grow much faster. These larger firms may then dominate the market and remove the opportunity for other businesses to expand.
- When two separate businesses are brought together, managers and employees in each business may fear loss of their jobs or status. This is particularly the case if one

of the businesses is much larger than the other. The newly enlarged firm may be more complex to control and managers may not have the skills needed to manage effectively. This could lead to poor decision-making and inefficiency.

- If a business becomes too large then diseconomies of scale may occur. This will increase the business's average costs and reduce its profit margins.
- Any two businesses that are brought together through integration are likely to have different ways of doing things. They may have different objectives, pay and other conditions of work. Management styles may also be different. All of these factors could result in conflict between management and employees and even between different groups of employees.
- The integration of two firms will change the control of the business for the original owners. There will be a loss of control. This may happen if a sole trader becomes a partnership.



#### **Diseconomies of scale:**

see Chapter 16, page 220.

#### **Sole trader, partnership:**

see Chapter 4, page 45.

#### **Leadership style:**

Chapter 7, page 99.

The way these problems are managed will determine the success of the larger business.

The secret of success for business growth is careful planning. Senior managers must make sure that they have the resources available to meet their growth objectives. These resources include time, finance and management expertise to manage the growth process. Keeping employees fully informed about plans for growth and how they will be affected is also important for minimising or removing possible conflict situations.

### Why some businesses remain small

Some businesses never grow and remain small businesses. There are various factors that explain why these businesses do not have growth as one of their objectives, or if they do, why they fail to grow.

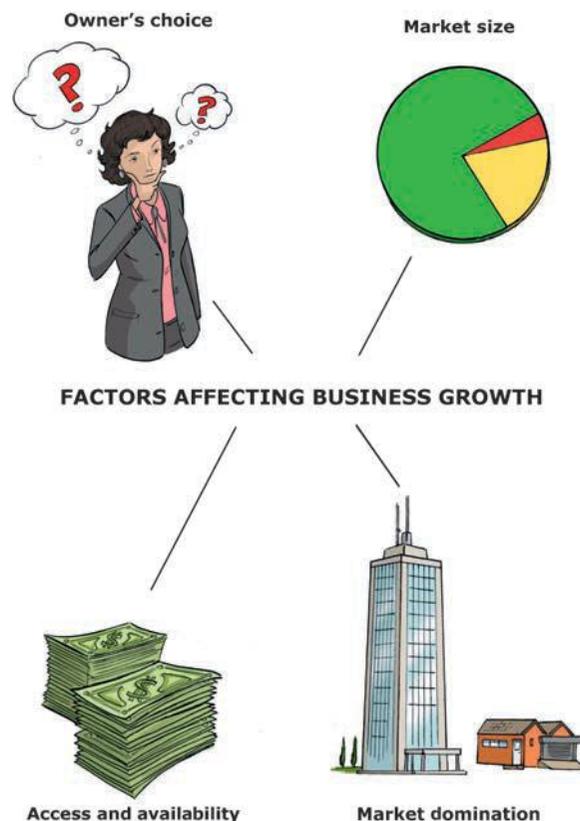


Figure 3.7 Factors affecting business growth  
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### Owner's choice

Most businesses start off small. Once they become established in the market, the owner may set growth as an objective, but not always. There are several reasons for this.

- The owner does not want the responsibility or workload of managing a larger business. For some this is a lifestyle choice.
- The owner wants to keep total control of the business and fears that growth will reduce the level of control they have over decision-making and day-to-day management.
- The owner wants to maintain a close relationship with customers and provide a personal service. This is much more difficult with larger businesses.
- The owner does not want to take the risk of having growth as an objective. Often additional capital must be borrowed to finance expansion plans. If growth is too slow or profits do not increase, the business may not be able to finance its borrowing. If so, then the business will not survive. The owners of unincorporated businesses, such as sole traders and partnerships, have unlimited liability for the debts of the business. They have to use their own wealth to pay business debts.



**Sole traders, partnerships, unlimited liability:** see Chapter 4, page 46.

### Market size

Some businesses have market size as an objective and this influences their growth. But not all businesses have market size as their objective. For example, businesses that serve a local market – such as hairdressers, taxi firms or dentists – may not want to offer their services beyond the local neighbourhood. They know that consumers in other neighbourhoods will not want to travel to their businesses when there are similar businesses close to where they live.

### Access and availability of capital

Another important factor influencing growth is the access and availability of capital to finance growth plans. You will learn later that one of the disadvantages of small businesses is the difficulty they have in obtaining loans from banks and other lenders. This is probably the most important factor that prevents businesses of this type from expanding.

### Market domination

Some industries are dominated by a few very large companies and it is difficult for smaller businesses to compete. Market domination often means that consumers have a brand loyalty to the larger businesses that can offer lower prices than smaller firms due to them enjoying the benefits of economies of scale.



**Disadvantages of small businesses such as sole traders:** see Chapter 4, page 46.

## TEST YOURSELF

- 1 Explain **two** reasons why owners might want to grow their business.
- 2 What is the difference between internal and external growth?
- 3 State **two** reasons why some businesses remain small.

## Why some businesses fail

Businesses are not always successful. Many new businesses fail within their first one or two years. Even long-established businesses fail.

## Budget airline failures

Working in pairs, read through the following articles about business failures. For each business, discuss what you think were the main causes of their failure.

### Article A

Itime Airline was the second largest low-fare private airline in South Africa by market share. It was one of three low-cost airlines operating in South Africa.

In November 2012 the airline stopped all its flights. It was no longer able to operate at profitable levels.

### Article B

Zambezi Airlines had its aircraft repossessed by the owners, General Electric Commercial Aviation Services (GECAS), for failing to pay arrears amounting to more than US\$2 million. The previous year the government had suspended Zambezi Airlines' operating certificate because of safety concerns.

### Article C

Pacific Blue stopped flying domestic routes in New Zealand. It had been difficult to make any money on these routes. Aviation analyst Rob Mercer was not surprised by the news. 'The New Zealand market wasn't big enough to support three domestic carriers,' he said.

### Article D

At the end of January 2012, Malév Hungarian Airlines announced that it could no longer fund its operations. It ceased all flight activity on 3 February 2012, after 66 years of continuous operation. The airline's total debts were \$270.5 million at the time of shutdown.

## Causes of business failure and why new businesses fail

Figure 3.8 shows some of the most common reasons for business failure.





**Business plan:** see Chapter 3, page 29.

**Objectives:** see Chapter 5, page 57.



**Cash-flow management:** see Chapter 20, page 258.

### Poor planning and lack of objectives

The lack of a detailed business plan, covering aspects such as marketing and finance as well as detailed costings and profit predictions, is often a cause of business failure.

Clear objectives are essential for business success. New business owners often fail to set objectives and as a result the business lacks focus and direction.

### Liquidity problems

A business receives cash from the sale of its products. However, most businesses sell their products on a credit basis. This means that they will receive the cash from sales at a later date, for example 30 days after delivery to the customer.

Cash will leave the business when it pays for expenses such as supplies of raw materials, employees' wages and other business expenses.

There must be enough cash coming into the business to pay the expenses and other debts. Sometimes businesses do not manage the inflow and outflow of cash effectively. This poor cash management can result in liquidity problems - that is, the business does not have enough cash to pay its expenses and debts.

### Poor choice of location

Choosing the right business location is a very important business decision and one that could be the difference between success and failure. This is often true for businesses such as retailers, restaurants and leisure facilities, which need to be located close to their market.

### Poor management

Many owners of new businesses may have excellent ideas and products, but they often lack the management skills and experience to run their business efficiently.

### Failure to invest in new technologies

A business that does not invest in the latest technologies will often find it is unable to compete in terms of price, design and quality. Instead, consumers may buy their competitors' products, and the business will fail to survive.

### Poor marketing

Successful businesses are ones that identify and then meet the needs of their customers. Market research is essential to new businesses for identifying the potential size of the market, the level of competition and what consumers want. Businesses that do not carry out market research are likely to fail.

### Lack of finance

New businesses often lack the finance they need to take full advantage of the opportunities available to them.

### Competition

All businesses face competition. However, one of the reasons for business failure is the effect of the globalisation of markets. Globalisation – the growth of multinational businesses and increased international trade – gives businesses access to wider markets, but this also means that competition is increased. Businesses that are unable to compete on price and quality are unlikely to survive in the long run.



**Marketing:** see Chapter 10, page 139.



**Finance:** see Chapter 19, page 245.



**Globalisation:** see Chapter 26, page 327.



**Interest rates and taxation:**  
see Chapter 24, page 303.

### Economic influences

Unemployment, high interest rates and taxation may reduce the amount of money consumers have to spend on goods and services produced by businesses. This, in turn, will reduce businesses' earnings from sales and profits. Firms that are well established may have the finance to continue even when they are making a loss. However, new businesses may fail when the economic condition is difficult.

### ACTIVITY 3.4

Misaki is worried. Her business, designing and selling wedding dresses, has made a loss for the first time in 12 years. She knows her dresses are more expensive than those of her main competitors, but her customers have always been prepared to pay a little more to have the dress of their dreams!

She has telephoned her accountant for some advice. He told Misaki, 'The economic conditions are not good. Many people are losing their jobs and those that are still working are having to pay higher taxes on their earnings.'

'But people are still getting married,' said Misaki.

'Yes they are, but they have less money to spend on dresses and other wedding items,' he replied.

- 1 Identify **two** economic factors that may have affected Misaki's business.
- 2 Explain **two** reasons that might explain why Misaki's business has made a loss.
- 3 Do you think that Misaki's business is at risk of failure? Justify your answer.

### TEST YOURSELF

- 1 Identify **two** causes of business failure.
- 2 Why are new businesses more likely to fail than businesses that have existed for a long time?

## Revision checklist

- An entrepreneur is someone who has an idea for a business and is prepared to take the risk of setting up the business using their own money.
- A business plan provides purpose and direction for the business by clearly setting out the objectives and financial forecasts and the resources needed to achieve these.
- Capital employed, number of employees, value of output and market share are all methods that can be used to measure business size.
- Although some businesses might remain small, others will choose to grow using internal or external methods.
- There are many reasons why businesses, especially new businesses, fail. The most common reason for business failure is poor financial management.

## Exam-style practice questions

- 1** Grace has always been interested in owning her own business. Even when she was still at school she was always looking at ways of making money – baking cakes, making sweets which she sold to her friends and one time even organising a dance competition. Her drive and determination to succeed at whatever she does in life have often enabled her to achieve success where others might easily have failed.

She has a new idea for a disposable seat. At a recent outdoor music concert she realised that many people wanted to sit down between acts, but this was not possible because the ground was damp and people did not want to get dirt or grass stains on their clothes. The seat is made of cardboard so it is lightweight, and it is easy to carry and assemble. Once finished with, it can be recycled.

- a** Grace's new business activity will be part of the secondary sector. Identify the other **two** sectors of business activity. [2]
- b** Define 'entrepreneur'. [2]
- c** Identify **four** characteristics you think Grace has that make her a good entrepreneur. [4]
- d** Explain **two** benefits to Grace of preparing a business plan. [6]
- e** Which two factors do you think are most likely to affect the success of Grace's business proposal? Justify your answer. [6]

- 2** Leroy and Lance are farmers. In addition to the owners, the business employs three other workers. They sell their produce – vegetables, eggs and milk – to businesses in the tertiary sector.

Leroy is keen to grow the business through forward vertical integration, but Lance is not so sure about Leroy's plan for growth.

- a** Identify **two** ways of measuring the size of Leroy and Lance's business. [2]
- b** Define 'tertiary sector'. [2]
- c** Outline how the business might achieve growth through forward vertical integration. [4]
- d** Explain **two** problems the business might experience if it decides to set growth as an objective. [6]
- e** Do you think Lance is right to be concerned about Leroy's plan for growth? Justify your answer. [6]

# 4

## Types of business organisation

### Objectives

*In this chapter you will learn about:*

- sole traders and partnerships
- private and public limited companies
- franchises and joint ventures
- the differences between unincorporated and incorporated businesses
- the role of public sector organisations.

### Introduction

Your local business directory will list all types of businesses, from accountants to plumbers, florists to furniture manufacturers, department stores to banks, and many, many more. They all have one thing in common – they are businesses, but that is where the similarity ends. Some may be sole traders, some may be limited companies, some may be public corporations, and so on. Some businesses may be in the private sector; others will be in the public sector.

In this chapter you will learn about the different types of organisations found in the private and public sectors. You will look at the advantages and disadvantages of different forms of private sector organisation and how entrepreneurs choose the best form of organisation for their business.

### Forms of business organisation

Business organisations in the private sector are defined by their legal structure. Figure 4.1 shows the forms of business organisation which you need to study as part of your Business Studies course.



#### TOP TIPS

Make sure you know the main features of each type of business ownership and the advantages and disadvantages to the owners of each type.

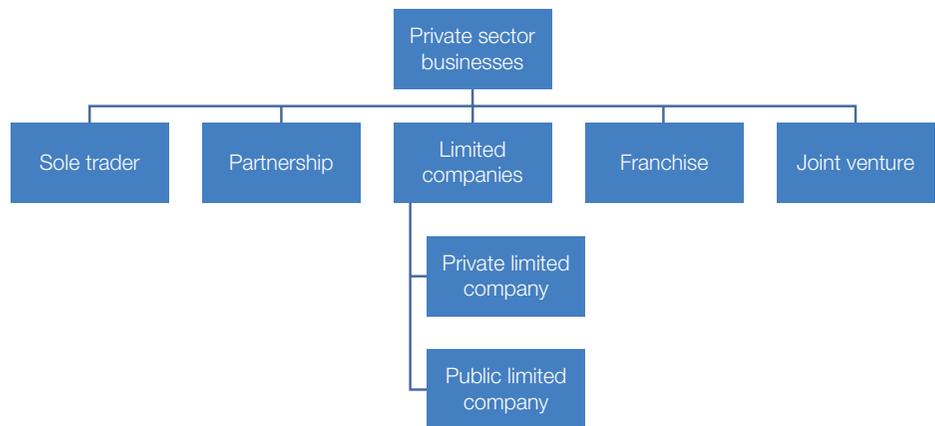


Figure 4.1 Main forms of business organisations in the private sector



#### KEY TERM

**Sole trader:** a business that is owned and controlled by just one person who takes all of the risks and receives all of the profits.

### Sole traders

A **sole trader** is a business owned and managed by one person. Your local florist or plumber may be sole traders.

People often choose to become sole traders for their own personal reasons, for example because they want to:

- be their own boss and make their own decisions
- decide when and how many hours to work
- have a business that uses their skills and interests.

**KEY TERM**

**Start-up capital:** the finance needed when first setting up a business.



A sole trader



**Why some businesses fail:** see Chapter 3, page 40.

The main advantages of a sole trader are:

- It's quick and easy to set up a business.
- The sole trader makes all of the decisions so has complete control over the business.
- The business can often be set up with a small amount of **start-up capital**. For example, someone setting up a window cleaning business may only need to buy a ladder, bucket, detergent and cloths.
- The owner keeps all the profit.

Many of the advantages above explain why sole traders are the most common form of business organisation found in countries throughout the world. Sole trader businesses are common in industries such as retailing, catering and construction. In some countries many owners involved in agriculture are also sole trader businesses.

Despite its popularity, being a sole trader has several disadvantages.

- The owner has unlimited liability for the debts of the business and risks losing their personal wealth to pay for these.
- It is often difficult to raise funds to expand the business.
- As small businesses, it is difficult to compete with larger firms in the same industry.
- Owners often lack some of the essential business skills needed for running a business, such as financial management. This is one of the main reasons for the failure of sole trader businesses.
- Sole traders often have to work very long hours to make a living from their business.
- If a sole trader retires or dies, the business no longer exists.

**Advantages:**

- Easy to set up business
- Makes all the decisions
- Has complete control
- Keeps the profit



**Disadvantages:**

- Unlimited liability – Responsible for business debts
- May not be able to raise funds to expand the business
- May have to work long hours
- Difficult to compete with larger rival firms
- May not have business skills to run a business

Figure 4.2 Advantages and disadvantages of being a sole trader  
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**KEY TERM**

**Partnership:** a business formed by two or more people who will usually share responsibility for the day-to-day running of the business. Partners usually invest capital in the business and will share profits.

## Partnerships

A **partnership** is a business owned and managed by two or more people. Partnerships are often formed to overcome some of the disadvantages of sole traders.

This form of business organisation is popular with professions such as accountancy, law and dentistry.

The main advantages of a partnership are:

- Partnerships usually have greater access to finance than sole traders as there is more than one person investing capital in the business.
- Decision-making is shared and can often lead to better decisions.
- The management and day-to-day running of the business are also shared, which reduces the workload for individual owners.
- It is easy to set up. The partners may sign a legal agreement known as a Deed of Partnership. This document sets out the rights and obligations of each partner.

Partnerships have the following disadvantages:

- The partners usually have unlimited liability for the debts of the business. They may have to use their personal wealth to pay these if the partnership is not able to do so.
- The partners must share profits.
- If one of the partners leaves then the business ceases to exist and will need to be re-formed if the other partners want to continue trading.
- Business decisions are binding on all partners, even if they don't agree to them.
- Partnerships are often fairly small businesses and, like sole traders, find it difficult to raise additional finance to expand the business.



**Sources of business finance:** see Chapter 19, page 246.

### Advantages:

Easy to set up a Deed of Partnership

Partners invest in the business so greater access to funds

Shared decision making

Shared management and workload

### Disadvantages:

Unlimited liability – responsible for business debts

Share the profits

Business ceases to exist if one partner leaves

Decisions binding on all partners

Difficult to raise finance



Figure 4.3 Advantages and disadvantages of partnerships

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**ACTIVITY 4.1**

Chata is a sole trader. He owns a bakery which supplies bread products and cakes to local supermarkets and independent retailers. His cakes are very popular. In recent months Chata has had to turn down orders from existing customers because he is unable to produce enough cakes with the equipment he has available. Chata was discussing his problems with Juma, an old friend from catering college.

Juma is looking to start his own business making chocolate. He has suggested to Chata that they go into partnership. Chata has \$10 000 to invest in the business, which he says can be used to buy additional equipment for Chata's bread and cakes, but also for Juma's chocolate production.

Discuss the advantages and disadvantages to Chata of entering into partnership with Juma.

**KEY TERMS****Unincorporated business:**

a business that does not have legal identity separate from its owners. The owners have unlimited liability for business debts.

**Unlimited liability:** if an unincorporated business fails, then the owners might have to use their personal wealth to finance any business debts.

**Shareholder:** a person or organisation who owns shares in a limited company.

**Private limited company:**

often a small to medium-sized company; owned by shareholders who have limited liability. The company cannot sell its shares to the general public.

**Public limited company:**

often a large company; owned by shareholders who have limited liability. The company can sell its shares to the general public.

**Ordinary shareholders:** the owners of a limited company.

**Limited liability:** the shareholders in a limited liability company which fails only risk losing the amount they have invested in the company and not any of their personal wealth.

**Dividend:** a payment, out of profits, to shareholders as a reward for their investment.

**Private and public limited companies**

Sole traders and partnerships are **unincorporated businesses**, which means that the owners are responsible for the debts of the business. They have **unlimited liability**. Another form of business organisation is the limited company. The advantage of this type of business over a sole trader or partnership is that the people who run the business are not responsible for the business's debts. A limited company is owned by its **shareholders**. These are investors who invest money in the company in exchange for shares.

There are two main types of limited company:

- **private limited companies**
- **public limited companies.**

Private limited companies and public limited companies share the following features:

- Legal documents, including Articles of Association and a Memorandum of Association, must be completed when setting up the business.
- Shareholders invest their capital by purchasing shares in the company.
- **Ordinary shareholders** are the owners of the company.
- Shareholders have **limited liability**. If the business fails, they risk losing the value of their shares – that is, the amount of money they have invested in the company.
- The business continues even if one or more shareholders die.
- The company can raise finance by selling shares.
- Profit belongs to the ordinary shareholders.
- Profit is shared between the shareholders through the payment of **dividends**.
- Shareholders vote on major decisions taken by the company.
- End of year financial statements must be produced and submitted to the correct authorities. The company's financial accounts are available for the public to look at.

**Differences between private and public limited companies**

There are some important differences between a private limited company and a public limited company, as shown in Table 4.1.

**TOP TIP**

Do not confuse public limited companies with public sector organisations. Public limited companies are in the private sector.

	Private limited company	Public limited company
Owners	Usually a very small number of shareholders. Often members of the same family or friends.	Usually a very large number of shareholders.
Size	Usually fairly small.	Most common form of organisation for very large companies.
Sale of shares by the company	Can only be sold privately, often to family members, friends or employees.	Can be offered for sale to the general public and other organisations.
Sale of shares by shareholders	Often difficult to sell as must be sold privately and with the agreement of other shareholders.	Quick and easy to sell as they can be offered for sale to the public.
Control	Only a few shareholders. One shareholder may own 51% of the shares in the company and so has control over major decisions. Ownership is not separated from control.	Often thousands of shareholders. The Board of Directors appointed by shareholders at the Annual General Meeting controls major decisions. Ownership and control are separated.
Raising additional capital through share issue	Even if successful, it may be difficult to raise additional capital as shares cannot be sold to the general public.	If successful, it can often raise very large sums quite easily through the sale of additional shares.
Borrowing finance	Often difficult to raise finance as unincorporated businesses because they are usually small businesses with low-value assets to offer as security – known as <b>collateral</b> .	Can often raise very large sums at good rates of interest because of its reputation and valuable collateral.

Table 4.1 The main differences between private and public limited companies

**KEY TERM**

**Collateral:** non-current assets offered as security against borrowing.

**TOP TIP**

Make sure you understand the difference between unlimited and limited liability, and what that means for the owners of a business.

Public limited companies also have disadvantages which are not shared by private limited companies. These include:

- The legal formalities of setting up a public limited company are very costly.
- Directors' decision-making is sometimes influenced by major investors who seek to satisfy their own objectives. For example, major investors might demand that the directors pay higher dividends than they had planned. This reduces the profit available for reinvestment into the company.
- The company is always at risk of a takeover by another company, because its shares can be freely bought and sold. Any other business needs only to buy 51% of the shares in a company to become the new owner.
- The legal requirements for the publication of information about the company are much stricter than they are for private limited companies.

## ACTIVITY 4.2

**Chata and Juma – their story continues!**

After considering the advantages and disadvantages of entering into partnership with Juma, Chata decided it was the only way he was going to be able to expand his bakery business. Juma not only brought much needed capital to the partnership, but also brought many ideas too. The business, which they now call Chaju Bakery and Confectionery Products (CBCP), has been very successful, so successful that the partners are considering further expansion. They plan to open their own retail outlets for the products they currently produce and new ones which they hope to manufacture when they move to larger premises.

Chata and Juma realise that they need to raise additional finance for the expansion. Chata's father and Juma's sister are both keen to invest in CBCP. However, the two potential investors are worried about the unlimited liability they will have if CBCP remains a partnership. Chata and Juma do not want to risk losing the capital their family members are prepared to invest in the business, so are considering becoming a private limited company.

- 1 Explain the main advantage to Chata's father and Juma's sister of CBCP becoming a private limited company.
- 2 Explain **three** possible advantages and **three** possible disadvantages to Chata and Juma of CBCP becoming a private limited company



## KEY TERM

**Franchise:** a business system where entrepreneurs buy the right to use the name, logo and product of an existing business.

## Franchises

A **franchise** is a form of business organisation in which a firm which already has a successful product or service – called the franchisor – agrees to allow another business – called the franchisee – to use the franchisor's trade name, logo and products in exchange for a fee. This is a popular way for multinational businesses to expand across many countries. For example, there are very few countries in the world that do not have a McDonald's! Most of these are franchised outlets. The franchisee makes the decision about whether to operate as a sole trader, a partnership or an incorporated business organisation.

Business entrepreneurs may decide to enter into a franchise agreement rather than setting up their own business because of the benefits of this type of organisation. These benefits include:

- There is less chance of business failure because the product and brand are already well established, for example Chicken Licken, The Natural Source and Hilton Hotel franchises.
- The franchisor often provides advice and training to the franchisee as part of the franchise agreement.
- The franchisor will finance the promotion of the brand through national advertising.
- The franchisor will already have checked the quality of suppliers, so the franchisee is guaranteed quality supplies.

However, there are some limitations of franchising. These include:

- The initial cost of buying into a franchise can be very expensive.
- The franchisor will take a percentage of the revenue or profits made by the franchisee each year.
- There are very strict controls over what the franchisee is allowed to do with the product, pricing and store layout. For example, if you go to different



A franchise

McDonald's restaurants you will see that they all look very similar and sell identical products.

- The franchisee will still have to pay for any local promotions they decide to do.

### ACTIVITY 4.3

Read the following franchise opportunities.

#### Advert

#### 100% Natural Frozen Yoghurt

This is a superb opportunity to sell healthy, natural frozen yoghurt in your own store. Your customers will love serving themselves with treats from the delicious menu, which features a natural frozen yoghurt selection. It also includes fruit smoothies with an ample choice of fresh fruit toppings including strawberry, blueberry, kiwi, pineapple and mango.

#### Affordable House Cleaning

The house cleaning industry is life-friendly. Unlike restaurant or retail industries, cleaning is done primarily within normal business hours. Customers want to come home from work to a clean living space, which in turn creates a manageable schedule for you.

#### Fabulous Mobile Accessories

Our products and services allow people to express themselves through their most visible accessory – their phone. We offer a vast selection of fashionable accessories, as well as providing specialty services like phone repair, at mall-based kiosks.

In pairs, discuss how successful you think each of these franchise businesses might be in your local area.

Choose the one which you think has the best chance of success – it does not have to be the same one as the person you are working with. Write a short report identifying and explaining **three** reasons for your choice.



#### KEY TERM

**Joint venture:** two or more businesses agree to work together on a project and set up a separate business for this purpose.

### Joint ventures

Sometimes it benefits two or more businesses to work closely together on a business opportunity. The main reasons for a **joint venture** are:

- It reduces the risk for each business and cuts costs.
- Each business brings different expertise to the joint venture.
- Market and product knowledge can be shared to the benefit of the businesses in the joint venture.

However, joint ventures have limitations, such as:

- Any mistakes made may damage the reputation of all firms in the joint venture, even if they were not the cause of the mistake.
- The businesses may have different business cultures or styles of leadership, making decision-making difficult.

Over the years there have been many examples of joint venture agreements.

- One of the best known was between the Japanese consumer electronics company Sony Corporation and the Swedish telecommunications company Ericsson to make mobile phones. The joint venture brought together Sony's consumer electronics expertise with Ericsson's technological leadership in the communications sector.
- In 2007 Virgin Group announced a joint venture with Tata Group in India. The 50–50 joint venture combined the large network and customer base of Tata TeleServices with Virgin Mobile. This enabled Virgin to enter a very profitable mobile phone market, which was the fastest growing in the world at the time. As part of the deal, Virgin committed to use its marketing expertise to target the youth of India, using the slogan 'Hop to the Hatke Service' – hatke is the Hindi for 'different', 'offbeat' or 'not mainstream'.

## Jaguar Land Rover agrees joint venture with Chery in China

Jaguar Land Rover (JLR) and Chery Automobile have agreed a joint venture. This agreement will lead to the production of Jaguar and Land Rover cars in China.

A new, jointly owned company will be formed to:

- create a research and development facility
- develop and manufacture new models
- set up engine manufacturing operations
- create a sales network in China.

'Demand for Jaguar and Land Rover vehicles continues to increase significantly in China,' JLR's chief executive Ralf Speth and Chery's chief executive Yin Tongyao said in a joint statement.

'We believe that JLR and Chery can jointly realise the potential of these iconic brands in the world's largest car market.'

Chery makes smaller, less luxurious cars than JLR, but has good knowledge of the Chinese market.

You can watch a news report of this joint venture at [www.youtube.com/watch?NR=1&feature=endscreen&v=5OdzseHYBGI](http://www.youtube.com/watch?NR=1&feature=endscreen&v=5OdzseHYBGI). The report starts 3 minutes 22 seconds into the video.

### TASK

- a Define 'joint venture'.
- b Identify **two** benefits to Chery of a joint venture with JLR.
- c Do you think JLR has made the right decision to enter into a joint venture with Chery? Justify your answer.

## Differences between unincorporated businesses and limited companies

An unincorporated business is one which does not have a separate legal identity from its owners. This means that the owners are legally responsible for the activities of the business. Also, the owners have unlimited liability for the debts of the business. Sole traders and partnerships are the best examples of unincorporated businesses.

An incorporated business, such as a limited company, has a separate legal identity from its owners. The company, and not the owners (shareholders), is legally responsible for the activities of the business. The owners of an incorporated business have limited liability for the debts of the business.

### Risk, ownership and limited liability

Unincorporated business ownership has greater legal and financial risks for owners than incorporated businesses. This is because:

- Owners and the business have the same legal identity. If, for example, a customer is injured as a result of using a faulty product made by the business, then the owners of the business are legally responsible and may be sued for damages.
- Owners have unlimited liability for business debts. If the business fails and has unpaid debts, then the owners may have to use their personal wealth to pay these debts.

These risks are removed for the owners of incorporated businesses such as private and public limited companies because:

- Owners and the company have separate legal identities. If a customer is injured by a product made by an incorporated business then they sue the company for damages and not the owners.
- Owners have limited liability for business debts. This means that if the company fails, the owners do not have to use their personal wealth to pay any debts. The only financial risk that owners of incorporated businesses have is that they can lose all of the money they paid for their shares.

### Choosing the type of business organisation

You have already learnt, earlier in this chapter, that it is much easier to set up an unincorporated business than an incorporated business. This explains why sole traders and partnerships are the most popular form of business organisation in most countries.

Private limited companies, and especially public limited companies, are more complex to set up. They have many more legal controls than unincorporated businesses; for example, they must produce more detailed financial statements every year.

Most businesses start small and often as a sole trader or partnership. However, as a business grows, the original owners may decide to incorporate – become a private or public limited company. They may decide to do this for a number of reasons, such as:

- To reduce the legal and financial risk to owners. Incorporation has the benefit of separating legal identity between the business and the owners, and providing owners with limited liability.
- Separate legal identity also has the benefit of business continuity. If one or more owners leave, then the business is still able to continue.
- The business may want to raise additional capital to invest in growth plans. This may be easier to achieve by becoming a limited company and selling shares in the business.

When setting up a new business, the choice of which form of business organisation to use will depend on several factors.

- **The number of owners.** A sole trader can only have one owner. If there is more than one owner then the choice will usually be between a partnership and an incorporated business. The larger the number of owners, the more likely it is that the owners will choose an incorporated business organisation.



**Sources of finance:** see Chapter 19, page 246.

- **The owner's role in the management of the business.** Some owners may only want to invest in a business and have nothing to do with the running of it. If this is the case then an incorporated business organisation may be a better choice.
- **The attitude towards financial risk.** If owners do not want to risk their personal wealth, then they are more likely to set up an incorporated business.
- **How quickly the owners want to start operating their business.** Unincorporated business organisations such as sole traders and partnerships are much quicker to set up than incorporated ones. This is because they do not have any complex legal requirements.
- **The potential size of the business.** Most businesses start small and many will remain so because of factors such as the size of the market, or the owners' choice. These businesses are more likely to be set up and remain as sole traders or partnerships.

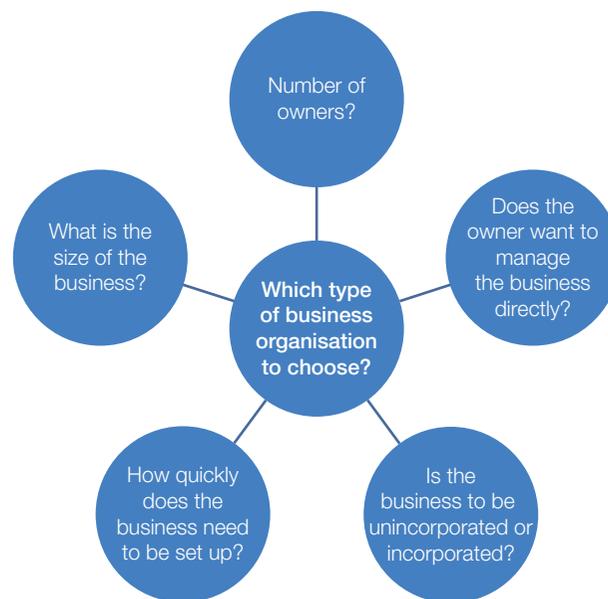


Figure 4.4 Factors affecting the type of business organisation chosen

In addition to the legal structure of a business, entrepreneurs may consider the benefits of a franchise (see page 50).

## Business organisations in the public sector

### Public corporations



A public corporation

**KEY TERM**

**Public corporation:** a business organisation that is owned and controlled by the state.



**Public sector:** see Chapter 2, page 25.

You have already learnt that **public corporations** are in the public sector of the economy. The main features of public corporations are:

- They are owned and controlled by the state.
- They are financed mainly through taxation.
- In many countries they have social objectives rather than profit objectives, for example to provide a service to the public and meet the needs of the less well-off in the population. In some countries the public sector organisations still have social objectives, but they might also have a profit objective too.
- The services of public corporations are often provided to the population free or at a low price.

Most countries throughout the world have public corporations or public sector enterprises, for example Pakistan International Airlines (PIA), Brunei National Petroleum Company and South African Post Office.

**EXPLORE!**

Use library resources or the internet to research one public sector organisation in your country.

- What is the name of the organisation?
- What goods or services does it offer to the people of your country?
- How are the activities of the organisation financed?
- Does it charge consumers for the goods or services it produces? Are all consumers charged the same price?
- Do you think the organisation you have researched should be controlled by the government? Justify your answer.

**TEST YOURSELF**

- 1 Identify **three** features of a sole trader.
- 2 Define 'unlimited liability'.
- 3 Explain **two** advantages of a partnership.
- 4 State the main difference between an unincorporated business and an incorporated business.
- 5 Explain **three** differences between a private sector business organisation and a public corporation.
- 6 State **two** disadvantages of a private limited company.
- 7 State **two** legal documents that must be completed when setting up a limited company.
- 8 Outline the main difference between a private limited company and a public limited company.
- 9 Identify **three** advantages to an entrepreneur of setting up a business through a franchise agreement.
- 10 Explain the benefits to the businesses in a joint venture.

## Revision checklist

- The main forms of business organisation found in the private sector are sole traders, partnerships, limited companies, franchises and joint ventures.
- There are advantages and disadvantages to each form of business organisation. One of the most important disadvantages of unincorporated businesses is that the owners have unlimited liability for any debts of the business.
- Most countries will have both a private and a public sector. Unlike organisations in the private sector, public sector organisations are more concerned with social objectives than profit objectives.

## Exam-style practice questions

- 1** An and Bo are in partnership together. They buy and renovate properties which they then rent out or sell to other people.

The business has been going for six years and is profitable. They want to expand the business to offer a maintenance and repairs service to both the private sector and the public sector.

However, the partners do not have the capital needed for this expansion.

Bo's sister, Jiao, has said that she is prepared to invest in the business in return for a share in the profits.

An and Bo are also considering changing the legal structure to a private limited company.

- a** Identify **two** features of private sector organisations. [2]
- b** Define 'public sector'. [2]
- c** Identify **two** advantages and **two** disadvantages to An and Bo of being a partnership. [4]
- d** Explain **two** benefits to An and Bo of expanding their business. [6]
- e** Do you think the partners should become a private limited company? Justify your answer. [6]

- 2** Mactar is a public limited company based in Country X. It specialises in the construction of motorways and other major road networks. KC Diggers is an incorporated business in Country Y. It manufactures large earth-moving equipment which it sells or hires to the construction industry.

The government of Country Y has recently announced plans to extend the country's motorway network. It is planning a new motorway which will run 120km from the north to the south of the country. To speed up the completion of the motorway, the government is offering the work to private sector businesses.

Mactar has asked KC Diggers to join it in a joint venture so that it can bid for the contract to construct the new motorway.

- a** Identify **two** features of an incorporated business. [2]
- b** Define 'private sector'. [2]
- c** Outline **two** advantages to Mactar of being a public limited company. [4]
- d** Explain **two** possible reasons why Mactar might want to expand into Country Y. [6]
- e** Do you think it is a good idea for Mactar to enter into a joint venture with KC Diggers? Justify your answer. [6]

**Total available marks 40**

# 5

## Objectives

*In this chapter you will learn about:*

- business objectives and how the importance of these may change
- the role of stakeholders in business
- the differences between private sector and public sector objectives.

# Business objectives and stakeholder objectives

## Introduction

The things you want to do and achieve are your personal objectives. They provide you with a target – something to aim for. How you achieve your personal objectives will not happen by accident. They require careful planning. Even careful planning will not guarantee that you will be successful. The future is uncertain and unforeseen events may cause you to change your plans.

Just as you have things that you want to do and achieve in the short term, the medium term and the long term, so do businesses. They have their own objectives. These are statements of what a business wants to achieve through its activities. However, these activities may affect individuals or groups who are internal and external to the business. These individuals or groups are known as business stakeholders, for example owners and suppliers – they also have objectives.

In this chapter you will learn about the objectives of businesses and how these may conflict with the objectives of stakeholder groups.

### ACTIVITY 5.1

Think about the things that you want to do in the next year, five years and ten years. How are you going to achieve them?

57

## Business objectives and how their importance can change

### Need for business objectives

Every aspect of a business needs **objectives**. From these objectives the business can produce a plan, or strategy, which sets out how the objectives will be achieved. The plan needs to be reviewed regularly to make sure that the business is on target to achieve its objectives. If the business looks as if it will not achieve its objectives then it might need to change its plan, or even change the objectives themselves.

### Objectives need to be SMART

Businesses need to set clear and effective objectives. They often use SMART criteria to help them do this. Objectives must be:

- Specific – for example, an airline may set an objective about the level of seat occupancy on its planes.
- Measurable – the airline may set an objective of achieving an average 85% seat occupancy across all of its flights.



#### KEY TERM

**Objective:** a statement of a specific target to be achieved. It should be SMART.

- **Achievable and Agreed** – the airline seat occupancy objective needs to be discussed with the marketing department as it will need to decide on promotional activities to see that the objective is met.
- **Realistic and Relevant** – the airline seat occupancy objective will need financial resources, perhaps for an advertising campaign. The objective is relevant to the marketing manager, but less relevant to the human resources manager.
- **Time-specific** – the airline may set an objective to achieve average seat occupancy of 85% within the next 18 months.

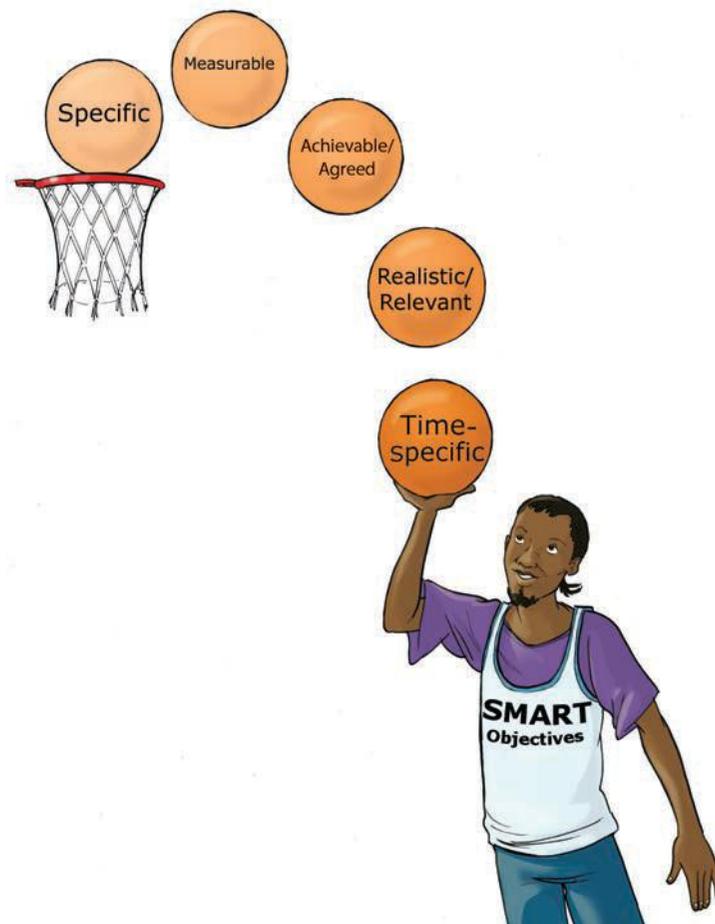


Figure 5.1 SMART objectives



**Business plan:** see Chapter 3, page 29.

Setting objectives helps managers to develop a plan for the business. The plan will also list the resources needed in order to achieve the objectives.

### Different business objectives

How do businesses decide on their objectives? New businesses, for example, are likely to have a different set of objectives from established businesses. The most common business objectives are concerned with survival, profit, growth, market share and corporate social responsibility.

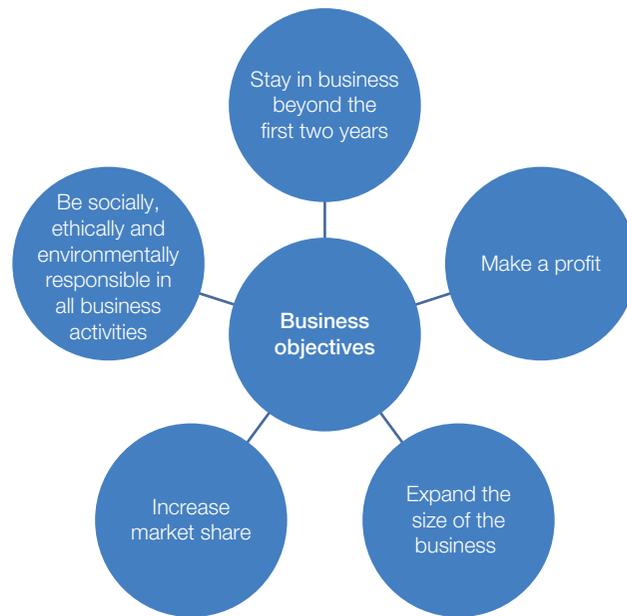


Figure 5.2 Business objectives



**Profit:** see Chapter 21, page 268.



**Economies of scale:** see Chapter 16, page 219.



#### KEY TERM

**Market share:** the revenue of a business expressed as a percentage of total market revenue.

#### Survival

Many new businesses fail in their first or second year of trading, so survival is a very important short-term objective for these businesses. Once they are established they can focus on long-term objectives such as profit and growth.

#### Profit

For many businesses, profit is an important objective. They aim to produce and sell the level of output where there is the greatest difference between revenue and total costs.

#### Growth

A business that decides to expand the size of the business in order to increase output may benefit from economies of scale. This will reduce the cost of producing each item and help to increase the firm's competitiveness, revenue and profits.

#### Market share

As a business grows, it may achieve a larger share of the market. Increased **market share** often benefits a business in that it helps develop a strong brand image which makes it easier to sell the product to consumers.

#### Corporate social responsibility (CSR)

Nowadays, many businesses take an interest in social, ethical and environmental issues and the impact that their decisions and activities may have on employees, customers, the community and the environment. Businesses that ignore their social responsibility run the risk of bad publicity and possible legal action. Both can affect the reputation, sales, revenue and profits of a business.



## KEY TERMS

**Corporate social responsibility (CSR):**

businesses taking responsibility for the impact their activities might have on society and the environment.

**Pressure group:** a group of like-minded people that puts pressure on businesses and government to change their policies to reach a predetermined objective.



**Pressure groups:** see Chapter 25, page 320.

**Trade unions:** see Chapter 7, page 103.



## TOP TIP

Don't just learn a list of business objectives. You must make sure you know why an objective is important to a business.



## KEY TERM

**Social enterprise:** a business with social objectives that reinvests most of its profits back into the business or into benefiting society at large.

**Corporate social responsibility** has become an important objective for businesses as a result of:

- the activity of **pressure groups**
- the media, which has created a greater awareness of social, ethical and environmental issues among consumers
- the role of trade unions and other employee representative groups
- the role of governments and the laws they pass at local, national and international levels.

## ACTIVITY 5.2

Peter and Petra are celebrating their third year in business together. They are qualified accountants who decided to go into partnership in 2010. They rented offices in the country's largest city and, starting with just two clients, PP Accountancy Services (PPAS) was born.

In the early days their main objective was survival. The market for accountancy services in the city was very competitive. They knew that it would take time to build up a list of clients and they were prepared to work long hours with little pay. However, they hoped that once PPAS was established it would be a success. After three years of hard work and providing a quality service to clients, PPAS was a very successful business. Peter and Petra employ five other qualified and partly qualified accountants as well as secretarial support staff.

Peter and Petra are considering opening a new office in the country's second largest city. Growth has always been a long-term objective of the partners and they are both excited about the expansion to their business, which will be financed by a \$20 000 bank loan.

In pairs or as a class, discuss:

- 1 Why was survival the main objective for PPAS in its early years?
- 2 Other than survival, identify **three** objectives that Peter and Petra set for PPAS.
- 3 How and why have the objectives for PPAS changed over its first three years?
- 4 Why do some businesses not have growth as one of their objectives?

## Objectives of social enterprises

**Social enterprises** are businesses mainly concerned with social objectives. Their activities relate to the needs of the community and the environment. They have profit as an objective, but, unlike other private sector businesses you have studied so far, the profit is reinvested in the business. This allows social enterprises to expand their activities or benefit the local community, rather than earning high profits for owners or shareholders. Social enterprises still need to choose a legal structure for their business and many choose to operate as a limited company or cooperative.

You will find social enterprise organisations in many countries throughout the world. They are sometimes small locally based businesses, but others can be very large, as shown in the following case study.

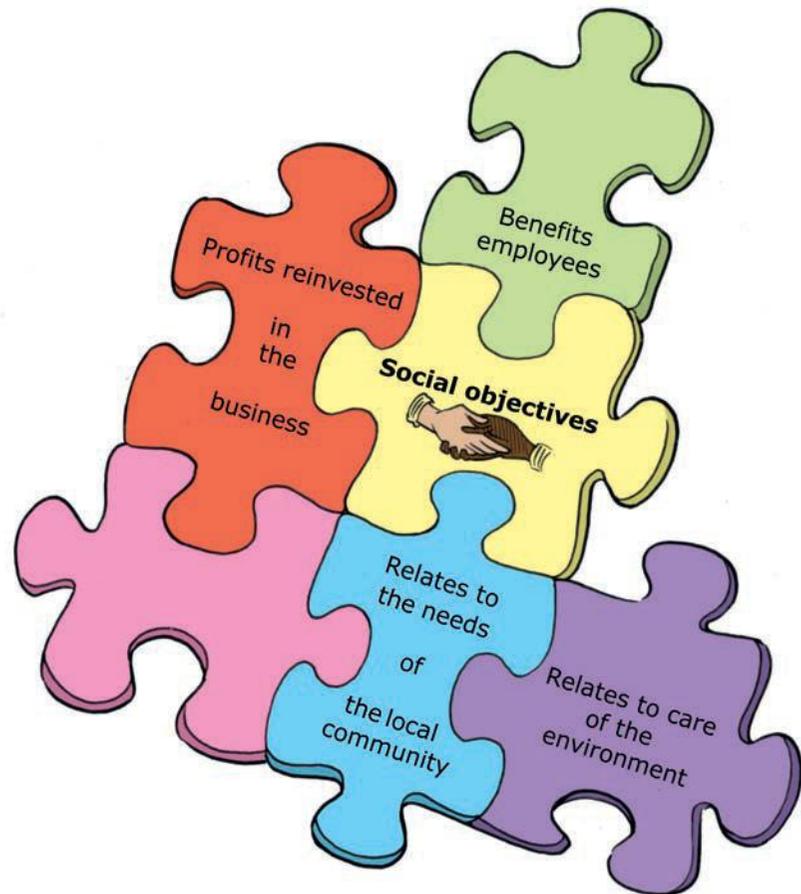


Figure 5.3 Social enterprise objectives

## Social enterprise in China

Canyou Group is a Chinese software company. Formed in 1997 by Zheng Weining, it is now the largest social enterprise in China with more than 3700 employees, most of whom are people with disabilities.

Zheng started the social enterprise with a gift of \$47 000 from his mother, who wanted to give him an incentive to do something productive with his life. It was at this point that he had the idea of helping not just himself but other people who had chronic diseases, or were ‘handicapped’ in some way or another. He thought a computer and internet company would be ideal.

The group’s business activities include software development, computerised cartoons and animation, e-commerce and other ventures.

The profits earned by Canyou Group are used to benefit employees and people with disabilities in the wider community. It not only takes care of its employees during working hours, but also provides meals, sleeping accommodation and medical help – all for free and at a cost of \$426 per employee. If an employee’s parents visit, the company management hosts a meal and provides a car so they can tour the city.

Adapted from *China Daily*, 6 September 2012, [www.chinadailyasia.com/life/2012-09/06/content\\_116476.html](http://www.chinadailyasia.com/life/2012-09/06/content_116476.html)

### TASK

- a Identify **two** reasons why Zheng Weining could be described as an entrepreneur.
- b Explain **two** reasons why Canyou Group is a social enterprise.

## TEST YOURSELF

- 1 Define 'objective'.
- 2 Explain why a business needs objectives.
- 3 Explain **three** business objectives.
- 4 Identify the main objectives of a social enterprise.



## KEY TERM

**Stakeholder:** an individual or group which has an interest in a business because they are affected by its activities and decisions.

## The role of stakeholder groups

**Stakeholders** are any individual or group who may be affected by the decisions and activities of a business. Figure 5.4 shows the main stakeholders of a business. You are a stakeholder in all the businesses you buy goods and services from. Members of your family are a stakeholder in the business they work for, or businesses they own.

There are two types of stakeholder:

- internal stakeholders
- external stakeholders.

### Internal stakeholders

Internal stakeholders have an interest in the decisions and activities of a business.



Figure 5.4 The main stakeholders of a business



**Dividend:** see Chapter 4, page 48.

### Owners and shareholders

Owners and shareholders are interested in the performance of the business. They will want to know if it has earned a profit. Profit belongs to the owners and is their reward for risking their investment in the business. Shareholders are the owners of a limited company and the higher the profits earned then the higher the dividend they will receive. Also, the market value of shares is usually affected by the

profitability of a business. If profits rise then the market value of the shares is likely to rise. Shareholders in public limited companies may gain from selling their shares for a higher price than they paid for them.

### Managers

Managers are responsible for the performance of a business. If the business does well, for example achieves its objectives, then the managers may receive bonuses, or a salary increase. They may also gain promotion.

### Employees

Employees are also interested in the performance of the business. If the business is profitable, it can mean better job security and the chance of pay rises. Some businesses have profit sharing schemes for employees. Profitable businesses might use some of their profits to expand. This can provide employees with more job security and perhaps opportunities for promotion.



**Profit sharing schemes:** see Chapter 6, page 82.

### External stakeholders

Like internal stakeholders, external stakeholders also have an interest in the decisions and activities of a business.

### Lenders

Lenders such as banks will want to know if they will be paid the interest on any loans given to the business. They will also want to check that the business can repay the amount borrowed.

Existing lenders will want to know that the business is making enough profit and has enough cash to make these payments.

Potential lenders will want to know about the long-term profitability of the business as well as the amount of borrowing the business has already. They may also want to know the value of any non-current assets that can be used as collateral (security) against any lending. This information will be used by the lender when deciding on whether or not to make loans to the business.

### Suppliers

Suppliers have an interest in the activities of a business for two main reasons.

First, they want to know if they will get paid on time for any goods they have supplied to the business on credit. They will want to know that the business has enough cash to pay its short-term debts.

Second, the success of suppliers depends a lot on the success of the businesses they supply. If a business is expanding then this means it will be producing more goods and will need more inventories. This will increase the sales and potential profits of the supplier. However, a possible disadvantage for suppliers is that as a business expands and buys greater quantities of inventories from its suppliers, it may expect to pay lower prices. This can reduce the profit margins of suppliers.



**Profit:** see Chapter 21, page 268.

**Liquidity:** see Chapter 23, page 288.

**Non-current asset:** see Chapter 22, page 278.

**Economies of scale:** see Chapter 16, page 219.

**Inventories:** see Chapter 15, page 205.



#### TOP TIP

Don't confuse stakeholders with shareholders. Shareholders are only one group of possible stakeholders in a business.

### Customers

Customers have an interest in the activities of a business because they want to be sure that the business is going to continue to exist in the future. This is particularly important for goods that may need spare parts. Also, if a business is earning good profits then they may reinvest some of the profit into product development and expansion. Customers may then receive a better quality and a better variety of products.

As a business expands it may benefit from economies of scale. These advantages as the level of production rises reduce the cost of making each unit of output. The business might decide to reduce the price of its products, which will benefit customers.

### Government

The government receives taxes on the profits of businesses. The higher the profits, the higher the tax revenues paid to government. Tax revenues are an important source of finance for government spending on such things as education, health, roads and defence. Many governments pay benefits to unemployed workers. If businesses are expanding, this will reduce the level of unemployment and so reduce government spending on these benefits.

### Local community

The business may offer local people employment opportunities. Other businesses in the area may benefit as a result because the employees will spend some of their money locally. This will increase the revenue and profits of local businesses such as retailers, restaurants and entertainment outlets. A business may also provide financial support or other benefits to the local community. For example, it may sponsor a local sports team or provide leisure facilities for use by local residents.

However, the business may have a negative impact on the local community, for example through noise or air pollution resulting from the production process, or traffic problems as businesses receive deliveries and send out orders to customers. Roads may also become congested during particular times of the day when employees are starting or finishing work.

### ACTIVITY 5.3

The statements below have been taken from the objectives of a leading clothing manufacturer.

We are committed to:

- offering our customers quality products at the most competitive prices
- providing shareholders with good returns on their investment
- developing the talents of our employees through excellent training schemes and development programmes
- building long-term, positive relationships with our suppliers
- protecting the environment and supporting the well-being of the community.

- 1 Identify the different stakeholder groups mentioned in the above statements.
- 2 Identify stakeholder(s) not mentioned in any of the above statements.
- 3 Select any **three** stakeholders you have identified in Question 1. Explain the benefits to the company of having objectives specifically aimed at each of the stakeholder groups you have identified.

## Objectives of stakeholder groups

Table 5.1 identifies the main objectives of internal and external stakeholders.

Stakeholder	Objectives
<b>Internal</b>	
Owners/stakeholders	To receive high returns/dividends as reward for risking their investment in the business. To benefit from an increase in share value.
Managers	To have job satisfaction and status. To receive salary increase and bonuses.
Employees	To have job security. To receive a fair wage that reflects their contribution to the business's success.
<b>External</b>	
Lenders	To receive interest payments when due. To have borrowing repaid by the due date.
Suppliers	To receive prompt payment for goods supplied on credit. To be treated fairly and not be forced to reduce their prices by businesses with strong buying power.
Customers	To receive quality goods and after-sales service. To be charged a fair price which gives value for money.
Government	To be paid the correct amount of taxes on time. To have minimal spending on unemployment benefits.
Local community	To receive benefits for the local economy such as employment and subsidising of community facilities. To avoid the negative impact of business activities such as noise, air and traffic pollution.

Table 5.1 Main objectives of business stakeholders

As you have already seen, the decisions and activities of a business may have positive and negative effects on stakeholders. Stakeholders, too, have their own objectives that they will want to achieve through their relationship with the business in which they have an interest. You will not, therefore, be surprised to learn that there is often conflict between two or more business stakeholders. This is because it is often not possible for a business decision or activity to satisfy the differing objectives of different groups of stakeholders. Sometimes a single business decision or activity will have both positive and negative effects for the same stakeholder.

### ACTIVITY 5.4

Look at each of the following statements about the decisions and activities of different businesses.

#### Statement A

A company decides to invest \$5 million in new technology. The investment will be funded from profits. The new technology will mean it needs 30 fewer employees.

#### Statement B

A local supermarket has decided to expand the size of its store. It will now be able to add an in-store bakery. The expansion will be financed through a long-term bank loan.

**Statement C**

A manufacturer of fizzy drinks has been granted planning permission to build a new factory on land close to a local housing estate and primary school. When fully operational, the factory will provide employment for 260 workers.

**Statement D**

The owners of a clothing manufacturing business have decided to have some of its items produced in another country where labour costs are much lower. This will increase profit margins and help to keep the price of their garments below that of competitors.

- 1 For each of the above statements, identify the key stakeholders who will be affected by the action taken by each business.
- 2 For each statement, identify the positive and/or negative effect of the business activity on each of the stakeholders you have identified in Question 1.
- 3 For each statement, explain how there might be a conflict between any two groups of stakeholders.

**TEST YOURSELF**

- 1 Define the term ‘business stakeholder’.
- 2 Identify **five** business stakeholders.
- 3 Explain the objectives of any **three** business stakeholders.



Figure 5.5 Public sector organisations

## Objectives of private sector and public sector enterprises

Earlier in this chapter you studied the main objectives of private sector organisations (see page 58).

Public sector organisations have very different objectives from those in the private sector. The services and facilities they provide must be:

- **Accessible** – they can be used by everyone regardless of their location or income.
- **Affordable** – they must be cheaper than if the service was provided by the private sector. The service may even be free at the point of use.
- **Open to all** – they must be available to everyone regardless of their income, class, ethnicity, culture, religion, and so on.



**Public sector organisations:** see Chapter 4, page 55.

**TEST YOURSELF**

Explain **two** objectives of a public sector organisation.

## Revision checklist

- It is important for every business to set SMART objectives.
- The main objectives of private sector businesses are survival, profit, growth and market share and these objectives may change in importance over time.
- A social enterprise is a private sector business that makes profit, not for the owners or investors, but to benefit local communities and reinvest to grow the business.
- All businesses have internal and external stakeholders. These are individuals or groups who have an interest in the activities of a business. Each stakeholder group will have their own objectives and these might conflict with the objectives of other stakeholder groups, or with the objectives of the business.
- Public sector organisations might have profit as an objective, but social objectives will be more important.

## Exam-style practice questions

- 1** Aisha is a qualified hairdresser. She opened her own salon, as a sole trader, five years ago. At first business was very slow due to competition from other salons and the fact that Aisha was unknown in the area. Aisha knew that the first year was going to be about survival.

Aisha survived her first six months and within a year she was making profit.

Aisha wants to grow her business. She thinks that adding beauty treatments to the services she offers will be a profitable option. She has a friend, Christine, who is a trained beauty therapist. She is thinking of asking Christine to become a partner in the expanded business.

- a** Other than sole trader, identify **two** forms of business organisation. [2]
  - b** Define a 'stakeholder'. [2]
  - c** Outline the benefits to Aisha of setting objectives. [4]
  - d** Explain **two** advantages to Aisha of operating as a sole trader. [6]
  - e** Aisha thinks there are more advantages than disadvantages of expanding her business as a partnership. Do you agree? Justify your answer. [6]
- 2** Company Z is a private limited company in the secondary sector of the economy. It manufactures components used in the computer industry. It employs 80 production workers and 10 management and administrative staff. The company has just made record profits. The shareholders are very pleased because they expect to receive high dividends as their share of profits. The employees' trade union thinks that its members should get a big pay rise. The directors of Company Z are considering each of these options.

Over the past two years the company's profits have increased by 15% each year.

- a** Define 'private limited company'. [2]
- b** Define 'secondary sector'. [2]
- c** Identify **four** of Company Z's stakeholders. [4]
- d** Explain **two** ways the objectives of a private sector business like Company Z are different from those of public sector organisations. [6]
- e** Do you think the directors should use the profits to reward shareholders or to reward employees? Justify your answer. [6]

**Total available marks 40**

## Exam-style case study

### Tabansi's Drinks and Smoothies

From an early age Tabansi displayed many of the characteristics of an entrepreneur. At 13 years old he made soft drinks which he sold by the glass to tourists who visited the ancient sites near to his home. He saved all of the profit from this business and two years later he bought a bicycle and cooler bags (these are bags which help to keep drinks cool) so that he could take his drinks to a wider market. When he left school he had enough money to pay for the rent of a stall at his local market. He expanded his product range to include freshly squeezed fruit juices and fruit smoothies. Although he was making a living as a market trader, Tabansi knew that to earn the money he wanted to provide for his future and support his parents and younger brother and sister he had to be more ambitious.

Tabansi recently bumped into Uba, an old school friend. Uba's father has a small business unit for sale in the town where Tabansi lives. Tabansi arranged with Uba to visit the property. He saw the potential for converting the premises into a small production unit for his drinks business. Tabansi agreed to buy the business unit. He has produced some financial data for this purchase (see Appendix 1).

Tabansi went to see a small business adviser. Following the meeting, the adviser has written to Tabansi (see Appendix 2) and told him that he should set clear objectives for his business and that a bank will want to see a business plan before they will consider lending him the money he needs as start-up capital. Tabansi has produced financial forecasts for the next three years as part of his business plan (see Appendix 3).

#### Appendix 1

*Financial data for purchase and equipping of business unit.*

	\$
Purchase price	10 000
Equipment needed	4 000
Personal savings	6 000
Borrowing required	8 000

#### Appendix 2

*Letter from the business adviser*

Dear Tabansi

It was very good seeing you yesterday and I hope you found the meeting useful. I am writing to confirm the main points of our discussion. These are:

- 1 You need to set clear objectives for your business.
- 2 You should produce a business plan for the business.
- 3 You should consider changing your business into a private limited company.

If you need any further assistance from me or one of my colleagues at the small business advisory service then please do not hesitate to get in touch.

Yours sincerely

S. P. Godwin

#### Appendix 3

*Financial forecasts for the next three years.*

	Revenue	Profit
Year 1	\$13 000	\$7 000
Year 2	\$14 800	\$9 000
Year 3	\$17 300	\$12 000

- 1 a** Explain **two** characteristics that have made Tabansi a successful entrepreneur.

Characteristic 1:

Explanation:

Characteristic 2:

Explanation:

[8]

- b** The small business adviser told Tabansi that 'he should set clear objectives for his business'. Explain the importance of each of the following objectives to Tabansi's business.

Which objective do you think is the most important? Justify your answer.

Profit:

Growth:

Survival:

Recommendation:

[12]

- 2 a** Explain **two** benefits to Tabansi of being a sole trader.

Benefit 1:

Explanation:

Benefit 2:

Explanation:

[8]

- b** Explain how the following **three** factors might influence Tabansi's decision to change his business to a private limited company.

Which factor do you think is the most important? Justify your answer.

Limited liability:

Additional source of finance:

More owners:

Conclusion:

[12]

- 3 a** New businesses such as Tabansi's are at greater risk of failure. Explain **two** reasons why new businesses fail.

Reason 1:

Explanation:

Reason 2:

Explanation:

[8]

- b** The small business adviser has recommended to Tabansi that he produces a business plan. Consider the importance of the following elements of a business plan for Tabansi.

Which element of the business plan do you think is the most important? Justify your answer.

The business opportunity:

The market:

Financial forecasts:

Conclusion:

[12]

- 4 a** Explain **two** ways Tabansi might increase his business's added value.

Way 1:

Explanation:

Way 2:

Explanation:

[8]

- b** Consider why each of the following stakeholders will be interested in Tabansi's business. Which stakeholder group do you think will be most interested in the success of Tabansi's business? Justify your answer.

Lenders:

Suppliers:

Government:

Conclusion:

[12]

## Section 2: People in business

Businesses of all sizes are organisations which need people. They may be owners, managers or other employees; full-time or part-time; skilled or unskilled. People are the most valuable asset of any business. The way that they work will have a direct effect on the success or failure of the business. The recruitment, selection and training of employees is an important function of human resource management. You will learn the importance of having a well-trained workforce and how managers might use theories of motivation to ensure that employees produce maximum output of the highest quality.

As a business grows it will need to have a clear organisational structure with effective managers and leaders. You will learn about the functions of management and the importance of different leadership styles. In many countries employees benefit from membership of a trade union who will negotiate on their behalf with management to achieve better pay and working conditions.

# 6

## Objectives

*In this chapter you will learn about:*

- why people work
- the meaning and importance of motivation in the workplace
- key motivational theories
- financial and non-financial methods of motivation.

# Motivating employees

## Introduction

Why do you come to school? Do you use both your time and resources well? How hard do you work at your studies? What will make you work harder? Do you work harder in some subjects than you do in others? Why do you work harder and more efficiently in some subjects than in others? If you know the reasons why, then could this help to improve the way you work in all of your subjects? These questions are similar to questions that may be asked of people at work. Just as your teachers want you to work hard and efficiently, so too do the managers of employees. Managers want to be able to motivate employees so that they produce as many good-quality products as they can during their time at work.

In this chapter you will study why people work and what motivates them to work. A well-motivated employee is likely to work harder and more efficiently and enjoy what they do than an employee who has no interest in their job. So you will also learn about people who have studied **motivation** at work and how this can help managers and businesses achieve a well-motivated workforce.

## The importance of a well-motivated workforce

Why people work and what motivation means



People working in an office

Motivation at work results from a combination of factors such as money, job security, how interesting the work is and promotion prospects. These factors encourage employees to be interested and committed to their job so that they work harder and more efficiently.

If you ask people why they work, most will answer ‘to earn money’ so they can buy what they need to live. But there are many other reasons that motivate people to work. Some of the most important factors to influence **motivation** at work are shown in Figure 6.1.



### KEY TERM

**Motivation:** the factors that influence the behaviour of employees towards achieving set business goals.



Figure 6.1 Factors that influence motivation at work

**EXPLORE!**

The questionnaire that follows lists some of the most important reasons why people work and factors that influence people's motivation at work.

- 1 Using the questionnaire, survey five people you know who work. You might need to explain motivation.
- 2 When everyone in the class has collected their results, these can be combined into one results table. If your class is very large, then work in groups of 6–8 and combine results. (If you have access to computers, then use a spreadsheet as this will make it easier to complete tasks 3 and 4.)
- 3 For each question, calculate the average score. For example, if five people in the survey gave the scores 3, 4, 5, 3, 5 in response to a statement in the questionnaire, then the average score would be:

$$\frac{(3+4+5+3+5)}{5} = \frac{20}{5} = 4$$

- 4 Using the average score for each question, produce a bar chart to compare the importance of each factor in influencing motivation at work.
- 5 Using the survey results and your analysis and presentation of these, write a short report explaining the importance of different factors on influencing motivation at work.

Questionnaire: Factors that motivate people at work

**On a scale of 1 to 5, with 5 being very important and 1 being not important, how would the following factors increase your motivation at work?**

**Results of survey of five people**

	A	B	C	D	E
Increased pay					
Chance of promotion					
Recognition by managers for a job well done					
Option to work from home					
Training to help improve job prospects					
Longer holidays, better pensions, staff discounts					
Improved work environment – cleaner and safer					
Option to work flexible hours					
Bonus based on targets					
Increased variety of tasks					



#### KEY TERMS

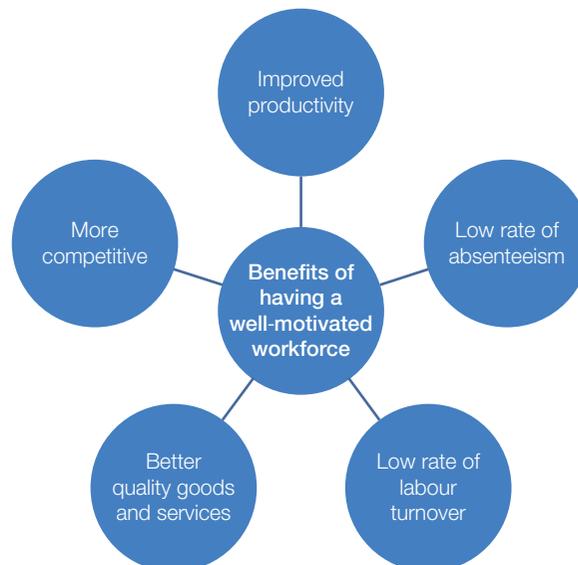
**Labour productivity:** a measure of the efficiency of employees by calculating the output per employee.

**Absenteeism:** employees' non-attendance at work without good reason.

**Labour turnover:** the rate at which employees leave a business.

#### Benefits of a well-motivated workforce

A well-motivated workforce will help a business to achieve its objectives. Well-motivated employees will want to work efficiently and produce quality goods and services for customers. Motivated employees will increase **labour productivity** and this will help a business to reduce average costs and increase competitiveness. Employees who are motivated will enjoy going to work, and are less likely to take days off – ensuring a low rate of **absenteeism** – or to leave the business. A lower **labour turnover** will reduce recruitment costs. A well-motivated workforce is easier to manage and will want to work with management to help improve the business. The main benefits to a business of having a well-motivated workforce are shown in Fig 6.2.



**Recruitment costs:** see Chapter 8, page 107.

**ACTIVITY 6.1**

Zhengdong HuPeng Automobile Fittings Ltd (ZHAF) is a Chinese manufacturer of electronic components used in the car industry. It was founded by Hu Peng 15 years ago. Many of the company's employees have worked for the company all of their working lives. Two years ago Hu Peng retired and the company is now managed by his son Bo, who has a degree in Business Management and worked for several manufacturing companies before joining ZHAF.

Bo believed that ZHAF had not been working efficiently for several years and that is why it was less profitable than its competitors. First, he introduced new machinery. ZHAF now produces more car parts with fewer employees. Six employees were made redundant. Other employees were trained to use the new machinery, but they find the work boring. They liked their work when it had more variety and they used their skills.

Next, Bo looked at the employees' wages. The employees at ZHAF earned a higher wage than that offered by similar businesses. Bo felt that some employees were paid too much because they did not produce as many items as other, more hard-working employees. He introduced a new pay system. Many employees did not receive a pay rise. However, they can earn a bonus if they meet production targets set by Bo. Employees say that the targets are too high to achieve. Their pay is now lower than that of similar businesses.

In the past six months many employees have left the business, and absenteeism is at an all-time high. Production levels have fallen while customer complaints about late deliveries and poor quality have risen.

- 1** Identify factors that suggest employees at ZHAF have become less motivated since Bo took over control of the business.
- 2** Discuss the possible reasons that have caused the employees at ZHAF to become less motivated.
- 3** What does this case study tell you about the importance of having a well-motivated workforce?
- 4** Do you think the new pay system introduced by Bo will motivate employees? Justify your answer.

### The concept of human needs – Maslow's Hierarchy

Abraham Maslow identified the main needs of humans. These are shown in Maslow's Hierarchy of Needs – see Figure 6.3.

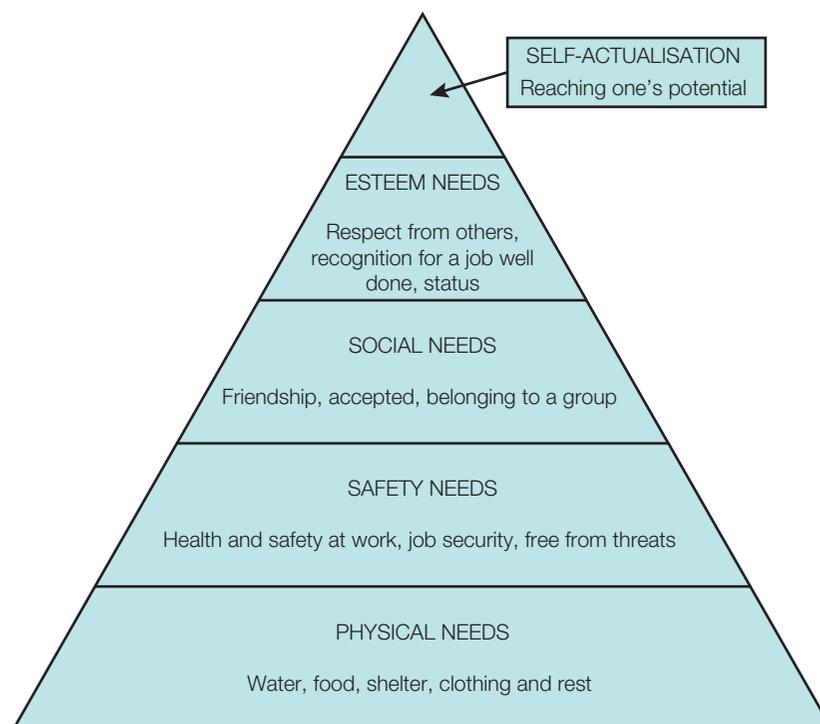


Figure 6.3 Maslow's Hierarchy of Needs  
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Maslow believed that humans have five levels of need:

- **Physical needs** – these are the basic needs we must have to be able to survive. They include water, food, shelter, clothing and rest.
- **Safety needs** – we need to be safe from physical danger and individuals need to know that they have job security.
- **Social needs** – most people want to be accepted by others and to feel that they are loved and trusted. It is important to have friends and belong to a group where social activities can be shared and enjoyed together.
- **Esteem needs** – individuals want to be respected and to have their achievements recognised by others. For some people, having a certain status is also an important need.
- **Self-actualisation** – not everyone will reach their full potential, but for some individuals it is a very important need. Even the most successful people rarely achieve self-actualisation because they will always set themselves another challenge.

According to Maslow, all humans start at the lowest level of need – physical needs. Once they have satisfied their physical needs, then they are motivated to try to reach the next level – safety needs – and so on, until they reach the top level of need – self-actualisation. Once a need has been satisfied it is no longer a motivator.

Maslow's Hierarchy of Needs is important to managers because it is possible for an individual to satisfy some, or all, of their needs at work. If managers want to motivate employees then they have to organise work so that individuals are able to satisfy their needs. If managers do this, and employee motivation is improved, then this will increase business efficiency. Employees will produce more better-quality goods and services for customers. This will improve competitiveness and help to reduce business costs and improve profitability.

However, there are some limitations of Maslow's theory of motivation. These include:

- It is often difficult to identify how much of each need has been met and which level each employee is on.
- Money might also satisfy esteem needs as well as those lower down the hierarchy.
- Not everyone has the same needs as those in Maslow's Hierarchy.
- Self-actualisation is rarely, if ever, achieved. Therefore, unless more challenging tasks are always being provided, it is unlikely that work will help to satisfy this need. There is the risk that if jobs are no longer challenging employees will become demotivated.



**Contract of employment:**  
see Chapter 8, page 119.

### ACTIVITY 6.2

Each of the following could help an individual to achieve one of the needs identified by Maslow. Copy and complete the table that follows by entering each of these into your table against the correct level.

- 1 Pay received is high enough to buy basic needs.
- 2 The manager praises employees.
- 3 Employees are given a contract of employment setting out their pay and working conditions.

- 4 Employees are organised into teams or groups.
- 5 Employees are provided with protective clothing.
- 6 Work is challenging.
- 7 The business is very profitable.
- 8 Employees are given responsibility for completion of tasks.
- 9 Employees are given free meals at work.
- 10 Employees are given the opportunity to develop new skills to increase their potential.
- 11 Employees are given the opportunity for promotion.
- 12 Social activities are organised for employees.
- 13 Employees receive payment during periods of illness.
- 14 Respect from other employees.
- 15 Employees are trained how to use equipment correctly.

Level of need	How a business helps individuals to satisfy their needs
Physical needs	
Safety needs	
Social needs	
Esteem needs	
Self-actualisation	

### Key motivational theories: Taylor and Herzberg

Many researchers have carried out studies to try to find out what motivates people at work. These studies have produced a number of motivational theories. Many of these theories have identified that individuals are motivated by the wish to satisfy 'needs'. You have already seen how Maslow's research described these needs. You are now going to learn about the work of other motivational theorists and how their studies may help management to motivate employees.

#### F. W. Taylor – scientific management theory

Taylor's scientific management theory aims to reduce inefficiency in the workplace by finding the quickest method of performing each task and then training all employees to use this method. The scientific management approach is still used in many countries today; for example, employees involved in flow production specialise in performing one task really well.

Taylor believed that employees are motivated by money alone. To get employees to increase their efforts they have to be rewarded with more money. This is sometimes known as **the theory of economic man**. The **piece-rate** method of paying production employees developed from Taylor's research. Employees are paid a fixed amount for every unit they produce. If employees are motivated by money then they will work harder because the more units they produce, the more they will be paid.



**KEY TERMS**

**The theory of economic man:** the view that humans are motivated only by money.

**Piece-rate:** paying employees for each unit produced.



Figure 6.4 A flow production process

**Flow production:** see Chapter 15, page 209.

### Fredrick Herzberg – two-factor theory

Herzberg wanted to find out about the factors that motivate people at work. His research identified two groups of factors which he called **hygiene factors** and **motivators**. These factors are shown in Table 6.1.

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#### KEY TERMS

**Hygiene factors:** the factors that must be present in the workplace to prevent job dissatisfaction.

**Motivators:** the factors that influence a person to increase their efforts.

Hygiene factors	Motivators
■ Working conditions	■ The work itself
■ Relationships with others	■ Responsibility
■ Salary or wage	■ Advancement
■ Supervision	■ Achievement
■ Company policy and administration	■ Recognition of achievement

Table 6.1 Herzberg's two-factor theory

#### Hygiene factors

- 1 Working conditions** – these include things such as how clean and safe the workplace is and what facilities are provided for employees, for example washrooms, drinks machines and a canteen for meals.
- 2 Relationships with others** – this factor considers the importance to an employee of having good working relationships with other employees – the need for friendship and to belong to a group – and a good relationship with managers – to be treated fairly and with respect.
- 3 Salary and wage** – Herzberg argued that people had to be paid enough to encourage them to do a job, but money was not enough for them to want to do the job well.

#### TOP TIP

Don't assume that an increase in pay automatically motivates employees to increase output. There may be other factors that cause an increase in output.

**KEY TERM**

**Job dissatisfaction:** how unhappy and discontent a person is with their job.

- 4 **Supervision** – this factor considers the importance of leadership style and how closely employees are supervised.
- 5 **Company policy and administration** – these are the rules and procedures which control and affect the way that employees work and their relationships with others in the workplace.

According to Herzberg, hygiene factors must be present at a level which is acceptable to employees to prevent **job dissatisfaction**. Improving hygiene factors makes job dissatisfaction less likely, but will not motivate employees to work more efficiently.

**Motivators**

- 1 **The work itself** – the tasks that employees do are an important influence on the motivation of employees. The work needs to be varied and challenging and Herzberg suggested that this could be achieved by introducing job enrichment.
- 2 **Responsibility** – giving employees more responsibility for the tasks they perform, for example allowing them to make decisions about their tasks. The manager is showing that they trust employees and value their contribution.
- 3 **Advancement** – employees have the opportunity for promotion.
- 4 **Achievement** – employees need to feel that they have reached challenging goals.
- 5 **Recognition of achievement** – employees need to have their achievements recognised by management and the other people they work with.

According to Herzberg, managers can use one or more motivators in order to increase the motivation of employees. However, these motivators will not work unless there is an acceptable level of hygiene factors to prevent job dissatisfaction.

The effect of hygiene factors and motivators on employee satisfaction and motivation is shown in Figure 6.5.



Figure 6.5 Hygiene factors and motivators

**TOP TIP**

It is more important that you can apply the ideas of different theories to business situations than to list all the findings.

## ACTIVITY 6.3

The senior managers of Farook Fashions (FF) are concerned about the fall in productivity at one of its factories – Factory A. The company's human resources director has produced the following data for last year.

	Factory A	Average for FF's other factories
Average weekly productivity per employee	220	350
Average number of days' absence per employee	19	8
Number of employees who left	40	18
Average weekly wage	\$126	\$125

Factory A employs 500 workers and is the oldest of FF's factories. Employees in Factory A have often complained to the factory manager about their poor working conditions compared to employees in FF's other factories.

In a recent meeting when this issue was raised again, the factory manager said: 'I do not understand why you keep complaining about working conditions. You all have well-paid jobs. All factories are noisy and dirty places, this one is no different.' This was a typical comment from a manager who was not very well liked by the employees. He never showed any interest in them. The only time he spoke to them was to give orders or to tell them off for breaking one of the many rules he had introduced when he became manager 20 years ago.

- 1 Identify **two** factors that suggest employees in Factory A are less well motivated than in FF's other factories.
- 2 Calculate the percentage of employees who left Factory A in the last year.
- 3 Do you think that money is the cause of poor motivation at Factory A? Justify your answer.
- 4 How might the senior managers at FF use Herzberg's two-factor theory to improve productivity at Factory A?

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## TEST YOURSELF

- 1 List, in the correct order from bottom to top, the five levels of need as identified by Maslow.
- 2 Explain the difference between Herzberg's motivators and hygiene factors.



## KEY TERMS

**Financial rewards:** cash and non-cash rewards paid to employees which are often used to motivate employees to increase their efforts.

**Non-financial rewards:** methods used to motivate employees that do not involve giving any financial reward.

## Methods of motivation

Managers can motivate employees in several ways. These can be divided into **financial rewards** and **non-financial rewards** as shown in Figure 6.6, page 80.

## Financial rewards and methods

The theorists we looked at earlier agree that money is an important reason why people work. However, they do not all agree on how important money is as a motivator. Taylor's view of 'economic man', for example, argues that money is the most important motivator, whereas Herzberg's theory only sees money as important for preventing job dissatisfaction, but not as a 'motivator'.

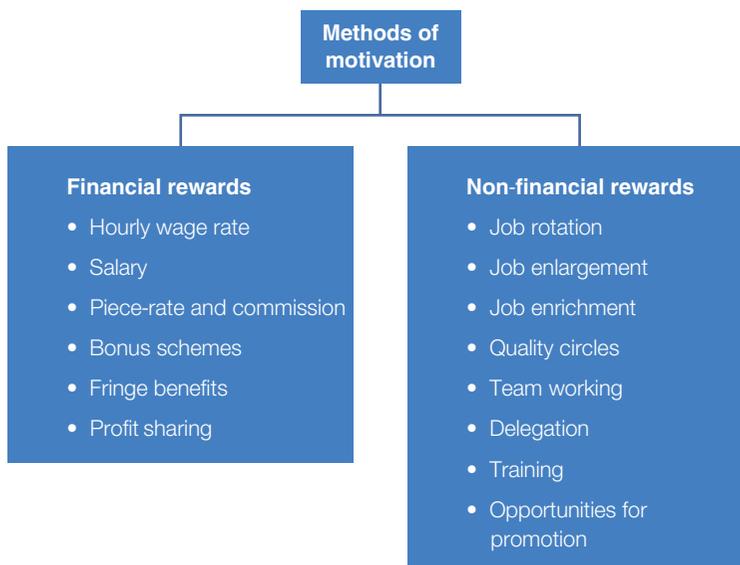


Figure 6.6 Financial and non-financial methods of motivation

If money is an important motivator then managers need to consider how best to use it to achieve a well-motivated workforce. The methods of financial rewards identified in Figure 6.6 are explained below.



**KEY TERM**

**Hourly wage rate:** a payment to employees based on a fixed amount for each hour worked.

**Hourly wage rate**

An **hourly wage rate** means that employees are paid a fixed amount per hour worked. The longer an employee is at work, the more they get paid. For example, if an employee is paid \$5 per hour and works 40 hours in a week, then they will earn a wage of  $\$5 \times 40 = \$200$ .

This is the most common method of paying production employees and non-managerial staff.

The main advantage of this method is that the business pays employees only for the number of hours they are at work.

However, the disadvantage is that employees' pay is not linked to how much they produce. For example, one employee might produce an average of 20 units per hour and another may produce 28 units per hour, but both employees will receive exactly the same pay.



**KEY TERM**

**Salary:** a fixed annual payment to certain grades and types of staff not based on hours worked or output.

**Salary**

With a **salary**, employees are paid a fixed amount per year, which is usually paid monthly. This method is best used for employees whose work effort is not directly linked to production, for example supervisors, managers and professional staff.

The advantage of this payment method is that employees do not receive more pay if they have to work longer hours to complete a task. The main disadvantage is that salary is not linked to employee effort or the amount produced.



**KEY TERM**

**Piece-rate:** a payment to employees based on the number of units produced.

**Piece-rate**

**Piece-rate** means that pay is based on the number of units of output employees produce. For example, if an employee is paid \$0.25 for every unit they produce, and they produce 600 units in a week, then their wage will be  $\$0.25 \times 600 = \$150$ . Piece-rate systems are only used to reward production employees.

The main advantage of this method is that employees are paid only for the number of items they produce. The main disadvantage is that the quality of goods produced may be poor because employees may work too quickly to increase their output.

**KEY TERM**

**Commission:** a payment to sales staff based on the value of the items they sell.

**KEY TERMS**

**Bonus:** an additional reward paid to employees for achieving targets set by managers.

**Performance-related pay:** a bonus scheme used to reward staff for performing to the required standard.

**Commission**

With **commission**, pay is based on the value of sales made by staff. This method is only ever used to reward sales staff.

The main advantage of this method is that pay is linked to the value of goods sold. The main disadvantage of this payment method to employees is that they are never certain about how much they will earn. This may mean that they leave as they cannot guarantee that they will earn enough to pay for their basic needs. This might then become a disadvantage to the business because they will have to spend more time and money on recruiting and training new employees.

**Bonus scheme**

A **bonus** scheme is a method of **performance-related pay**. Employees receive an additional payment for achieving a target set by managers. This method can be used to reward any individual employee or group of employees where a performance target can be set by managers. If the targets set by managers are realistic then they can motivate employees to work harder because they know they will receive a bonus.

The main advantage to businesses of this method is that it is linked to performance targets. Employees are awarded a bonus only if they increase their productivity. An increase in productivity will reduce average costs. The main disadvantage is that if the targets set are unrealistic then employees could become demotivated. Also, if the target is group-based and the target is reached, all employees in the group will receive the bonus even if some have worked harder than others to achieve the target. This could lead to conflict between members of the group.

**ACTIVITY 6.4**

The table below shows how the pay and average weekly output of employees at three different companies are calculated.

	Company A	Company B	Company C
Hourly rate	\$4.75	–	\$4.50
Piece-rate	–	\$0.10	–
Bonus based on producing more than 1,900 units per week	\$5	–	\$15
Hours worked	40	40	40
Average weekly output per employee	1850	2000	1950

- 1 Calculate the average weekly wage for an employee in each of the three companies. Show your workings.
- 2 Based on your results to Question 1, which company would you choose to work for? Justify your answer.

**KEY TERM**

**Fringe benefits:** non-cash rewards often used to recruit or retain employees and to recognise the status of certain employees.

**Fringe benefits**

**Fringe benefits** are an alternative to cash payments. They include discounts on company products, company cars, health insurance and pensions received by the employees in a business.

All employees could receive fringe benefits. It is more usual for different types of fringe benefits to be linked to the individual's status within the business. For

example, all employees might receive a discount if they want to buy the firm's products, but only managers receive a company car.

The main advantage of fringe benefits is that they can help in the recruitment and retention of employees. The main disadvantage is that fringe benefits are often linked to status and not performance.

**KEY TERM**

**Profit sharing:** an additional payment to employees based on the profits of the business.

**Profit sharing**

**Profit sharing** is an additional payment to all staff based on the profits of the business. It is usually paid once a year. It may be in the form of a cash payment, calculated as a percentage of an employee's wage or salary, or employees may be given shares in the company.

It can be used to provide additional financial reward to all employees, or just certain groups of employees. The argument for using profit sharing to reward employees is that everyone – from senior managers to production employees – has contributed to the business earning the profit and they should all, therefore, share in the success.

The main advantage is that profit sharing is directly linked to the performance of the business. The better the performance, the higher the profit and the greater the share of profits for employees.

The main disadvantage is that any profit given to employees might reduce the dividends to shareholders or reduce the amount available to be reinvested into the business.

**TOP TIP**

Focus on understanding how different rewards may motivate employees, not just on learning what the different rewards are.

**ACTIVITY 6.5**

Read the two job adverts for vacancies at the same health and fitness company and then answer the questions that follow.

**Advert A**

### Director of Communications and Marketing

Salary package \$100 000+

We are looking for an exceptional communications professional to take forward an ambitious, far-reaching communications strategy. You will have a strong track record in communications and marketing, excellent interpersonal skills and well-developed strategic leadership skills, ideally in a health and fitness-related environment. Appropriate professional qualifications are also a requirement of this key senior management post.

We offer an attractive rewards package to include a high basic salary plus performance-related bonuses, company car, free health insurance, company pension and relocation expenses.

**Advert B**

### Receptionist

We require a full-time receptionist for our new health and fitness club.

You must have a confident telephone manner and a friendly and cheerful personality is more important than formal qualifications.

We can offer a good working environment and an hourly wage rate of \$6 per hour. Hours of work are between 37 and 42 hours per week.

No experience necessary as full training will be provided.

- 1 Identify the pay systems the businesses are using to recruit employees for these two jobs.
- 2 How much will the receptionist earn in a week if they work 40 hours?
- 3 Using Advert A, explain the meaning of the term ‘fringe benefits’.
- 4 Why do you think the business in Advert A is offering fringe benefits, but the business in Advert B is not?
- 5 Choose **one** fringe benefit you think the company can offer to attract better-quality applications for the receptionist post? Explain your choice.



## KEY TERMS

**Job rotation:** increasing variety in the workplace by allowing employees to switch from one task to another.

**Job enlargement:** increasing or widening tasks to increase variety for employees.



## KEY TERMS

**Job enrichment:** organising work so that employees are encouraged to use their full abilities.

**Job satisfaction:** how happy and content a person is with their job.

## Non-financial rewards and methods

If Maslow and Herzberg are correct about money not being enough to motivate employees, then managers need to consider non-financial methods of motivation. The importance of training and opportunities for promotion have been identified earlier in this chapter. The other methods listed in Figure 6.6 are explained below.

### Job rotation, enlargement and enrichment

- **Job rotation** – instead of doing the same task, employees switch from one job to another. This makes the work more interesting and helps prevent boredom. Employees become multi-skilled, which helps create a more flexible workforce.
- **Job enlargement** – employees are given a greater variety of similar-level tasks to do. Their jobs become more interesting and, as with job rotation, this reduces boredom.
- **Job enrichment** – this method was developed from Herzberg’s research. Work is organised so that employees are able to use more of their skills and abilities. They often become more involved in decisions affecting their job. Employees feel more valued by their employer and this increases their **job satisfaction**, efficiency and motivation.

Increasing the variety or difficulty of tasks employees do, using any of the above methods, is known as job redesign. The aim of job redesign is to make the work more interesting and more challenging for employees. It can also help them to learn new skills which may help their chances of promotion.

## ACTIVITY 6.6

Ever since the management of Company X increased automation and introduced new technology into the workplace, production line employees have not been happy. Many have left and those that remain are less productive than they used to be and absenteeism is much higher. Many of the employees no longer use their skills. The work is boring and does not have the same level of interest or challenge for employees.

Company X has appointed a new operations manager, Eduardo. He has been told by the directors that he ‘must improve productivity and reduce absenteeism and recruitment costs’. Eduardo thinks that job redesign is the solution to these problems.

- 1 Identify **two** factors that may have caused motivation problems at Company X.
- 2 Explain **two** benefits to Company X of improving employee motivation.
- 3 Do you think that Eduardo is right in thinking job redesign is the solution to the problems at Company X? Justify your answer.



## KEY TERMS

**Quality circles:** groups of employees who meet regularly to discuss work-related problems.

**Team working:** organising production so that groups of employees complete the whole unit of work.

**Delegation:** passing responsibility to perform tasks to employees lower down in the organisation.



**Delegation:** see Chapter 7, page 99.

### Quality circles

**Quality circles** are groups of employees who meet regularly to discuss work-related issues. Employees come up with solutions to problems or suggest how improvements can be made. The results of quality circles are presented to managers and good ideas and solutions are introduced into the workplace. This approach is similar to Herzberg's 'responsibility' motivator.

### Team working and delegation

- **Team working** – production employees are organised into groups or teams and are given the responsibility for the completion of the whole task. For example, a team of employees might be responsible for the production of a complete car engine instead of individual employees completing just one small part of it.
- **Delegation** – this involves managers passing authority for the performance of tasks to lower-level employees. It is often combined with empowerment – for example, allowing employees to make decisions about how tasks are performed.

### ACTIVITY 6.7

Work in pairs to discuss the method(s) you think might be the most appropriate for motivating employees in each of the following circumstances:

- 1 a shop assistant who works in a large fashion outlet
- 2 employees on a production line where the level of faulty products has increased over the past three months
- 3 a pizza delivery driver
- 4 a marketing manager for a shoe manufacturer
- 5 someone who works as a bank cashier
- 6 a car salesman
- 7 a farm labourer
- 8 a young university graduate who has worked for a company for 12 months
- 9 staff who work in the research and development department of a cosmetics manufacturer
- 10 a teacher in your school or college.

### Choosing methods of motivation

We have seen that managers can use different methods to motivate employees. However, there is no 'best' method of motivation. Managers must choose the method that they think is best to motivate different types of employee. They may consider the following factors when choosing which method to use:

- What is the cost to the business of using a particular method? Every method we have discussed above will increase costs. Can the business afford it? Will the benefit to the business of motivating employees be greater than the increase in costs of



Figure 6.7 A quality circle

doing so? For example, using job redesign to improve motivation might reduce the absenteeism of employees or reduce the number leaving the business. This will improve productivity and reduce recruitment costs. If this cost-saving is greater than the costs of redesigning jobs, then it has been a success.

- Some methods of motivation can only be used for certain types of employees; for example, the piece-rate system is only suitable for production employees.
- A method of motivation which works for one employee or group of employees may not work for other employees. For example, some employees might be motivated by higher pay for working longer hours, but others might be satisfied with lower pay and longer leisure hours.

### TEST YOURSELF

- 1 Using examples, explain the difference between financial and non-financial methods of motivation.
- 2 What is the difference between job rotation and job enrichment?

**ACTIVITY 6.8**

Muzmed Footwear Company (MFC) is a manufacturer of ladies' fashion shoes in India. The company employs 200, mainly female, employees. Each employee is skilled in one part of the production process; for example, ten employees cut out the shape of the soles for shoes from sheets of leather or rubber. All employees involved in the production of shoes are paid using the piece-rate system.

Recently, another footwear manufacturer has opened a factory in the same area as MFC. This factory is very modern and offers employees better working conditions than those offered by MFC. It pays employees an hourly rate, plus a performance-related bonus.

Some employees have already left MFC to work for this new competitor. The owner of MFC is worried that he is going to lose more of his skilled employees to this new competitor company.

- 1 Define 'working conditions'.
- 2 Define 'performance-related bonus'.
- 3 Explain **one** advantage and **one** disadvantage to MFC of its employees being skilled in one part of the production process.
- 4 Explain **two** reasons why employees might be leaving MFC to work for the new competitor?
- 5 The owner of MFC is considering changing the way he pays his employees. Do you think this is a good idea? Justify your answer.

## Revision checklist

- Many factors which motivate people to work were identified by the research of Taylor, Maslow and Herzberg.
- Financial and non-financial motivation methods can be used to make sure a business has a well-motivated workforce.

## Exam-style practice questions

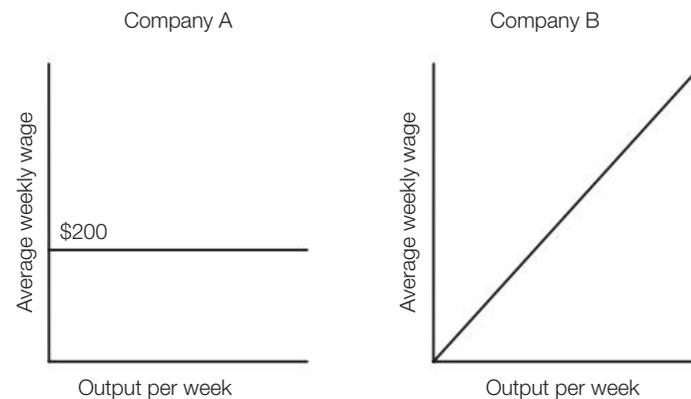
- 1 The diagrams below show the payment received by employees in two manufacturing companies, Company A and Company B.

Company A is a manufacturer of televisions. The number of televisions produced by the workforce during the past four weeks were 270, 240, 280 and 250.

Company B is a manufacturer of pottery items. Employees do not require any special skills to complete their tasks. Many employees leave before completing one year of employment with the company.

Company A pays employees based on an hourly rate. Employees work an average of 40 hours per week.

In addition to their wage, Company B provides all employees with fringe benefits.



- a Define 'fringe benefits'. [2]
- b Calculate the hourly rate Company A pays its employees. [2]
- c Outline how the method of payment used by Company B benefits its employees. [4]
- d Explain **two** financial methods Company A could use to improve the motivation of its employees. [6]
- e The management of Company B believes that money is the only way to motivate employees. Do you agree? Justify your answer. [6]



### TOP TIP

Information in examinations might be presented in the form of diagrams. Make sure you understand what such diagrams show.

- 2** ABC is a candy manufacturer. It employs 50 employees. Employees are paid \$150 per week based on a 40-hour week. Employees also receive a bonus if they reach production targets set by management.

The factory manager receives a salary of \$30 000 per year plus a company car. All managers at ABC are part of a profit sharing scheme. They also receive private health insurance.

The motivation of production employees is low. They leave the company after an average of only 16 months.

- a** Define the term 'bonus'. [2]
- b** Define the term 'motivation'. [2]
- c** Outline **two** benefits to ABC of offering fringe benefits to its managers. [4]
- d** Explain how any **two** non-financial methods of motivation might be used by ABC to improve the motivation of production employees. [6]
- e** Do you think that the production employees should receive the same fringe benefits and share of profits as the factory manager? Justify your answer. [6]

**Total available marks 40**

# 7

## Objectives

*In this chapter you will learn about:*

- simple organisation charts
- the role of management
- leadership styles
- trade unions



### KEY TERMS

**Organisational structure:** the formal, internal framework of a business that shows how it is managed and organised.

**Functional departments:** the main activities of business: finance, marketing, operations, human resources and research and development.

# Organisation and management

## Introduction

All businesses, except for a sole trader, will need some form of **organisational structure**. Everyone in the business – even if it is just two partners – needs to know their roles and responsibilities and what the roles and responsibilities are of others in the business. This will help the business to operate efficiently.

In this chapter you will learn the important features of organisational structure and how these can be represented on a diagram.

You will also study the different styles of leadership and the importance of management functions.

## Simple organisation charts

As a business grows in size, it divides into separate departments. Each department may specialise in the main functional areas of business such as marketing or finance. The **functional departments** of Company A are shown in Figure 7.1.

This is a very simple organisation chart. Now let's look at a more detailed example. The chart in Figure 7.2 is also of Company A, but this time it shows the structure of the company and its departments in more detail.

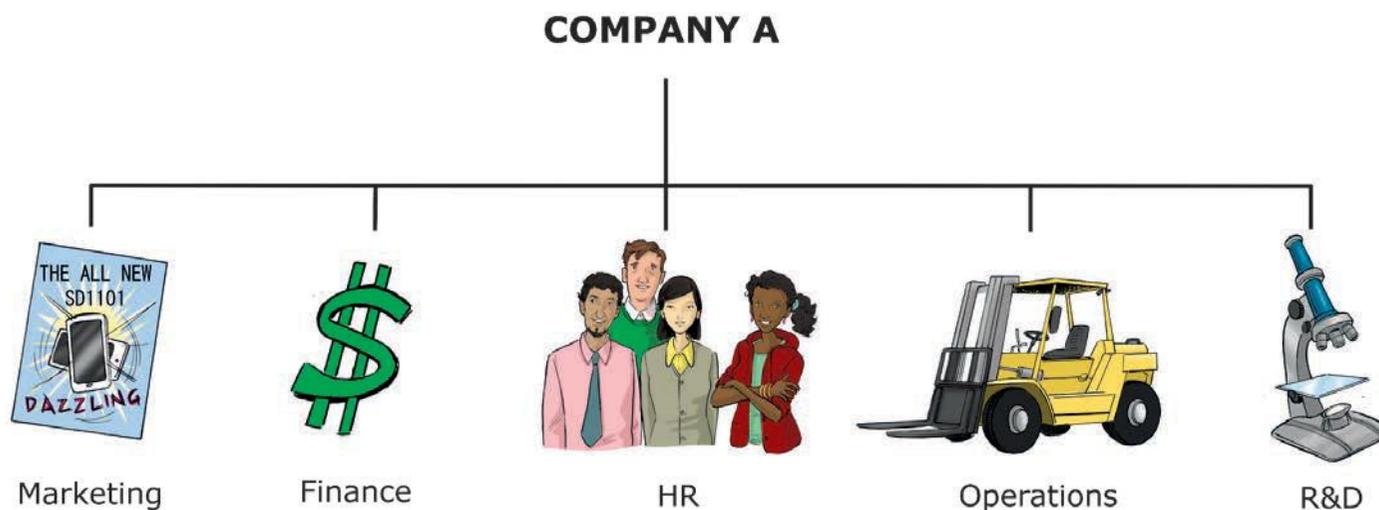


Figure 7.1 The functional departments of business

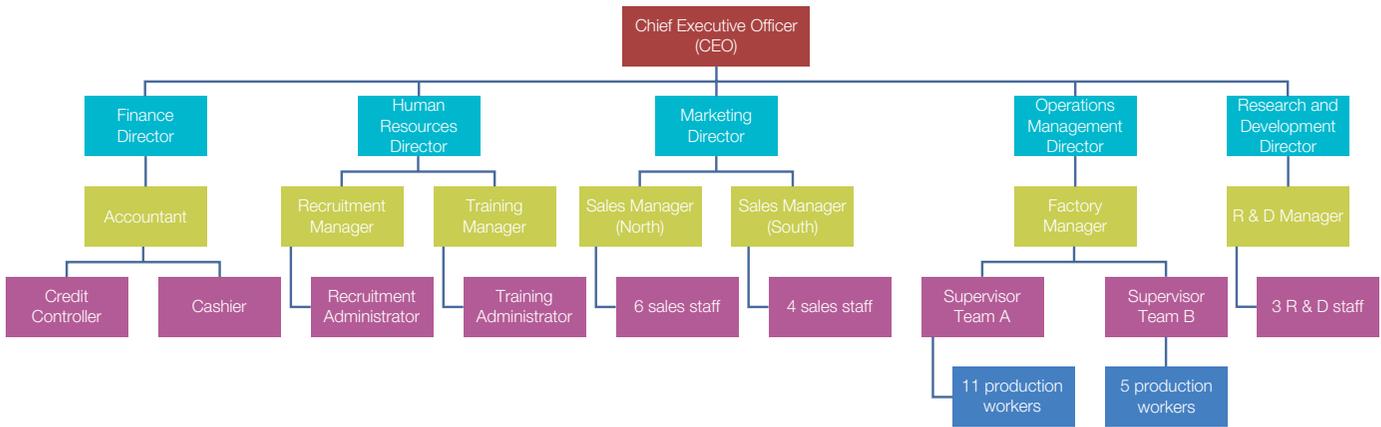


Figure 7.2 Detailed organisation chart

### Simple hierarchical structures

Figure 7.2 shows a simple hierarchical structure. The main features of this organisational structure are:

- levels of hierarchy
- chain of command
- span of control.

#### Levels of hierarchy

This describes the different levels in an organisational structure. In Figure 7.2, each of the five levels of the organisational structure is represented by a different colour. Production employees are at the lowest level of the **hierarchy** and the chief executive officer is at the top level. In larger organisations, as you move from the top to the bottom of the hierarchy, there are more and more people at each level. This is because it is not possible for one person or a group of senior managers to control the work of all employees. Middle managers, and perhaps supervisors below them, are needed to control employees.

The tasks become simpler as you move down the hierarchy so a wider span of control is possible at the bottom than it is at the top. People who are on the same level in the organisational structure have the same status. For example, in Figure 7.2 the accountant, the training manager and the factory manager are of equal status.

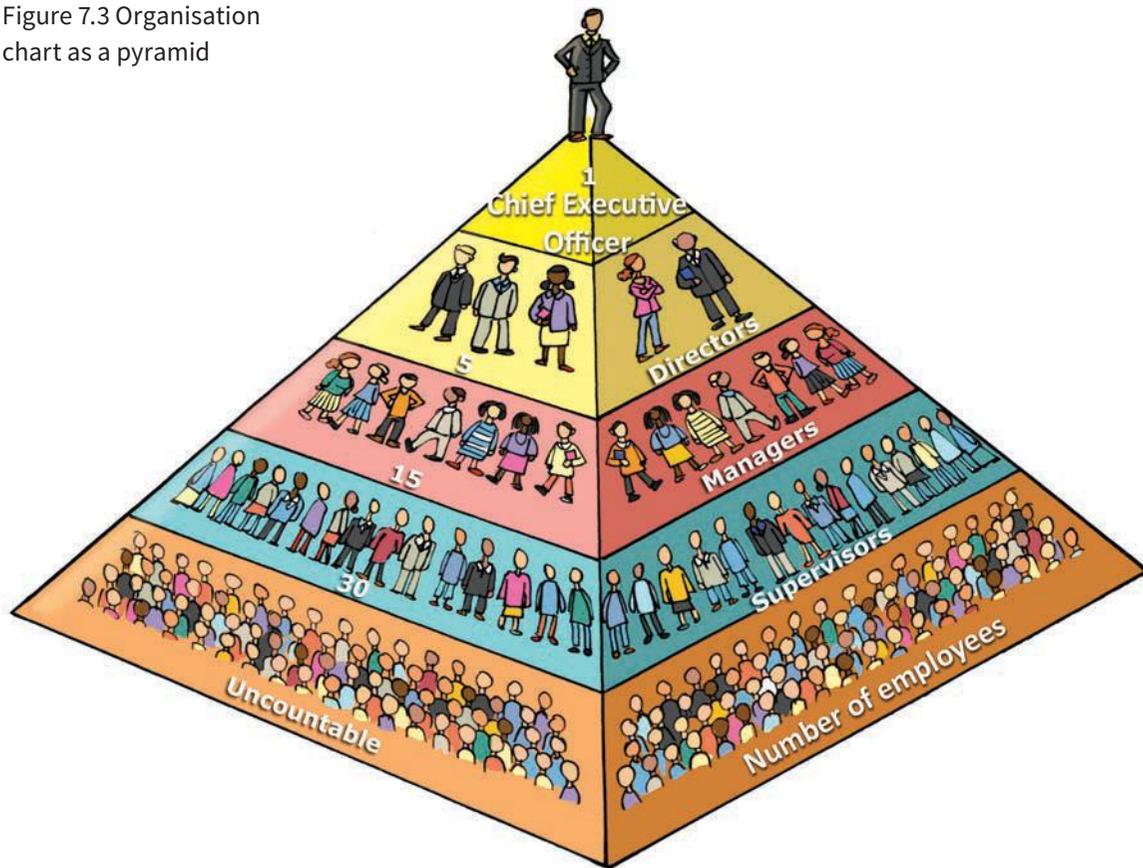
**KEY TERM**

**Hierarchy:** the number of levels in an organisational structure.



There are many levels to an organisation's structure

Figure 7.3 Organisation chart as a pyramid



### ACTIVITY 7.1

Use Figure 7.2 to identify **two** other individuals who have the same status in the organisational structure, but who are not the same status as the factory manager.



#### KEY TERM

**Chain of command:** the route through which authority is passed down through an organisation.

#### Chain of command

As a business grows it will employ more and more employees. It will not be possible for the person at the top to have effective control of all employees. The day-to-day control of employees becomes the responsibility of managers lower down the hierarchy. The term **chain of command** describes the route through which authority is passed down to these managers from the top. Each person in the chain of command is directly responsible to the person immediately above them and directly responsible for the person(s) directly below them. In Figure 7.2 the accountant is directly responsible to the finance director.

### ACTIVITY 7.2

Using Figure 7.2, which of the following statements is correct?

- 1 The recruitment manager is directly responsible to the recruitment administrator.
- 2 The recruitment manager is directly responsible for the human resources director.
- 3 The recruitment administrator is directly responsible to the human resources director.
- 4 The recruitment manager is directly responsible to the human resources director.

In a typical business situation, instructions are passed down the chain of command, whereas information about performance, for example monthly sales figures, is passed up the chain of command.

**KEY TERM**

**Subordinate:** an employee who is below another employee in the organisation's hierarchy.

**Span of control**

Each manager or supervisor is in charge of a number of employees, or **subordinates**. The number of subordinates reporting to each supervisor or manager is called the **span of control**. In Figure 7.2, the CEO has a span of control of five – the directors of each business function.

**ACTIVITY 7.3**

In Figure 7.2, who has exactly the same size span of control as the CEO?

**KEY TERM**

**Span of control:** the number of subordinates reporting to each supervisor/manager.

A span of control can be described as 'wide' or 'narrow' depending on how many subordinates a person is responsible for. For example, using Figure 7.2 we could say that the supervisor of Team A has a wide span of control because they are directly responsible for 11 employees. However, the factory manager, who is only directly responsible for two employees, has a narrow span of control.

There are a number of factors that affect the size of the span of control including:

- **The difficulty of tasks** – if the work that subordinates do involves simple and repetitive tasks, then a wide span of control can be used. The more complex the task subordinates do, the more likely that a narrow span of control will be used.
- **The experience and skills of employees** – highly skilled and experienced employees may require less control than those who are less skilled and less experienced. The span of control will often be wider when subordinates are more skilled and more experienced.
- **The size of the business** – larger businesses are often able to afford to employ more managers than smaller businesses. The span of control of individual managers in a large business is often narrower than that for managers in small businesses.
- **Levels of hierarchy** – managers in tall organisation structures will usually have narrower spans of control than managers in flat organisation structures.
- **Management style** – some businesses use a management style that has greater control over the workforce than others. In this type of business, managers have a narrow span of control.

**TOP TIP**

Note that many of the advantages of one size of span of control are the disadvantages of the other size of span of control. Learn the advantages and disadvantages of a narrow span of control and the opposite will be the disadvantages and advantages of a wide span of control.

There are a number of advantages and disadvantages of wide and narrow spans of control. These are shown in Table 7.1.

Wide span of control		Narrow span of control	
Advantages	Disadvantages	Advantages	Disadvantages
Less expensive as fewer managers/supervisors are needed.	Fewer managers/supervisors reduces promotion opportunities.	Effective communication is easier.	Communication and decision-making are often slower.
Less supervision improves employee motivation.	Less control over subordinates' work.	Better control over employees and their work.	More expensive because more managers are needed.
Faster communication and decision-making.	Effective communication may be difficult.	More managers/supervisors increases promotion opportunities.	More supervision may reduce employee motivation.

Table 7.1 Advantages and disadvantages of narrow and wide spans of control

### Tall or flat?

Organisational structures may be tall or flat, depending on the number of levels in the hierarchy.

Tall organisations have many levels of hierarchy. Each level in the hierarchy, except for the bottom level, is a layer of management. Because a tall organisational structure has several layers of management, and therefore more managers, the span of control for each manager will be narrow. The chain of command is long. Communication and decision-making are often slower because they must pass through several layers.

An example of a tall organisational structure is shown in Figure 7.4.

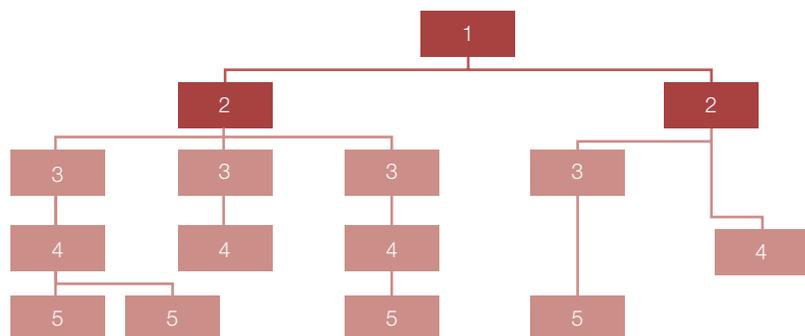


Figure 7.4 A tall hierarchical structure

Flat organisations have few levels of hierarchy, which means that the chain of command is very short. Communication and decision-making are much quicker in a flat structure because there are very few levels for these to pass through. There are fewer managers in a flat structure so the span of control is wide. An example of a flat organisational structure is shown in Figure 7.5.

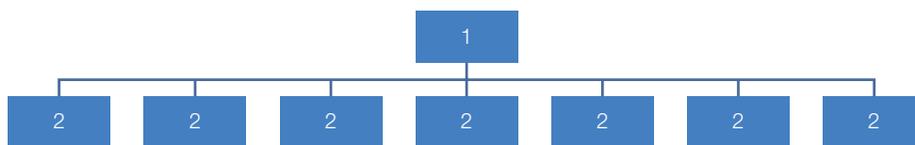


Figure 7.5 A flat organisational structure

**ACTIVITY 7.4**

Produce an organisation chart for your school or college.  
 Use your diagram to provide examples of hierarchy, chain of command and span of control.  
 Would you describe your school's/college's organisational structure as tall or flat? Justify your answer.

**KEY TERM**

**Delayering:** reducing the size of the hierarchy by removing one or more levels – most often middle management.

**TOP TIP**

There are a lot of technical terms in this chapter. You will find them easier to understand and explain if you construct a simple organisation chart.

**Delayering**

Sometimes a business with a tall organisational structure will reduce the levels in its hierarchy to save costs. This is known as **delayering**.

Delayering usually involves cutting out middle management. Middle management are often the managers of departments such as finance and marketing, or managers of different units within a business.

Figure 7.6 illustrates the effect on an organisation of delayering. In this example, level 3 has been removed from the hierarchy to reduce the number of levels from five to four. The organisational structure might still be described as tall, but it is not as tall as it was before the delayering. You can see that level 3 is middle management because it is between the senior management in level 1 and those employees at the bottom of the hierarchy in level 5.

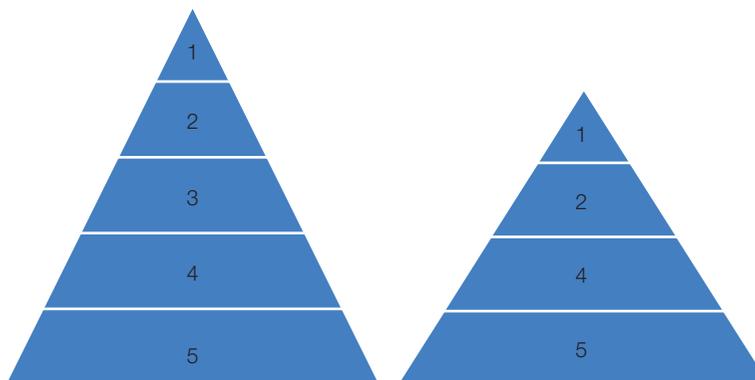


Figure 7.6 The effect of delayering a hierarchical structure

There are several advantages and disadvantages to a business of delayering, as shown in Table 7.2.

Advantages of delayering	Disadvantages of delayering
Reduces costs.	Increased workload for managers who remain could mean that tasks are not completed on time or that the quality of decision-making is not as good.
Reduces the chain of command so communication and decision-making should be quicker and more effective.	Business may have to make redundancy payments to managers who lose their jobs. This is a one-off increase in costs.
Wider span of control increases the opportunity for delegation. This helps develop employees' skills and could motivate employees who are given more trust by managers.	Employees who remain might fear redundancy and this reduces their job security.
Senior managers are in closer touch with what is happening in the business.	Wider span of control after delayering might reduce the effective management of subordinates.

Table 7.2 Advantages and disadvantages of delayering

### Centralised or decentralised?

One of the most important issues a business needs to deal with is who makes the decisions. Do senior managers at the centre of the organisation make all the decisions? Or is some of this authority for decision-making delegated to lower level managers? This decision involves making a choice between being a centralised organisation or a decentralised organisation.

A **centralised organisation** is one where decision-making power is held at the top, by senior managers, and then passed down to lower levels in the hierarchy through the chain of command. Many international franchise companies, such as Pizza Hut, operate a mainly centralised organisation structure. They do this to make sure that they control what each franchised outlet offers to customers. Pizza Hut needs to make sure that customers receive the same level of service and quality products in every one of its outlets.

In a **decentralised organisation** the authority to make some decisions is delegated to lower levels in the hierarchy or, in the case of a business with several production facilities or operating in different locations, to the managers within those areas. An example of a business that may have a decentralised structure is a national hotel chain such as Avari Hotels Ltd, Pakistan. Although the company directors are based in the head office in Karachi, each of its hotels in Pakistan and Dubai has managers who make decisions about how best to run their hotels.

Centralised and decentralised organisations have a number of advantages and disadvantages. Some of the most important of these are shown in Table 7.3.

Centralised organisation		Decentralised organisation	
Advantages	Disadvantages	Advantages	Disadvantages
<ul style="list-style-type: none"> <li>■ Decision-making is often quicker.</li> <li>■ Decision are taken for the benefit of the whole business.</li> <li>■ Greater use of specialist staff improves decision-making.</li> </ul>	<ul style="list-style-type: none"> <li>■ Slower communication.</li> <li>■ Unable to respond quickly to changes in local markets.</li> <li>■ May reduce employee motivation.</li> </ul>	<ul style="list-style-type: none"> <li>■ Decisions are made based on local needs.</li> <li>■ Can be used to train junior managers.</li> <li>■ Delegation helps to improve employee motivation.</li> </ul>	<ul style="list-style-type: none"> <li>■ Decisions taken might not be in the interests of the whole business.</li> <li>■ Poor decisions might be made because managers lack skills and experience.</li> </ul>

Table 7.3 The advantages and disadvantages of centralised and decentralised organisations

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## KEY TERMS

**Directors:** appointed or elected members of the Board of Directors of a company who have the responsibility for determining and implementing the company's policy. Some directors might also have a management role, for example a marketing director.

**Annual General Meeting (AGM):** a meeting for shareholders that limited companies must hold once every year.

## Roles, responsibilities and inter-relationships

**Directors and the chief executive officer**

**Directors** are the most senior level of management in any limited company. They may be employees of the business and be responsible for a specific function, for example marketing director or operations director. Some directors are elected by the shareholders at the **Annual General Meeting (AGM)**. The responsibilities of directors include:

- setting strategy – the long-term plans for the business
- making sure that the resources are available to achieve objectives
- reviewing the performance of managers
- protecting the interests of shareholders and other stakeholders
- providing leadership to ensure the success of the business.



An Annual General Meeting (AGM)

The **chief executive officer (CEO)** has overall responsibility for the day-to-day management of the business and implementing the decisions of the Board of Directors.

**Managers**

The day-to-day running of a department is usually the responsibility of a **manager**. For example, the human resource manager is responsible for making decisions about the day-to-day running of the human resource department.

The main responsibilities of all departmental managers include:

- making sure that the decisions of the directors are carried out
- delegating tasks to members of their department
- taking the decisions needed to achieve departmental targets
- motivating employees in the department so that they work hard to achieve the department's and the company's objectives
- solving day-to-day problems that may arise within the department.



## KEY TERMS

**Chief executive officer (CEO):** the most senior manager responsible for the overall performance and success of a company.

**Manager:** an individual who is in charge of a certain group of tasks, or a certain area or department of a business, for example factory manager.



**Limited company:** see Chapter 4, page 48.



## KEY TERM

**Supervisor:** an individual who checks and controls the work of subordinates.

### Supervisors and other employees

In a large department where there are many employees, **supervisors** may be responsible for giving out tasks to the employees, making sure they carry out the tasks and checking the quality of the work.

Other employees in a business must work together and with their manager to:

- complete their tasks efficiently and at the required quality standard set by managers
- work towards achieving individual, group or departmental targets.

### TEST YOURSELF

- 1 What is the purpose of an organisation chart?
- 2 Why are managers important?

### ACTIVITY 7.5

Read the following example and then answer the questions that follow.

Mohinder is the owner of three restaurants. Each restaurant has a manager and employs one full-time chef and other full-time and part-time kitchen and front-of-house staff. Mohinder has produced the following organisation chart for his business.

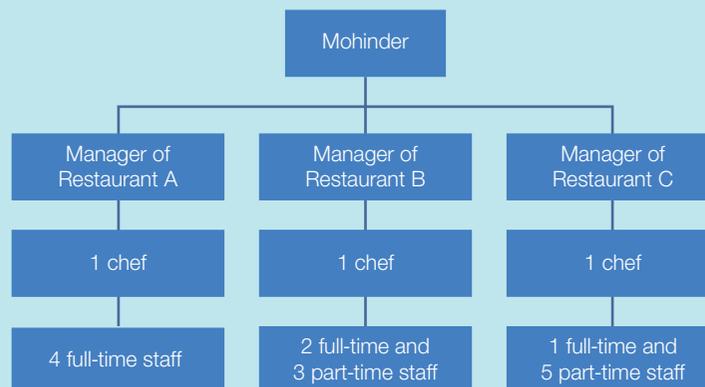


Figure 7.7 Organisation chart for Mohinder's business

The manager of each restaurant is responsible for recruiting their own employees, but all other decisions are made by Mohinder. Mohinder prefers to have a centralised organisation structure.

Mohinder has an individual weekly meeting with each manager and a monthly meeting with all three managers together. These meetings are used to compare and discuss the performance of the restaurants.

- 1 Define 'manager'.
- 2 Use the organisation chart produced by Mohinder to explain the meaning of the following terms:
  - a hierarchy
  - b span of control
  - c chain of command
- 3 Explain **one** advantage to Mohinder's employees of the organisation chart.
- 4 Do you think Mohinder is right in preferring a centralised organisation structure? Justify your answer.

## The role of management

In most organisations managers are responsible for:

- setting objectives
- motivating employees
- making sure employees have the resources they need to complete their tasks.

### Functions of management

All managers perform five functions, as shown in Figure 7.8.

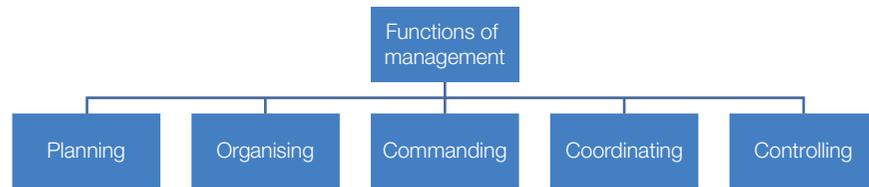


Figure 7.8 Functions of management

#### Planning

Planning is about looking at where the business is now and where it wants to be in the future. Once this has been decided, managers must then set clear objectives and decide on the actions needed for these to be achieved.

#### Organising

This function of management is about preparing and organising the resources needed to achieve the planned goals and objectives. Managers will have to decide the best way of completing important tasks at the lowest possible cost to the business.

#### Commanding

This function involves the control and supervision of subordinates. Commanding should also aim to motivate employees towards achieving the planned objectives.

#### Coordinating

Coordinating is making sure that all of the different parts of the business are working together towards achieving the business's goals and corporate objectives.

#### Controlling

This final function of management involves checking to make sure that the plan is working. Will it be completed on time and to the required standard? If not then action must be taken to correct it.

As well as these five functions, managers need to:

- understand the people who work for them
- set a good example
- treat subordinates fairly
- delegate tasks
- communicate effectively.



## KEY TERM

**Delegation:** passing authority down through the organisational hierarchy to a subordinate.

## Delegation

It is not possible for managers to complete all business tasks. They don't have the time and, in some cases, may not have the necessary skills. Therefore they need to delegate some of the tasks to employees in a lower level of the business – subordinates.

Delegation is giving the authority to subordinates to make decisions and complete tasks. Successful delegation requires the employee to be given not only the authority to complete the task, but also the resources and cooperation of other employees.

Managers are sometimes not keen to delegate tasks. Some managers believe that 'if you want it done right, you have to do it yourself'. They do not trust the subordinate to do a good job.

By delegating tasks, some managers fear they will lose control of decision-making. They may even feel threatened by subordinates who can complete a task to a better standard than the manager.

However, if the issues of control and trust are overcome, then delegation can benefit both the manager and their subordinates.

- Managers have time to focus on more complex tasks of greater importance.
- It can motivate employees who are given the opportunity to take on responsibility and develop their skills.
- Delegation is a way of developing the skills of employees and increasing the flexibility of the workforce.
- The quality of the work is often improved because lower-level employees have better skills than their managers for completing certain tasks.

### ACTIVITY 7.6

Go-by-Car is a large car rental company that operates through an extensive network of local offices in many countries throughout the world. Each country (in some larger countries each region) has a director who is responsible for, among other things, long-term planning.

Small teams manage and lead local Go-by-Car offices. Each office has a manager who needs to have the skills to motivate, lead and influence others. Local managers have the delegated authority to make decisions which affect their customers without referring back to senior management. Delegation brings many benefits to local managers, their team and Go-by-Car customers.

- 1 Define 'delegation'.
- 2 Explain **two** functions of Go-by-Car managers.
- 3 Explain **two** advantages and **two** disadvantages to Go-by-Car of delegation.

### TEST YOURSELF

- 1 State the five functions of management.
- 2 Why do some managers not delegate tasks to subordinates?

## Leadership styles

Leadership is an important role of a successful manager. Employees will want to follow and help a popular leader to achieve business goals.

The three main styles of leadership are shown in Figure 7.9.

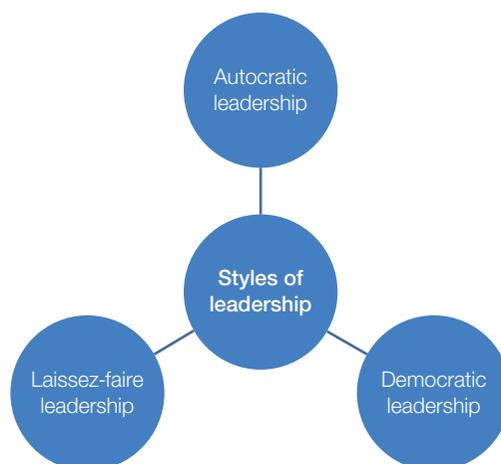


Figure 7.9 Leadership styles

#### KEY TERM

##### **Autocratic leadership:**

a leadership style where the leader makes all the decisions.

#### KEY TERM

##### **Democratic leadership:**

a leadership style where employees take part in decision-making.

#### KEY TERM

##### **Laissez-faire leadership:**

a leadership style where most of the decisions are left to the employees.

### Autocratic leadership style

An **autocratic leader** will make all of the decisions without any discussion with others. They decide the objectives and how these will be achieved. Instructions are passed down to employees and the leader will check to make sure that these have been carried out and that tasks have been completed. An autocratic leader is more interested in the completion of the task than in the welfare and motivation of employees. It is likely that employee motivation will be low and that employees will require close supervision.

This style of leadership makes for faster decision-making and this could be well-suited to situations that require an immediate response, for example in the event of a serious health and safety issue at work.

### Democratic leadership style

The opposite of an autocratic leader is the **democratic leader**. This type of leader will discuss with employees before taking any decision. This should improve the quality of the final decision, especially where individual employees have more experience of a work situation than the leader. Communication will be two-way, with employees having the opportunity to start the discussion as well as provide feedback to any suggestions made by the leader.

A democratic leader is more likely to delegate authority for some decision-making to subordinates. This style of leadership is likely to motivate employees as they are trusted and their opinions are respected. Employees will complete tasks without close supervision.

This style of leadership is suited to a wide variety of business situations, but is especially useful where staff are skilled, experienced and keen to be involved in decision-making.

### Laissez-faire leadership style

**Laissez-faire** means 'let them do it'. It is a style of leadership which allows employees to make decisions and carry out tasks with very little or no input from the leader. The leader will provide a coordinating and supporting role for the team members.

This leadership style could be effective for employees involved in creative tasks, for example those working in the research and development of new products or designing a new advertisement.

**ACTIVITY 7.7**

Work in pairs to discuss which of the three leadership styles might be the most appropriate in each of the following circumstances:

- 1 a business that designs and creates television advertisements
- 2 a business facing a potential financial crisis
- 3 a manufacturing business where employees are highly skilled
- 4 a business that operates in a market where competitors are constantly changing their marketing decisions
- 5 the research and development department of a games software design company
- 6 a large department store with several departments selling different types of goods.

In each case, justify your choice.

### Features of the main leadership styles

The main features of the three leadership styles are shown in Table 7.4.

	<b>Autocratic</b>	<b>Democratic</b>	<b>Laissez-faire</b>
Objectives	Set by the leader without any input from employees.	Set by the leader, but employees are often consulted.	Usually set by the leader with or without any input from employees.
Decision-making	Taken by the leader without any input from employees.	Employees are encouraged to take part, but the leader still takes the final decision.	Delegated to employees who take the decisions.
Communication	One-way, from the leader to employees. No opportunity for feedback.	Two-way – feedback is encouraged.	Communication is most often upwards from subordinates to the leader. Little feedback from the manager.
Supervision of employees	Closely supervised by the leader.	The leader is available to solve problems, but otherwise close supervision is not needed.	No supervision by the leader.
Availability of information	Employees are given very limited information about the business.	Employees are given information which allows them to fully participate in the business.	Employees are provided with all the information they need to take decisions.
Motivation levels	Likely to be low.	Likely to be high.	Could be high or low depending on the task and skills of the employees.

Table 7.4 Main features of autocratic, democratic and laissez-faire styles of leadership



#### TOP TIP

Don't just describe leadership styles. Think about how they might link to employee motivation and business effectiveness.

### Choosing a leadership style

There is no one 'best' leadership style that fits every business situation. Each of the styles discussed above has its strengths and weaknesses and which one is best will depend on a number of factors, including:

- **The skills and experience of the workforce** – the more skilled and experienced employees are, the less important it is for the manager to make all decisions and supervise employees. A more democratic leadership style may be 'best'.

- **The time available to make a decision** – if a decision needs to be taken quickly, then there will be no time to discuss the situation with employees. This will require an autocratic approach to management. However, if there is time to consult and for employees to participate in the decision-making process, then a more democratic management style may be used.
- **The personality of the manager** – some managers are naturally autocratic or naturally democratic. It can be very difficult to use a management style which is opposite to their own personal style.
- **The task to be completed** – you have already seen how employees whose tasks require them to be innovative and creative may be more motivated with a laissez-faire leadership style. The nature of the task, for example complex, simple or creative, may require different leadership styles.

Managers should try to use a management style that takes these factors into account. Perhaps the best approach is for managers to realise that they may have to use different styles in different circumstances. For example, a manager may usually use a democratic style of management, but if a crisis situation happens, which places the business at some risk, then a more autocratic style may be needed.

## CASE STUDY

## Leadership styles in the oil and gas industry

The production of oil and gas is an important industry in the primary sector of several countries throughout the world. The industry, which can be a dangerous one to work in, employs people in many different types of jobs. Managers must use the most appropriate management styles to ensure employee safety and the best solutions to problems.

A key role in the industry is the installations manager. This manager is responsible for the safety and well-being of everyone working within the installation. Employees must comply with instructions at all times due to the nature of the work. Rules and procedures must be followed to ensure safety.

However, the installations manager may also have to take complex decisions about shutting down a piece of equipment and the effect this may have on other areas of production. Such decisions may require a different approach. The installations manager may not have all the knowledge or skills needed to take such a decision alone.



An installations manager in the oil and gas industry

### TASK

- a The production of oil and gas is in the primary sector. State the other two sectors.
- b Define a 'manager'.
- c What is the most appropriate leadership style for an installations manager? Justify your answer.

### TEST YOURSELF

- 1 Outline the main difference between an autocratic leadership style and a democratic leadership style.
- 2 Identify **one** circumstance when an autocratic leadership style might be appropriate.

**KEY TERM**

**Trade union:** an organisation of employees aimed at improving pay and working conditions and providing other services, such as legal advice, for members.

**EXPLORE!**

Work in small groups to research a trade union in your country. Use local newspapers, magazines, library resources, the internet, or write to the head office for information.

What type of employees are their members? What services and benefits do they provide to members?

Make a short presentation to your class about your chosen trade union.

## Trade unions

### What is a trade union?

A **trade union** is an organisation formed and financed by employees for the purpose of protecting the interests of its members and improving their pay and working conditions.

There are many different types of trade unions. Some of these represent specific types of employees, for example the South African Democratic Teachers Union, whereas others have members from different industries, such as the General Employees Federation in Mauritius.

Trade unions help their members by carrying out the following roles:

- Negotiating with employers to improve pay and working conditions – this is the main role of trade unions. They will represent their members in talks with employers at national or local level on issues such as pay, hours of work, holidays, health and safety in the workplace. Negotiations between trade unions and employers are known as ‘collective bargaining’.
- Resolving conflict – when there is disagreement between an employer and its employees which the employees themselves have been unable to resolve then the trade union will try to negotiate a solution on behalf of its members.
- Providing legal support and advice – a trade union will provide its members with advice about their legal rights as an employee. If an employee is treated unfairly by an employer, for example dismissed without good reason, then their trade union will offer the services of legal specialists so that they are able to take legal action against the employer.
- Providing services for members – many trade unions provide a range of benefits for members including pension schemes, insurance schemes, holiday schemes and many other benefits.

### Effects of employees being trade union members

The main benefits and drawbacks of trade union membership for employees are:

- Employees who join together in a trade union have greater power when dealing with employers than if they were to do so as individuals. Collective bargaining is the best example of this ‘strength in numbers’. The trade union negotiates with employers on behalf of all its members in a business or industry. The collective power of all the members of the trade union, acting as one, achieves much better improvements in pay and conditions than if they were to negotiate with their employers on an individual basis.
- Trade unions provide support and legal advice to members who are being unfairly treated by employers, or who have been injured at work. This legal advice would often be too expensive for individual employees to afford themselves.
- Trade unions will try to protect employees’ job security by discussing with employers any major changes to the workplace that might involve job losses and redundancy. The trade union will encourage employers to look at other options which might reduce the number of job losses.
- Employees must pay a membership fee to belong to a trade union.
- The decision of the majority of union members is binding on all members, even if they do not agree with the decision or action to be taken. Individual members who do not support the majority decision could be fined or have other action taken against them for breaking union rules.
- During strike action, employees lose wages which cannot be recovered. This could cause personal hardship for employees and their families.

### Effects on employers of trade unions

There are also benefits and drawbacks to employers of recognising trade union membership in the workplace. These include:

- Unions provide a single point of contact between employers and employees for negotiations and this is simpler and less time-consuming than having to negotiate with each individual employee.
- Unions help to improve working conditions and health and safety in the workplace. This can improve employee motivation and reduce the level of absenteeism and labour turnover.
- Powerful unions can often force employers to meet high wage demands. This increases business costs and could reduce the competitiveness and profitability of businesses.
- Unions could use industrial action, such as strikes, to try to force employers to meet their demands. This can disrupt production and result in loss of orders, which reduces profitability.

#### ACTIVITY 7.8

Possible strike action in the sugar industry has been avoided following an agreement reached between industry employees and the Mauritius Sugar Producers' Association.

Source: Adapted from <http://allafrica.com/stories/201006181068.html>

The subway system in Brazil's biggest city was halted on Wednesday when around 8000 subway employees went on strike in support of their demand for a 20% pay rise. The management of the public company which runs the subway system have offered employees a 7% rise.

Source: Adapted from [www.vosizneias.com/106816/2012/05/23/sao-paulo-brazil-brazil-subway-workers-go-on-strike-in-sao-paulo](http://www.vosizneias.com/106816/2012/05/23/sao-paulo-brazil-brazil-subway-workers-go-on-strike-in-sao-paulo)

Members of SOMU, the dock employees trade union in Argentina, went on strike on Thursday for better working conditions. Their action has slowed the country's ports just ahead of the harvests for corn and soya bean which are both vital to the local economy.

Source: Adapted from [www.reuters.com/article/2012/03/01/argentina-grains-strike-idUSL2E8E183X20120301](http://www.reuters.com/article/2012/03/01/argentina-grains-strike-idUSL2E8E183X20120301)

- 1 Define 'trade union'.
- 2 Explain **two** effects of trade union membership on subway employees in Brazil.
- 3 Why do you think MSPA has signed an agreement with sugar industry employees?
- 4 Define 'working conditions'.
- 5 Do you think the strike action taken by dock workers in Argentina will help them to achieve an improvement in their working conditions? Justify your answer.

#### TEST YOURSELF

- 1 What is the main purpose of a trade union?
- 2 Why might an employee not join a trade union?

## Revision checklist

- The main features of an organisational structure, such as levels of hierarchy, chain of command and span of control, can be explained with the use of simple organisation charts.
- The different styles of leadership are autocratic, democratic and laissez-faire.
- The main functions of management are planning, organising, coordinating, commanding and controlling.
- There are benefits and limitations of delegation.
- Trade unions are organisations that aim to protect the interests of their members by improving pay and working conditions and providing other advice and support when needed.



Figure 7.10 Organisation chart of Retro Fashions (RF)

## Exam-style practice questions

- 1 Gopal is the CEO of Gopal Leisure (GL). GL has a tall organisational structure.  
Gopal likes to know what all his directors and managers are doing. He has delegated authority to the other directors for marketing, finance and human resources management.  
The employees in one of GL's leisure facilities are unhappy about a recent decision taken by Gopal to block a pay increase. The local manager had agreed the pay rise with the director of human resources. The manager said, 'This is typical of Gopal's autocratic leadership style.'
    - a Define 'manager'. [2]
    - b Define 'organisational structure'. [2]
    - c Identify **four** functions of management. [4]
    - d Explain **two** benefits to GL of delegation. [6]
    - e Do you think that an autocratic management style is the best approach for Gopal to use? Justify your answer. [6]
- 2 Bimla is the chief executive officer (CEO) of Retro Fashions (RF). Bimla's uncle is the finance director and her two brothers are the marketing director and the operations director.  
Figure 7.10 shows RF's organisational structure.  
Most production employees are members of a trade union.  
RF is a very successful and profitable company. Over the past five years sales and profits have increased by 25%. Bimla believes that this is due to the strong leadership provided by the Board of Directors.
    - a Define 'director'. [2]
    - b Identify **two** roles of managers. [2]
    - c Outline why RF's employees might join a trade union. [4]
    - d Use the organisation chart to explain **two** features of RF's organisational structure. [6]
    - e How important is the Board of Directors to the success of RF? Justify your answer. [6]

**Total available marks 40**

# 8

## Objectives

*In this chapter you will learn about:*

- recruitment and selecting employees
- the importance of training
- methods of training
- reasons for reducing the size of the workforce
- legal controls over employment.

# Recruitment, selection and training of employees

## Introduction

You probably know people who are looking for a job, or who have recently started a new job. You will have teachers who leave your school or college and need to be replaced so that subjects can continue to be taught. All of these are examples of situations that involve recruitment of staff.

When employees start a new job, they will need some training so that they produce work that is up to the standard required.

In this chapter you will find out how organisations recruit employees and why it is important that they receive training when they first start their job. You will also look at the importance of training to existing employees as the needs of the job change.

## Recruitment and selecting employees

The success of any business depends on a number of factors. One of the key factors to business success is having the best possible workforce. A business is unlikely to achieve its aims and be competitive unless it recruits the right number of employees with the right skills.



Figure 8.1 It is important to have the best possible workforce

## Recruitment and selection methods

All businesses will, at some point, have to recruit new employees. They may need more employees because the business is growing in size, or they may need to fill a vacancy where an employee has left the business.

Recruitment of new employees can be time-consuming and costly. However, it is important that the business recruits the right people because if it fails to do so, it will have to go through the whole process again.

#### KEY TERMS

**Internal recruitment:** filling a vacant post with someone already employed in the business.

**External recruitment:** filling a vacant post with somebody not already employed in the business.

### Difference between internal and external recruitment

When a business has a job vacancy to fill it can look for someone in its existing workforce – **internal recruitment** – or search outside the business – **external recruitment**.

#### Internal recruitment

A business may decide that it already has the right people with the right skills to do the job. If so then instead of filling a job vacancy by employing someone from outside, they can choose someone who already works for the business.

The main advantages of internal recruitment are:

- The vacancy can be filled more quickly and more cheaply.
- Applicants already know how the business works.
- The business already knows the strengths and weaknesses of applicants.
- Employees can become more motivated when they see that there is a chance of promotion.

There are limitations to internal recruitment including:

- A better candidate may have been available from outside the business.
- It could cause conflict within the workplace if other internal candidates feel they should have got the job.
- It does not bring in any new ideas.
- There will still be a vacancy to fill, unless the employee's previous job has become redundant.

#### External recruitment

If a business decides that none of its current employees has the necessary skills or expertise to fill a vacancy, or they want to increase the choice of candidates for a job, then they will use external recruitment. This does not mean that current employees cannot apply for the job and might even be successful in getting the job. Businesses that are growing rapidly or that have a high labour turnover will frequently use external recruitment to fill job vacancies.

The main benefits to a business of external recruitment are:

- External applicants might bring new ideas and this can improve the effectiveness and efficiency of the business.
- There will be a wider choice of applicants with different skills and experience.
- It avoids the risk of upsetting employees when someone who is internal is promoted.

The limitations of external recruitment include:

- It takes longer to fill the vacancy.
- It is more expensive than internal recruitment because of advertising costs and the time spent interviewing candidates.
- External applicants will need induction training, which increases their expenses.

**ACTIVITY 8.1**

Molly is the human resource manager for Coggins Plastics (CP). CP has two vacancies:

- 1 machining supervisor
- 2 factory manager.

Molly and the operations director are considering which method of recruitment to use to fill both of these vacancies. Recommend whether internal or external recruitment should be used to fill these posts. Justify your recommendation.

### Main stages in recruitment and selection of employees

Finding new employees requires a business to go through a recruitment and selection process. There are several stages to this process, as shown in Figure 8.2.

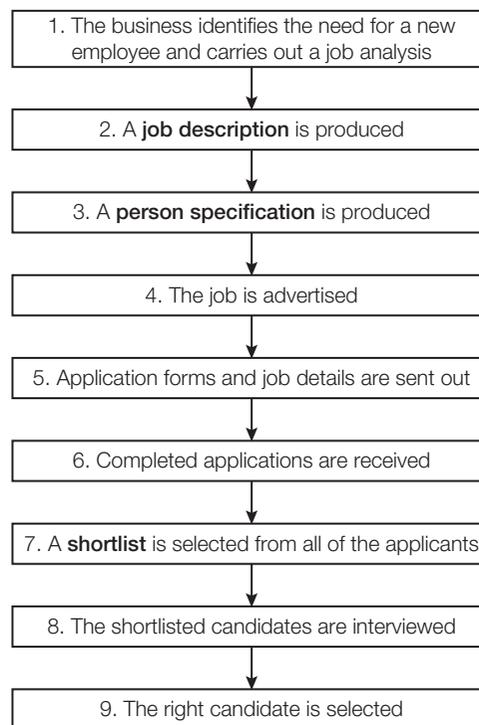


Figure 8.2 The recruitment process

#### Job analysis

When a vacancy occurs, the human resource department carries out a job analysis along with the manager of the department where the vacancy is. This is a process that identifies the content of a job in terms of the activities involved and the skills, experience and other qualities needed to perform the work. It also identifies the main job requirements.

**KEY TERM**

**Job description:** a list of the key points about a job, job title, key duties, responsibilities and accountability.

**TOP TIP**

Remember that a job description is mainly used to help managers decide what the job involves and select the applicant who best matches the requirements of the job.

**Job description**

A **job description** is a written document that provides all the details about what a job involves. It is usually prepared by the human resource department with input from the manager of the department which has the vacancy. It will be sent to anyone interested in applying for the job and should help to attract the best applicants for the job.

A job description needs to include:

- **Job title** – for example Sales and Marketing Executive.
- **The main duties of the post** – for example plan and carry out marketing activities to agreed budgets and timescales.
- **Responsibilities** – who the job holder is responsible for supervising/managing.
- **Accountability** – who the job holder reports to.

An example of a simple job description is shown in Figure 8.3.

Title:	Sales and Marketing Executive
Job purpose:	To plan and carry out direct marketing and sales activities, so as to maintain and develop sales, in accordance with agreed business plans.
<b>Key duties:</b>	
<ol style="list-style-type: none"> <li>1. Maintain and develop a computerised customer database.</li> <li>2. Plan and carry out direct marketing activities to agreed budgets and timescales.</li> <li>3. Develop ideas and create offers for direct mail and marketing to major accounts.</li> <li>4. Respond to and follow up sales enquiries by post, telephone, and personal visits.</li> <li>5. Monitor and report on activities and provide relevant management information.</li> <li>6. Carry out market research, competitor and customer surveys.</li> <li>7. Attend training to develop relevant knowledge and skills.</li> </ol>	
Responsible for:	Sales and Marketing Assistant
Accountable to:	Sales and Marketing Director

Figure 8.3 An example of a job description

**KEY TERM**

**Person specification:** a list of the qualifications, skills, experience and personal qualities looked for in a successful applicant.

**Person specification**

A **person specification** is a written document that is usually produced by the human resource department with input from the relevant manager. It is an analysis of the type of qualifications, skills, experience and personal qualities the business is looking for in applicants. Some businesses provide applicants with a person specification to help them understand the type of person they are looking for and hopefully attract only those applicants with the right level of skills, experience and personal qualities. Other businesses use the person specification to help in the selection process.

An example of a person specification is shown in Figure 8.4.

#### Person Specification — Sales and Marketing Executive

**Personality:** Self-driven, results-orientated with a clear focus on high quality and business profit. Reliable, tolerant, and determined. Able to get on with others and be a team-player.

**Specific job skills:** Excellent written communication skills. Understands the principles of marketing and advertising cost-effectiveness. Experience of managing marketing agency activities desirable but not essential. Must be an excellent face-to-face and telephone communicator.

**Computer skills:** Must be adept in use of MS Office 2007 or later, particularly Excel and Word, and ideally Access or similar database to basic level, internet and email.

**Management ability:** Some people-management skills, experience and natural ability will be useful.

**Qualifications:** Must be educated to 'A' Level standard.

Figure 8.4 An example of a person specification

### ACTIVITY 8.2

Think of a job you might like to do when you have finished your studies. Write the 'key duties' section of the job description for this job. Use the example of a person specification in Figure 8.4 to write a person specification for this job.

#### EXPLORE!

Look in your local newspaper for a job advertisement.

Use your advertisement to complete the following tasks.

- 1 What is the name of the employer?
- 2 What is the job title?
- 3 What qualifications, skills and experience are they looking for?
- 4 What is the wage or salary? Does it mention a figure or just give a description?
- 5 Are they offering any fringe benefits?
- 6 How do you find out more information?
- 7 How do you apply for the job?

### Advertising a job

Once the job description and person specification have been produced, the business needs to advertise the vacancy.

If the job is to be filled using internal recruitment, then the advertisement could be placed on the staff noticeboard, emailed to all staff, or included in a workplace newsletter.

If external recruitment is being used, then the advertisement could be placed in local or national newspapers and specialist magazines. The choice of whether to use local or national newspapers to advertise job vacancies will often depend on the nature of the job. If it is for middle and senior management jobs, or jobs requiring a specialist skill, then advertising nationally will probably attract more better-quality applicants than local advertising. Unskilled or semi-skilled job vacancies will probably be filled from the local population, so there is no need to advertise nationally. This is an important decision to make because advertising in national newspapers is always much more expensive and would be a waste of money if the job is likely to be filled by a local applicant.

Many businesses now include details of any job vacancies on their website. In some countries there are government-run job centres where vacancies can be advertised, usually for free. There are also a number of job websites such as Seek in New Zealand and JobsDB in Malaysia.

Some businesses might also use specialist recruitment agencies such as Candor Group (pvt) Ltd in Pakistan. These agencies often provide a complete recruitment service, which saves the time of the managers in the business with the vacancy. However, such agencies can be expensive to use.

The advert must be designed so that it attracts the right applicants and provides all the information they need about how to apply for the post.

### GloTech Engineering Products

#### Sales Manager

Salary up to \$75k basic, generous management bonus, company car, pension health care and benefits package

A growing, profitable and highly regarded manufacturer of engineered products seeks a highly experienced and talented Sales Manager.

Reporting directly to the Sales Director, you will personally and closely manage the day-to-day activities of your team and be responsible for the delivery of the company sales budget, target setting, performance monitoring and reporting on activity to the Board.

You must have a proven track record in sales, but also be a natural and stable sales team leader.

If you feel that you meet the demanding expectations above, we would like to hear from you. Please email your full CV to Nasreen Moini, Human Resource Manager: moini.n@glootech.com.

### Premium Floorcoverings

#### Sales Adviser (Full-time)

As one of our Sales Advisers you will be responsible for making sure our customers receive the best service we can deliver. You will be highly motivated, approachable and have fantastic people skills.

In return, we offer a competitive basic salary of \$12000, a generous commission scheme for each sale made and a range of fringe benefits such as product discounts.

Sounds interesting? Then apply today and give yourself the chance to work for an exciting and expanding company that offers great pay, a welcoming and supportive working environment and fantastic career progression.

Call Shaun on 08675432657 for an application form.

### Sending out application forms and job details

Once the job has been advertised then the business will need to send out further details and application forms to people who have shown an interest in applying.

Those who decide to apply will complete and return an application form or send a curriculum vitae – known as a CV – whichever the employer requests.

A CV contains the person's name, address and other contact details; the education and qualifications obtained; a history of their employment; other skills and experiences they have that might be relevant to the job; hobbies and interests; and the name and contact details of people who will provide references.

A sample CV is shown in Figure 8.5.

**C u r r i c u l u m V i t a e**

Name

Address

Home telephone number

Mobile number

Email address

Education including examinations and qualifications gained

University

Secondary school

Work experience (include dates from and to and reasons for leaving)

Other relevant qualifications and skills

Other interests and hobbies

Name and contact details of two referees

Figure 8.5 A sample CV

### ACTIVITY 8.3

Use the above CV template as a guide and write your own curriculum vitae.



#### KEY TERM

**Shortlist:** a list of candidates who are chosen from all of the applicants to be interviewed for the job.

### Receiving applications and shortlisting applicants

The human resource department and the manager of the department where the vacancy exists will look through all the applications. They will compare the information on the application forms and CVs with the job description and the person specification to produce a **shortlist** of applicants for interview.

### Interviewing shortlisted candidates

Shortlisted candidates will be invited to attend for interview. The interview may just be a question and answer session with one or two people interviewing each candidate, or there may be a panel of interviewers. Usually the more senior the position, the more people are likely to be involved in the interview process. Candidates may be asked to complete tests. These may include aptitude tests; for example someone applying for a car mechanics job may be asked to fix a problem on a car, watched by the interviewer. Other tests may involve team activities or in-tray exercises, such as reading typical letters that the business receives and deciding on the best course of action to take in response.



A candidate being interviewed for a job



#### TOP TIP

Don't confuse a job description with a person specification. Learn the difference between the two and how they are used in the recruitment process.

### Selecting the right candidate

Following the interviews and the results of any test, the interview panel will select who they think is the best applicant for the job. They could base their selection not only on the candidate's performance in the interview and any tests they have taken, but also on other factors such as educational qualifications, the number of years of relevant experience and skills gained, and references from previous and current employers.

The applicant will receive a formal job offer in writing, although they might first receive a phone call offering them the job. Once they start work, they will be given a contract of employment and induction training (see below).

### Benefits and limitations of part-time and full-time employees

Not all employees want to, or are able to, work full-time. Although in some countries things are changing, women are more likely to want to work part-time so that they can combine work with raising a family or other commitments. College and university students are another important source of part-time employees.

There are a number of benefits to a business of employing part-time employees, such as:

- A business can often attract well-qualified employees – mainly women – who want to return to work but need to have flexible working hours.
- Offering a full-time employee the opportunity to work part-time can help a business to keep experienced staff.
- Part-time work provides greater flexibility. For example, if an employee is off sick, part-time employees can often cover their duties at short notice.
- The contract hours of part-time employees may be flexible to allow for changes in demand. The part-time employee works longer hours during busy periods and fewer hours when the business is less busy.
- There is some evidence to suggest that part-time employees are more productive than full-time employees. Perhaps because they work fewer hours so are less tired, or because they are motivated to work for an employer who recognises the benefits of part-time employees.
- Employing two part-time employees instead of one full-time employee often increases the skills and experiences of the workforce.
- Part-time employees do not need to take time off work for medical and dental appointments. When full-time employees take time off for these reasons, output falls.

There are also limitations to employing part-time employees:

- There will be an increase in induction and training costs.
- There could be communication problems. Getting the same message to all employees is difficult when some employees are only in the workplace at certain times during the week.
- The quality of service offered to customers may not be as good with part-time staff as it is with full-time staff. For example, if an employee is dealing with a customer complaint on a Monday but is not at work again until Wednesday, then the customer has to wait longer for a solution.

The disadvantages of employing part-time employees are removed if full-time employees are employed. In addition, full-time employees are often more committed to the business and doing a good job because they are perhaps more keen on gaining promotion than part-time employees.

### TEST YOURSELF

- 1 What is the main difference between internal recruitment and external recruitment?
- 2 Identify **two** features of a job description.
- 3 State **two** advantages to a business of employing part-time employees.

## The importance of training and methods

### Why employees need training

Imagine you have just started a part-time job in a local department store. It is your first day at work. How will you know what to do? Your friend has been working at the store for some time. He has just changed jobs and it is his first day in a new department. How will he know what to do? Both employees need to be trained so that they can do their jobs effectively and efficiently. The same store has just introduced new technology at the tills. All till operators have been trained to use the new equipment. Without training, staff may become demotivated, and there are likely to be many unhappy customers, which will be bad for the business.

As you can see, training is important to both businesses and employees. The main benefits of training include:

- Trained production workers are more efficient. This increases productivity and improves quality.
- Management training improves the quality of business decisions and reduces the risk of costly mistakes.
- Training helps employees to develop their abilities and reach their potential. This improves their motivation and morale. Employees are less likely to want to leave a business that provides them with good training.
- It is easier to recruit new employees and to keep existing employees.
- Training can improve customer service. This helps to improve customer relationships and increases customer loyalty.
- Health and safety training helps to reduce accidents.
- A well-trained workforce improves a business's competitiveness.



**Productivity:** see Chapter 15, page 204.

**Quality:** see Chapter 17, page 229.

**Customer relationships and customer loyalty:** see Chapter 10, page 140.

## Methods of training

There are three main methods of training:

- induction
- on-the-job
- off-the-job.



### KEY TERMS

**Induction training:** a training programme to help new recruits become familiar with their workplace, the people they work with and the procedures they need to follow.

**On-the-job training:** training at the place of work; watching or following an experienced employee.

### Induction training

It is not enough for a business to recruit the right staff. Even the best qualified employee will need some form of training when they start a new job. This training is known as **induction training**.

Induction training introduces the new employee to:

- their work colleagues
- the organisation structure and their role and responsibilities within the structure
- the health and safety procedures in the workplace
- the facilities available to employees, for example canteen facilities.

The main benefit of induction training for the employee is that they quickly feel part of the business. This brings a benefit to the business because employees who are settled are more likely to perform their tasks more effectively from the start of their employment.

The main limitation of induction training is that it increases business costs and, during the period of induction training, employees are not adding to output but are receiving their wage or salary.

### ACTIVITY 8.4

Working in pairs, imagine you have been given the responsibility for helping a new pupil to settle in quickly at your school. Write an induction programme for this new pupil. Include all of the things they will need to know, the people they will need to meet, the rules they must learn and the facilities they are able to use.



On-the-job training

Some new employees will need to receive training so that they are able to do their job efficiently. Also, to keep their workforce operating at its most efficient level, businesses may need to provide employees with further training to update their skills, or learn how to use new technology. This training could be provided on-the-job or off-the-job.

### On-the-job training

**On-the-job training** involves the employee learning the skills they need to complete tasks in the workplace. They will often sit with an experienced employee and watch how they perform the task. They will then complete the task under the guidance of the experienced employee.

The main advantages of on-the-job training are:

- It is relatively cheap.
- Employees learn the way that the business wants the job done.
- Employees are producing output while training.



Off-the-job training

However there are also disadvantages of this method including:

- Employees might pick up any of the experienced employee’s bad habits.
- Employees might not learn the most up-to-date methods.
- Employees make more mistakes when learning and this increases waste.
- It slows down the production of the experienced employee.

**Off-the-job training**

**Off-the-job training** takes place away from the workplace. This might be at the company’s own training facility, or attending courses offered by specialist

training companies, or at local colleges and universities. It is most often used where the job requires a high level of technical skill, or specific management skills need to be developed.

The main advantages of off-the-job training include:

- Employees learn the latest methods and techniques.
- It does not disrupt the production of other employees.

The disadvantages include:

- It can be expensive, especially when the training is provided by a private training provider.
- The employee does not produce any output during training.

**KEY TERM**

**Off-the-job training:** training that takes place away from the workplace, for example at college, university or specialist training provider’s premises.

**ACTIVITY 8.5**

Ravinder is the owner of a shop that sells photocopiers, fax machines and other items of office equipment. He also offers his customers a repair and maintenance service.

Ravinder has interviewed for a new post of trainee repair and maintenance technician. He has decided to offer the job to Surjit. Surjit has very little experience of repairing or maintaining office equipment, but Ravinder thinks he will be a quick learner. However, Ravinder is not sure how best to train Surjit. He asks himself: ‘Should I use on-the-job or off-the-job training?’

Write a brief report to Ravinder that identifies the advantages and disadvantages to Ravinder and his business of each method of training. You should conclude your report by recommending which method Ravinder should use and why.

**TEST YOURSELF**

- 1 What is induction training?
- 2 Explain the main difference between on-the-job and off-the-job training.

**Reasons for reducing the size of the workforce**

There are several reasons why a worker’s employment with a business may be ended, or terminated. These are shown in Figure 8.6.

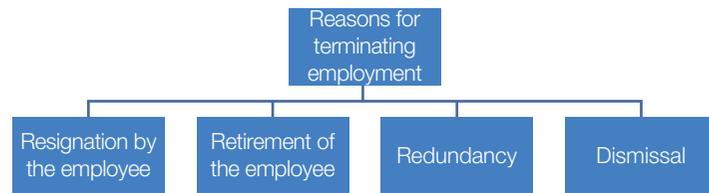


Figure 8.6 Reasons for terminating employment

## Resignation

**Resignation** means that an employee may decide to leave their job voluntarily; for example they leave to go and work for another employer. There may be several reasons for this such as promotion, better pay, shorter working hours or the new workplace is closer to home so easier to get to.

## Retirement

In some countries, employees must leave their job when they reach **retirement** age. Other countries do not have a compulsory retirement age. In these countries employees can work to any age.

## Redundancy

Sometimes a business closes down because the owners no longer want to run the business, or it has failed because it is no longer profitable. Sometimes businesses decide to relocate far away from their current location, perhaps even relocating to another country. Manufacturing businesses may introduce new technology into the workplace which can perform the work of several employees. In all of these situations a worker's employment can be terminated because their job is redundant. **Redundancy** describes a situation where the job that an employee does is no longer needed.

## Dismissal

An employer may **dismiss** an employee from their job for one of two reasons:

- 1 Incompetence – the employee does not perform their task to the required standard.
- 2 Poor conduct – the employee breaks the rules; for example they are often late for work, or put themselves and other employees in danger by ignoring health and safety procedures.

Redundancy and dismissal are both decisions that are made by the employer. They both result in an employee no longer having a job. However, with redundancy the job loss is not the employee's fault, but if they are dismissed then it is their fault.

## Reasons for downsizing the workforce

A business may need to reduce the size of its workforce for any of the following reasons:

- There may be a fall in demand for the product the employee produces. If demand does not increase, the business may need to reduce the size of its workforce because it is costly to employ employees who have nothing to do for any length of time.
- The business may introduce new technology which automates tasks that employees currently do. The business may no longer need these employees.
- The business may relocate some distance from its current site, perhaps to another country. It may not be possible for employees to move or travel to the new location, and they will have to leave their jobs.

### KEY TERMS

**Resignation:** termination of employment by the employee, perhaps because they have found a job with a different employer.

**Retirement:** termination of employment due to the employee reaching an age beyond which they do not need to work.

**Redundancy:** termination of employment by the employer because the job is no longer needed.

**Dismissal:** termination by the employer because the employee has broken company rules or is not performing work to the required standard.

**Location decisions:** see Chapter 18, page 235.

### Deciding which employees to recruit or make redundant

It is much easier for managers to deal with recruiting extra employees than it is to make employees redundant.

Selecting new recruits and selecting employees to be made redundant are both important tasks of managers and tasks that must be done fairly.

The process of selecting employees for redundancy must be clear and fair. Very often a business will use the last-in, first-out method. This means that employees who have been employed for the least amount of time will be the first to be made redundant. However, although this system is clear and might be seen as fair, it sometimes means that businesses lose employees who are better skilled and more productive than employees who have been employed longer.

For this reason some employers may use more measurable criteria to select employees for redundancy such as:

- **How productive employees are** – keeping the more productive employees as they are better for the future of the business.
- **How often employees have been late or absent from work in the past year** – employees who are often late or absent will be less productive because they are not at work.
- **How old an employee is** – perhaps those closer to retirement should be made redundant so that younger employees can be kept on.

#### TEST YOURSELF

- 1 Identify **two** ways a workforce may need to be reduced in size.
- 2 State **two** reasons why a business might dismiss an employee.

### Legal controls over employment issues

The governments of most countries have passed laws aimed at protecting employees from being exploited by employers and dismissed unfairly. The main areas covered by these legal controls are shown in Figure 8.7.



Figure 8.7 Legal controls over businesses

## Contract of employment

In most countries it is a legal requirement that employees are given a written contract of employment. This is a legally binding agreement between the employer and the employee and will include details such as:

- the name of the employer
- the name of the employee
- the date of commencement of employment
- the amount the employee will be paid
- the number of hours the employee is expected to work
- the job title and main responsibilities of the employee
- the number of days of holiday they will receive
- the period of time the employee has to give the employer if they wish to leave their employment – this is known as the ‘period of notice’
- the grievance and disciplinary procedures and where employees can find information about these.

A contract of employment has benefits to both the employer and the employee. It removes any misunderstanding that could arise over issues such as hours of work, rate of pay and holidays.

If an employer ignores any of the terms of the employment contract, for example pays the employee less than the amount agreed in the contract, then the employee could take legal action against their employer.

However, if an employee breaks any of the terms of the contract, for example refuses to work the number of hours in their contract of employment, then the employer could dismiss the employee for breaking their contract.

## Unfair dismissal

In most countries the law will protect employees and ensure that they are treated fairly by their employer. This includes the legal right not to be dismissed from their job without good reason. If they are, then this would be unfair dismissal.

An employee who thinks they have been unfairly dismissed can take legal action against the employer. If the employee is a member of a trade union then they will fight the case on the employee’s behalf.

If the courts decide that an employee has been unfairly dismissed, they can force the employer to give the employee their job back and/or compensate them for the loss of earnings.

## Discrimination

Many countries also have laws that prevent employers from discrimination when recruiting new employees, or in how they treat employees who are in their employment. Laws to prevent discrimination on the grounds of gender, race, colour, religion, disability and age are the most common. Any employee who feels that they have been discriminated against for any of these reasons has the legal right to take their employer to court. Trade unions will provide legal advice and support to any of its members who have been subject to any form of discrimination covered by law.

## Health and safety

The workplace can be a very dangerous environment for employees. Health and safety laws aim to protect employees from injury or physical discomfort, for


**EXPLORE!**

Use the internet, newspapers, libraries and any other relevant sources to find out about the different employment laws in your country.

Discuss with the rest of the class how these laws protect employees and the advantages and disadvantages to businesses in your country.

example being too hot or too cold. These laws also require the employee not to do anything that might cause harm or injury to their fellow employees.

Employees who ignore health and safety rules and procedures and cause injury to themselves or others could be dismissed for misconduct.

Health and safety in the workplace increases business costs but if it reduces accidents then fewer days will be lost due to employee injury. This will help to keep output at high levels and the employer will not have to pay employees' health bills or compensation for any injuries they receive while at work.

### Legal minimum wage

Some countries have introduced minimum wage laws to prevent employers from exploiting employees by paying very low wages. Minimum wage laws state that an employee cannot be paid less than a certain rate per hour.

Minimum wage laws often increase business costs. However, if employees receive a fair wage then this could motivate them to work harder and increase their productivity.

**TEST YOURSELF**

- 1 State **two** features of an employment contract.
- 2 Identify **two** types of discrimination in the workplace

## Unfair dismissal

### Dismissal for Rastafarian dreadlocks in the workplace declared unfairly discriminatory

**November 2012**

The Labour Appeal Court has held that five male prison employees at Pollsmoor Prison, who had been dismissed after refusing to cut their dreadlocks, had been unfairly dismissed. The prison dress code only prohibited male officers from adopting the hairstyle while female prison officials were free to do so.

No evidence was led to support the suggestion that the dreadlocked officials were less disciplined than their colleagues. On the contrary they were regarded as exemplary employees. Therefore the employees had been unfairly dismissed and the dismissals were automatically unfair because the employer unfairly discriminated against them.

*Source:* Adapted from [www.nortonrosefulbright.com/knowledge/publications/72309/dismissal-for-rastafarian-dreadlocks-in-the-workplace-declared-unfairly-discriminatory](http://www.nortonrosefulbright.com/knowledge/publications/72309/dismissal-for-rastafarian-dreadlocks-in-the-workplace-declared-unfairly-discriminatory)

**TASK**

- a Define 'unfair dismissal'.
- b Identify **two** types of discrimination that the prison employees were subject to by their employer.
- c Do you think that employees should be protected from discrimination in the workplace? Justify your answer.

## Revision checklist

- Businesses can use internal and external methods of recruitment to fill a job vacancy.
- The main stages of recruitment include producing job descriptions and person specifications, advertising the vacancy and interviewing shortlisted applicants.
- Induction, on-the-job and off-the-job training have benefits and limitations for employees and businesses.
- There are legal controls on the recruitment and selection of staff. Laws also protect employees in the workplace.

## Exam-style practice questions

- 1** Glowtech is a specialist lighting manufacturer. The company is expanding into new markets. It needs to employ ten more production workers and a supervisor. The human resource manager has prepared job descriptions and person specifications.
- a** Define 'person specification'. [2]
  - b** State **two** legal features of a job description. [2]
  - c** Outline how Glowtech is affected by **two** legal controls on employment. [4]
  - d** Explain **two** benefits to Glowtech of induction training. [6]
  - e** The human resource manager is undecided about whether to use internal or external recruitment for filling the supervisor vacancy. Which method would you recommend? Justify your answer. [6]
- 2** Aisha is the human resource manager for Bright Sparks. The company has decided to introduce new technology. This will result in redundancy for four employees.
- Aisha has also received a letter of resignation from the marketing manager. She has been asked by the marketing director to recruit a replacement.
- a** Define 'resignation'. [2]
  - b** Define 'redundancy'. [2]
  - c** Outline how Bright Sparks might use a person specification when recruiting a new marketing manager. [4]
  - d** Explain **two** benefits to Bright Sparks' employees of a contract of employment. [6]
  - e** The marketing director thinks that the costs of training are greater than the benefits. Do you agree? Justify your answer. [6]

**Total available marks 40**

# 9

## Objectives

*In this chapter you will learn about:*

- effective communication and why it is important to businesses
- different communication methods
- barriers to effective communication.

# Internal and external communication

## Introduction

Between getting up in the morning and going to bed at night, you communicate with many people, using different communication methods. You speak to family members over breakfast, chat to your friends on the way to school, listen to and speak to teachers, text friends, listen to television news, read newspapers and much more.

Businesses also communicate with many individuals and groups. Like you, they use many different methods to communicate their messages. They also receive messages.



Figure 9.1 Ways of communicating

In this chapter you will study the importance of effective communication to businesses and the methods they use to achieve this. You will also learn about those things that might prevent effective communication. These are known as barriers to communication.

## Effective communication and how it is achieved

Every day in businesses around the world, people communicate with each other. The purpose of communication is to ensure that all parts of a business's operations run smoothly. So, for example, when a manager gives instructions to employees, it is important that they understand what it is they are being asked to do, so that they carry out their work efficiently. When a customer places an order, it needs to be clear what it is they want so that the business supplies exactly what is required. Effective communication is essential to all businesses. Without it business life would stop!



Communication is important in business

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There are two main types of business communication:

- Internal communication is where employees communicate with each other. This may be with colleagues, managers or subordinates in their own department or with other departments in the business. Communications may include giving and receiving information, giving instructions or discussing day-to-day business activities. At a senior level, it may include meetings about the business's objectives and discussing ideas for products and services.
- External communication involves communicating with people and organisations outside the business – the business's stakeholders. This may include selling goods and services to customers, dealing with complaints, sending information about the business to shareholders, ordering goods from suppliers, sending press releases about the latest products and services to the media, liaising with government agencies over tax and regulations, and negotiating with trade unions. Businesses may also have to deal with pressure groups who may be concerned about their activities.

**Stakeholders:** see Chapter 5, page 62.

#### KEY TERM

**Communication media:** the methods used to communicate a message.

Communication takes many forms and uses many different types of **communication media**, for example letters, faxes, text messages, leaflets, video-conferencing and face-to-face conversations. The medium used will depend on the purpose of the communication. For example, if a manager wants to give a final warning to an employee about their timekeeping, this should be a letter so that the employee understands the seriousness of the warning and there is a written record of the warning being given.

### Effective communication and its importance to business

Communication between two or more people or groups of people will only be effective if:

- the message is sent using the correct communication medium
- the message is sent to and received by the right person
- the receiver understands the message
- the receiver provides **feedback** to the sender to confirm that they have received and understood the message.

#### KEY TERM

**Feedback:** the receiver's response to a message.

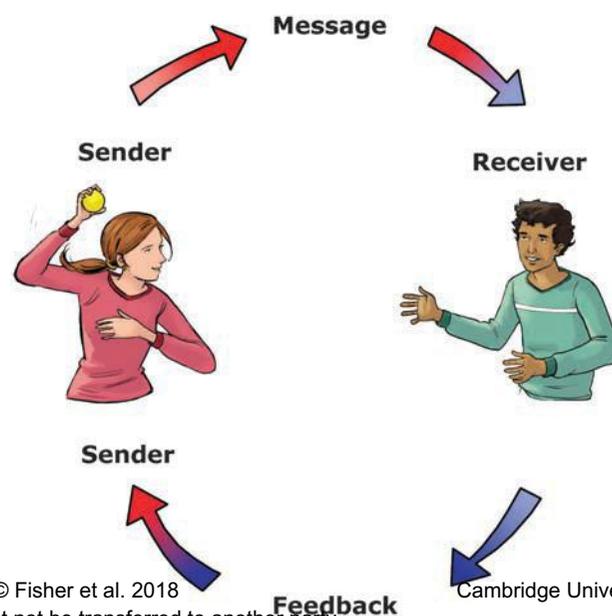


Figure 9.2 Effective communication cycle © Fisher et al. 2018

**KEY TERM****Effective communication:**

information passed between two or more people or groups, with feedback to confirm that the message has been received and understood.



**Motivation:** see Chapter 6, page 71.



**Customer relationships:** see Chapter 10, page 140.

**Effective communication** brings a number of benefits to businesses including:

- **Reducing the risk of mistakes** – the receiver of a message must understand what it is they are being asked to do by the sender. If the message is not understood then the instructions or task will not be completed correctly.
- **Enabling faster decision-making** – if the number of people who need to receive the communication is kept to a minimum, then this will speed up the decision-making process.
- **Enabling quicker responses to market changes** – the longer it takes to communicate changes in markets, the slower the business will be to respond and may miss marketing opportunities as a result.
- **Improving coordination between departments** – decisions taken by one department often have an impact on other departments. There needs to be effective communication between departments so that each knows what the other is doing and can respond appropriately. For example, if the marketing department is going to run an advertising campaign to increase sales, this needs to be communicated to other departments such as operations, because they will need to make sure they are able to produce the goods to meet any increase in demand.
- **Improving the morale and motivation of the workforce** – if the workforce knows what is going on in the workplace and is able to take part in discussions, this will make employees feel valued and part of the organisation.
- **Improving customer relationships** – keeping customers informed about the progress of their orders or any new products that the business has added to its range will make customers feel valued and they will want to continue to buy from the business in the future.

**ACTIVITY 9.1**

Look at these examples of different types of business communication:

- 1 a fire safety notice
- 2 a raw materials order to a supplier
- 3 a complaint from a customer about a product they have bought which is faulty
- 4 a warning to an employee who has been late for work three times in the last week
- 5 a sales order from a customer
- 6 new wage rates for all employees in three factories located in different parts of your country
- 7 a statement of the business's bank balances
- 8 customer contact details
- 9 the company website
- 10 an advertisement for a new product the business is introducing to the market.

Explain why it is important that these messages are communicated effectively. You should consider what might happen if the message is not communicated effectively – the consequences of poor communication.

**Benefits and limitations of communication methods**

Communication methods can be divided into four main types as shown in Figure 9.3.

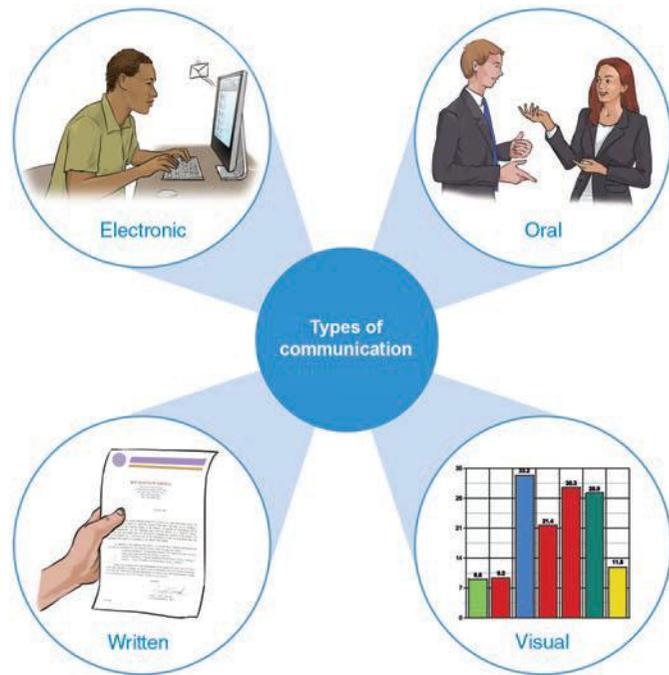


Figure 9.3 Types of communication



## KEY TERM

**Two-way communication:** the receiver is allowed to respond to the message and the sender listens to the response.

### Oral communication

This is communication using the spoken word, for example meetings and telephone calls. It allows for **two-way communication** between the sender and the receiver and provides the opportunity for feedback so that the sender can check that the message has been understood.

Oral communication can take place between two people; for example when you speak to your teacher about a topic you don't understand, you are using oral communication. When you call your friends on your mobile phone, this is also oral communication.

Some oral communication is between groups of people, for example a business meeting to discuss a new advertising campaign.

Oral communication is most appropriate to use when something needs to be discussed between two or more people. It helps to hear the ideas of other people so that any decision made considers all the different options. If an employee has a problem at work it is usually best for this to be discussed with their manager face-to-face. In some businesses, for example Nissan Cars, employees meet on a regular basis to discuss issues related to quality.

### ACTIVITY 9.2

Make a list of the ways you could communicate with someone using the spoken word.

### Written communication

Written forms of communication provide a permanent record of a message and can be looked at more than once to check understanding. The main forms of written communication used by businesses include:

- **Letter** – this is used for formal communication between the business and its stakeholders, such as employees and customers, for example informing employees about a pay rise or replying to a customer complaint.

- **Memorandum** – this is only used for communication within the business, for example a message from the human resource manager to the operations manager about the date and time for job interviews.
- **Agenda** – this is the order for the conduct of a meeting.
- **Minutes of meeting** – this is a written record of what was discussed at a meeting, the views expressed by those in attendance and the decisions taken.
- **Job description** – this is a written statement of what every employee's job involves.
- **Purchase order** – this is an official document which is sent to suppliers to request the supply and delivery of raw materials, components and other items needed by the business.
- **Invoice** – this is an official form sent to customers requesting payment for goods which the business has supplied.
- **Company magazine** – many businesses produce magazines for their employees or customers. They might include information about the business's products, its future plans, employee achievements and awards.

### ACTIVITY 9.3

Make a list of the ways you could communicate with someone using the written word.

### Electronic communication

Many businesses communicate with customers and suppliers via email, fax and text messaging. These electronic communication methods have the advantage of being much faster than traditional methods and the message is received instantly. The use of video-conferencing has reduced the need for people to travel to meetings as managers can connect with each other via the internet. They can see and speak to each other as if they were all sitting in the same room, but they might be hundreds or even thousands of miles apart! The growth of e-commerce and the ability of businesses to communicate with, and sell their products to, consumers across the world has been one of the most important developments in the world of business in recent times.



Video-conferencing

**ACTIVITY 9.4**

Make a list of the ways you could communicate with someone using technology.

**TOP TIP**

You have a lot of communication methods to learn. The table below would make a good revision aid, but remember you also need to think about the problems of using them.

**Visual communication**

The effectiveness of business presentations and information to internal and external stakeholders can be improved with the use of graphs and charts. Videos and photographs on company websites often have greater impact on the receiver than the spoken or written word. Visual communication methods may be used when trying to explain difficult concepts. Pictures and charts are often easier for some people to understand than words or complex tables of numbers or the detail contained in financial statements. Television advertising to introduce consumers to a new product or remind them of existing products is also an important method of visual communication used by many businesses.

**ACTIVITY 9.5**

Copy out the table below.

Types of communication			
Oral	Written	Electronic	Visual

- Enter each of the following methods of communication under the correct heading in your table.
 

Conversation	Interview	Text message
Email	Telephone	Noticeboard
Bar chart	Photograph	Diagram
Meeting	Memorandum	Letter
Fax	Telephone	Report
Graph	Video-conferencing	
- Explain which method of communication you would use, and why, for each of the following situations:
  - presentation of financial results to:
    - directors
    - the workforce
  - an invitation to all employees to a family fun day
  - an idea for a new student recreation room in your school
  - a reminder to heads of departments about a meeting in two days' time
  - performance feedback to an unsuccessful job applicant by the human resource manager.

The benefits and limitations of the four main types of communication used in business are outlined in Table 9.1.

Type	Benefits	Limitations
Oral	<ul style="list-style-type: none"> <li>Personal contact between sender and receiver</li> <li>Allows for immediate feedback</li> <li>Language used can be altered to the needs of the receiver</li> </ul>	<ul style="list-style-type: none"> <li>No permanent record</li> <li>Receiver might not listen</li> <li>Receiver might not hear the message correctly because of noise</li> </ul>
Written	<ul style="list-style-type: none"> <li>Provides a permanent record</li> <li>Can be used by the receiver more than once, to check understanding</li> <li>Can be sent to many receivers</li> <li>The message cannot be changed</li> </ul>	<ul style="list-style-type: none"> <li>No personal contact</li> <li>Feedback is slower</li> <li>Might not be understood because the language is too complex, or the message is too long</li> <li>Time-consuming for both sender and receiver</li> </ul>
Electronic	<ul style="list-style-type: none"> <li>Very quick</li> <li>Some methods, for example email, provide a permanent record and can be looked at more than once to check understanding</li> <li>Can be sent to many receivers at the same time</li> <li>Can be used to create a more interesting message – a company website, for example</li> </ul>	<ul style="list-style-type: none"> <li>Not everyone has access to the equipment needed</li> <li>Equipment and software can be expensive</li> <li>No personal contact – except for video-conferencing</li> <li>Risk of the message being received by people whom it is not intended for – lose confidentiality</li> </ul>
Visual	<ul style="list-style-type: none"> <li>Can simplify complex data so it is more easily understood</li> <li>Creates interest and grabs the attention of receivers</li> <li>Receivers often remember visual messages, especially if moving images are used</li> </ul>	<ul style="list-style-type: none"> <li>Some detail might be lost</li> <li>Different receivers might interpret the information differently</li> </ul>

Table 9.1 Benefits and limitations of different types of communication



**EXPLORE!**

Investigate all of the different methods used in your school/college to communicate with pupils, parents, teachers and one other stakeholder group of your choice.

Discuss the effectiveness of each method used.

**Choosing the best method of communication**

The choice of communication type and medium is an important factor influencing the effectiveness of communication. When choosing the best method of communication, businesses need to think about:

- **How urgent the message is** – for example, a telephone call or face-to-face conversation would be better than a letter if the message is urgent.
- **The length and complexity of the message** – written communication is best for long or complex messages, so that the receiver can read it over again to check they have understood.
- **How many people need to receive the message** – letters might be expensive, but it is a good way of contacting many people. Emails might be another method to use depending on the purpose of the message.
- **How far away the receiver is from the sender** – several methods could be used to communicate over long distances, such as email, text, phone call or letter. It will depend on other factors, such as how urgent the message is and if the receiver has access to the internet or a mobile phone network.
- **How important it is for all receivers to receive the message at the same time** – a meeting is the best way of getting the same message to everyone at the same time. If this is not possible then letters or emails could be used. Everyone will receive the same message, but not necessarily at exactly the same time.

- **The cost of media** – letters are more expensive than other methods because of the postage charge. However, email, text messaging and telephone calls all require investment in equipment and regular payments to the phone service or internet provider.
- **How important it is to have a written record of the communication** – if this is important, then the method must be a written one (such as letters, memorandums or reports) or electronic (such as email or text messaging).
- **If the message requires discussion** – meetings, telephone calls and video-conferencing are all ways for people to discuss and debate a message.
- **How confidential the message is** – a letter addressed to the person concerned is the best method for communicating a confidential message.

### ACTIVITY 9.6

Work in pairs to discuss which type and medium of communication might be the most appropriate for each of the following circumstances:

- 1 a warning to an employee about the poor quality of their work
- 2 a complaint from a customer
- 3 a promotion opportunity to be recruited internally
- 4 a 25% sale price reduction
- 5 late delivery of components from a supplier
- 6 a customer who has not yet paid for goods supplied two months ago
- 7 ten production employees who are to be made redundant
- 8 explaining plans for the future of the business to a workforce of 50
- 9 a marketing manager wanting an assistant to provide him with past sales data
- 10 a record of the discussions that take place at the monthly Board meeting.

In each case, you must justify your choice.

Communication media	Advantages	Disadvantages
Letter	Written record Confidential	Postage costs
Memorandum	Written record	Only used for internal communication
Email and text messaging	Written record	Cost of equipment Might not be confidential
Telephone	Can discuss the message to make sure it is understood	Cost Not face-to-face
Meeting	Everyone gets the same message Allows for the possibility of discussion and feedback	Time-consuming Costly if people have to travel from different locations No written record unless minutes are taken
Interview	Confidential Allows for the possibility of discussion and feedback	Time-consuming No written record unless minutes are taken
Video-conferencing	Reduces travel cost Less time-consuming as no need to travel	Cost of equipment Problem with different world time zones
Chart/diagram	Information is easier to understand	Loses some of the detail

**TEST YOURSELF**

- 1 Define 'effective communication'.
- 2 State the four main types of communication.

**CASE STUDY****Effective communication****Google's approach to effective communication**

Every single week Google has a meeting known as TGIF. Senior executives will stand up and tell the assembled employees what has happened over the past week. Some of the information which is shared between senior managers and employees is never shared with the public. More importantly there's an open session where any employee can ask any question about any aspect of the business.

*Source:* Adapted from [www.google.com/about/company/facts/culture](http://www.google.com/about/company/facts/culture)

**TASK**

- a Why is effective communication between senior managers and employees important to businesses?
- b Do you think Google achieves effective communication with its employees? Justify your answer.

**Communication barriers**

We have seen the importance to businesses of effective communication. We have also seen that different messages require different methods of communication.

However, choosing the best method for communication between two or more people does not guarantee effective communication. Barriers to communication can prevent a message from being received or understood by the receiver.

**How communication barriers arise and problems of ineffective communication**

The main barriers to effective communication can be divided into three main areas:

- problems with the channel of communication
- problems between senders and receivers
- problems with the physical environment.

The cause of these problems are shown in the following table.

Barrier	Cause
Problems with the communication channel	<ul style="list-style-type: none"> <li>■ The wrong medium, for example using the telephone to communicate complex technical information.</li> <li>■ The language used is too complex or too technical for the receiver to understand.</li> <li>■ Too much information is being communicated in one message.</li> <li>■ The channel of communication is too long.</li> </ul>
Problems between senders and receivers	<ul style="list-style-type: none"> <li>■ Lack of trust and respect between the sender and the receiver.</li> <li>■ Demotivated employees don't listen to the message properly.</li> <li>■ Poorly disciplined employees do not pass on the message to others.</li> </ul>
Problems with the physical environment	<ul style="list-style-type: none"> <li>■ Too much noise between the sender and the receiver.</li> <li>■ Too much distance between the sender and the receiver; the further apart the sender and the receiver are, the more difficult it is to have face-to-face conversations. However, electronic communication methods such as video-conferencing, Skype and Facetime have significantly reduced this particular problem.</li> </ul>

Table 9.3 Causes of barriers to effective communication

If any of the above barriers to effective communication are present then this can cause a number of problems for businesses including:

- Tasks are not completed, or are completed incorrectly. This reduces productivity and increases waste, both of which increase average costs and reduce profitability.
- The reputation of the business may be damaged, leading to a loss of customers. If customers do not receive their order on time, or receive an incorrect delivery, then they might decide to take their business elsewhere.
- The level of employee morale and motivation falls. This leads to problems such as lower productivity, poor quality, increased absenteeism and increased labour turnover. All of these problems will increase business costs and reduce profitability.
- Higher risk of accidents in the workplace. If health and safety procedures are not properly communicated to employees then this increases the chance of employees having an accident. An accident in the workplace reduces output if the employee has to have time off to recover and could result in the business being fined and having to pay compensation to the employee.
- Poor sales. If advertising and other promotional messages are not effectively communicated to consumers then they will not buy the firm's products.
- Recruitment and selection problems. If job descriptions and person specifications are not produced or are poorly written, or if job advertisements are poorly designed, then the business will not attract the best candidates. This can reduce business efficiency and might increase recruitment costs because the 'wrong type' of employee is appointed and they leave once they realise that the job is not for them.

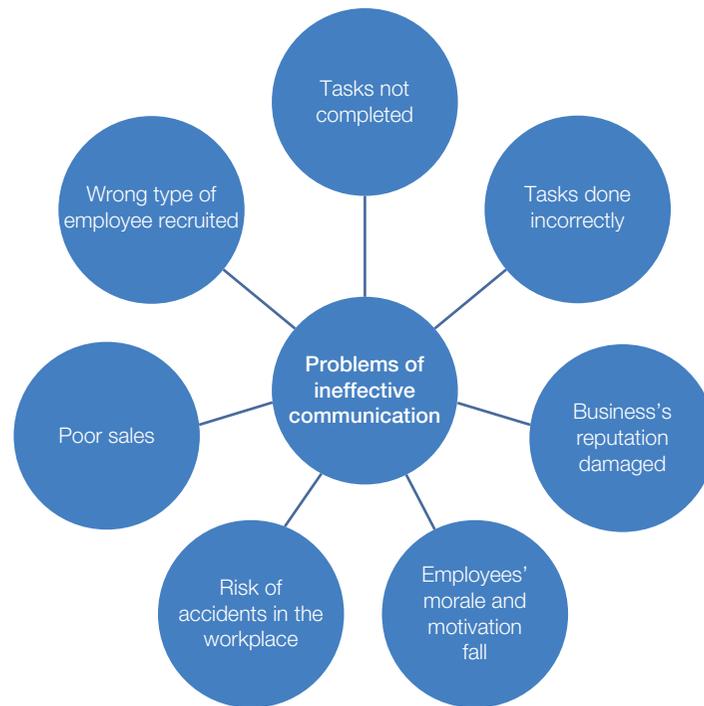


Figure 9.4 Problems arising from ineffective communication

**ACTIVITY 9.7**

In pairs, discuss what problems might prevent effective communication in the following circumstances:

- 1 sending an urgent text message
- 2 discussing a problem with an employee in an engineering workshop
- 3 sending a letter to a customer
- 4 asking an employee to pass on a message to other employees in his team
- 5 making a telephone call to a customer in another country.

**TOP TIP**

Just as businesses need to communicate with other people, so do you. When you are thinking about communication and its problems, think about the methods you use and the problems you sometimes have – they will be very similar to the problems of businesses; they just do it to many more people and probably more often.

**How communication barriers can be reduced or removed**

If communication is to be effective then it is important to reduce or remove any barriers. The method used to reduce or remove communication barriers will depend on what is causing the problem. Ways of reducing and removing communication barriers include:

- Make sure that the language used is appropriate to the receiver. This might mean using simple rather than complex words, or avoiding the use of complex technical terms that are not understood by people without technical knowhow.
- Keep the channel of communication as short as possible. The more people a message is passed through, the greater the risk of the message being changed before it gets to the final receiver.
- The sender must always insist on receiving feedback as this shows that the message has been received and understood.

- The sender must use the most appropriate medium for the message; for example, it would not be appropriate to send a long and complex instruction by text message.
- Physical barriers, such as noise, should be removed. If two people are having a conversation in a noisy environment, then they should move to somewhere quieter if the source of the noise cannot be turned off.
- Management must build a culture of trust and respect between all employees.

### ACTIVITY 9.8

Abdul owns a small design business. He has three problems he needs to deal with

- One of his employees, Indira, has been late again for work. Abdul has already spoken to Indira about this problem.
  - A customer has complained to Abdul about the poor service she received from Abdul's web designer.
  - Abdul orders goods from suppliers using written communication methods.
- 1 Define 'written communication'.
  - 2 Identify **two** communication methods Abdul could use when dealing with the customer complaint.
  - 3 Explain **two** methods Abdul could use when dealing with Indira's timekeeping problem.
  - 4 Explain how any **two** barriers to communication might affect the success of Abdul's business.
  - 5 Explain the importance to Abdul's business of effective communication.

### TEST YOURSELF

- 1 State the **three** main barriers to effective communication.
- 2 Identify **one** way of removing or reducing each of the barriers you identified in Question 1.

## Revision checklist

- Effective communication is when a message is sent using an appropriate medium and the receiver provides feedback to the sender to show that the message has been received and understood.
- All communication methods have benefits and limitations. The best method will depend on the given circumstances.
- Communication might not be effective because of barriers such as problems with the channel of communication, the attitudes of senders and receivers or physical problems.
- Businesses can use various methods to remove or reduce barriers to effective communication.

## Exam-style practice questions

- 1** Golden Sands Hotel has had a fire on the top floor. It will take three months to redecorate and furnish the 20 bedrooms. It has already accepted internet bookings from customers for these rooms. It does not have spare rooms on the other floors and will need to cancel these bookings.

The fire will also mean that the hotel will not need as many staff hours. The human resource manager has decided to reduce the hours of all 20 part-time staff for the next three months. She is wondering how to effectively communicate this decision to staff.

- a** Define 'effective communication'. [2]
- b** Identify **two** methods of visual communication. [2]
- c** Identify **four** barriers to effective communication. [4]
- d** Explain **two** methods the human resource manager could use to communicate her decision to the 20 part-time staff. [6]
- e** To what extent is effective communication important to the success of Golden Sands Hotel? Justify your answer. [6]

- 2** Company A employs 600 workers in two factories in different parts of Country Y. Each factory has a factory manager, supervisors and other employees. All major decisions are made by senior managers based at head office. These are communicated to the two factories using electronic communication methods.

The operations director meets with each factory manager once a month. However, he can never seem to arrange a meeting with both managers at the same time.

Company A is going to introduce new technology into its factories. The operations director is considering how best to communicate this information to the workforce. He is considering either sending a letter to all employees or holding a meeting in each factory.

- a** Define 'electronic communication'. [2]
- b** Identify **two** methods the factory managers might use to communicate with their supervisors. [2]

- c** Outline **two** different methods head office could use to communicate with the factory managers. [4]
- d** Explain the effect on Company A's effectiveness of **two** barriers to communication. [6]
- e** Should the operations director use a letter or a meeting to inform the employees about the plan to introduce new technology in the factories? Justify your answer. [6]

**Total available marks 40**

## Exam-style case study

### Precision Tooling

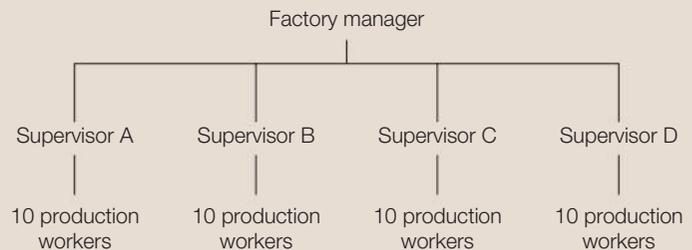
Precision Tooling makes components that are used in the manufacture of medical equipment. The company has one factory and 60 employees. There is a tall organisation structure. Production employees are the largest group of employees at Precision Tooling (see Appendix 1). There is division of labour at Precision Tooling. Each production worker is trained to complete specific tasks. Supervisors and production workers are paid using the hourly rate method. In addition, supervisors can earn a bonus if their section achieves a production target of 2500 units per month.

The operations director is concerned about the decrease in output of all four sections over the past three months, as shown in Appendix 2. He believes the production workers need to be better motivated. He has sent an email to the factory manager outlining his thoughts (see Appendix 3). Most of the production workers are members of a trade union.

The factory manager is due to retire in three months' time. Also, the supervisor of Section A has resigned. The human resource manager is considering the best way of recruiting replacements for these two employees. The operations director is very keen that the new factory manager has manufacturing experience and understands the importance of the functions of management.

#### Appendix 1

*Organisation of production workers*



#### Appendix 2

*Units of output produced by each section during the past three months.*

	Month 1	Month 2	Month 3
Section A	2 400	2 380	2 370
Section B	2 320	800	2 300
Section C	2 390	2 400	2 270
Section D	2 190	1 500	2 080

#### Appendix 3

##### **Email from the operations director to the factory manager**

*We need to improve employee motivation and I think the best way of doing this is to change the pay system from hourly-rate to piece-rate. What do you think?*

- 1 a** Explain **two** documents that the human resources manager might use in the recruitment process.

Document 1:

Explanation:

Document 2:

Explanation:

[8]

- b** The human resource manager is wondering whether she should use internal or external recruitment methods for replacing the factory manager and the Section A supervisor. State the advantages and disadvantages of each method of recruitment.

Which method do you think the human resource manager should choose? Justify your answer.

Internal recruitment:

External recruitment:

Recommendation:

[12]

- 2 a** Explain **two** benefits for the production workers of Precision Tooling of trade union membership.

Benefit 1:

Explanation:

Benefit 2:

Explanation:

[8]

- b** The operations director wants the new factory manager to 'understand the functions of management'. Explain the importance of each of the functions of management below for the future success of Precision Tooling.

Which function of management do you think is the most important? Justify your answer.

Planning:

Organising:

Coordinating:

Conclusion:

[12]

- 3 a** Other than improving productivity, explain **two** benefits to Precision Tooling of having a well-motivated workforce.

Benefit 1:

Explanation:

Benefit 2:

Explanation:

[8]

- b** The operations director has suggested replacing the hourly-rate system with a piece-rate system to improve the motivation of the production workers. State the advantages and disadvantages of each system for Precision Tooling.

Which system do you think they should use? Justify your answer.

Hourly-rate system:

Piece-rate system:

Recommendation:

[12]

- 4 a** Explain **two** features of Precision Tooling's organisational structure.

Feature 1:

Explanation:

Feature 2:

Explanation:

[8]

- b** Explain the advantages and disadvantages of each of the following methods of communication that might be used by Precision Tooling when communicating with employees.

Which method do you think would be most effective? Justify your answer.

Noticeboard:

Email:

Letter:

Conclusion:

[12]



## Section 3: Marketing

In this section you will learn about the role of marketing in business. Most businesses operate in markets that are constantly changing due to changes in the needs and wants of consumers, increased competition, legal controls and developments in technology.

As a consumer you, your family, friends, in fact all of us affect the marketing activities of businesses. Businesses need to find out our needs and wants and they do this through market research. The results of market research then influence the marketing mix: decisions about the products a business will produce and sell, the price it will charge, how these goods will be promoted and the place they will be offered for sale. These marketing decisions are combined into a marketing strategy and will influence the decisions of consumers. Will they buy the product? How many will they buy? How often will they buy the product? Businesses may look to enter foreign markets to achieve market growth. This opportunity presents businesses with another set of problems which they need to overcome if they are to successfully compete in global markets.

# 10

## Objectives

*In this chapter you will learn about:*

- the role of marketing
- why markets change and how businesses respond
- niche marketing and mass marketing
- market segmentation.

# Marketing, competition and the customer

## Introduction

Think about something that you've bought recently. What persuaded you to buy it? An advert? A salesperson? Perhaps a friend? In this chapter you are going to begin your study of marketing. The first thing to learn about marketing is that it is much more than just advertising and selling the goods and services of a business.

You will learn what is meant by 'market' and the role of marketing in identifying and satisfying consumer needs. You will also look at how consumers and competitors influence markets and the way businesses respond. Finally, you will consider how and why businesses divide the whole market into smaller parts, or segments.

## The role of marketing

Business activity involves more than just coming up with an idea for a product or service, making it and then selling it. First, the managers of a business need to understand what customers want. This may include identifying or even predicting what they require. Then the business has to produce exactly what customers want.

Finally, managers need to make sure that they have satisfied customer requirements. So, from this you can see that marketing is an essential part of a business's activities.

### Identifying and satisfying customer needs

You have already learnt the difference between consumers' needs and wants. The basic needs of individuals are goods and services that are necessary for survival – water, food, clothing and shelter. However, in addition to these essential needs, individuals will also have things they would like, but which are not necessary for their survival. These are known as 'wants'.

The main role of marketing is to convert the wants of an individual into a need.



#### TOP TIP

You must learn and understand the key terms of marketing, market segmentation, niche and mass marketing.



**Consumer needs and wants:** see Chapter 1, page 9.





**Promotional activities:**  
see Chapter 13, page 182.

**Market research methods:**  
Chapter 11, page 153.



**Business activity:** see  
Chapter 1, page 9.

**KEY TERM**

**Customer base:** the group of customers a business sells its products to.

Businesses often use promotional activities, especially advertising, to persuade consumers that something they want is a need. In doing so, business sales, revenue and profits will rise.

You will learn, in a later chapter, how businesses identify the needs of consumers through the use of market research methods. Once the needs of consumers have been identified, a business must then decide if it is able to satisfy those needs by producing goods or services which it can sell to the consumer at a profit. This is the main purpose of business activity. Businesses will also use market research to check that the goods and services produced and sold do satisfy consumer needs.

**Maintaining customer loyalty**

Without customers there is no business. Therefore one of the most important roles of marketing is to create a group of customers who the business can sell its products to. This is known as a **customer base**. The business must then build customer relationships to maintain the loyalty of its customers to the business and its products.

**Building customer relationships**

Once a customer base has been established, the marketing function must then aim to keep these customers – this is known as customer loyalty. This requires collecting as much information as possible about each individual customer, for example their income, lifestyle and buying habits. This information is then used to better identify and satisfy customers' needs and carefully target individual customers with information about the firm's products.

**Developing customer loyalty in the African mobile (cell) phone market**

Mobile (cell) phone usage has been increasing in Africa. With so much competition, operators are forced into new ways of holding on to their customers. Developing loyalty among multi-SIM customers is one of the major challenges faced by Telecom operators in Africa.

One of the ways operators are trying to increase their revenue is to offer added value services. Operators in Africa are investing in providing solutions that give the customer better value for their money.

It is true that poor customer service can cost operators millions of dollars. Customer service departments are studying their customers more closely to know who they are and what keeps them going. One of the strategies is to involve customers right from the product design stage.

**TASK**

- a** Define 'added value'.
- b** Explain the importance of customer loyalty in the mobile (cell) phone market.
- c** Do you think that the approach to customer service outlined in the case study will increase customer loyalty? Justify your answer.

**TEST YOURSELF**

- 1** Define 'marketing'.
- 2** Why is consumer loyalty important to business?

**KEY TERM**

**Market:** all customers and consumers who are interested in buying a product and have the financial resources to do so.

**KEY TERMS**

**Target market:** individuals or organisations identified by a business as the customers or consumers of its products.

**Customer:** an individual or business that buys goods and services from a business.

**Consumer:** the final user of a product.

**Consumer markets:** markets for goods and services bought by the final consumer.

**Industrial markets:** markets for goods and services bought by other businesses to use in their production process.

**Business environment:** the combination of internal and external factors that influence the operations of a business.

## Market changes

Before we go any further we need to have a clear understanding of 'market'.

One definition is:

*A market is a place where buyers and sellers come together to buy and sell goods and services.*

However, 'market' can also be used to describe all consumers who are interested in buying a product and have the financial resources to do so. These consumers can be described as the 'potential market' for a product.

When a business decides to produce products for a particular group of consumers, then these consumers are known as the 'target market'.

The term 'market' can also describe the type of **customer** who the goods or services are sold to. These customers may be the final **consumer** or other businesses. The markets for these customers are known as:

- **Consumer markets** – products sold to the final consumer, for example food items, televisions and cars.
- **Industrial markets** – products sold to other businesses for use in the production process, for example machinery and equipment.

### Why consumer spending patterns change

The **business environment** is one that is constantly changing. This means that the market for goods and services will also change over time.

The amount of money customers/consumers spend on buying goods and services is affected by a number of factors:

- **The price of the product** – for most products the higher its price, the lower the quantity sold and the lower the price, the greater the quantity sold. This relationship between the price of a product and the demand or sales of the product is shown in Figure 10.1.

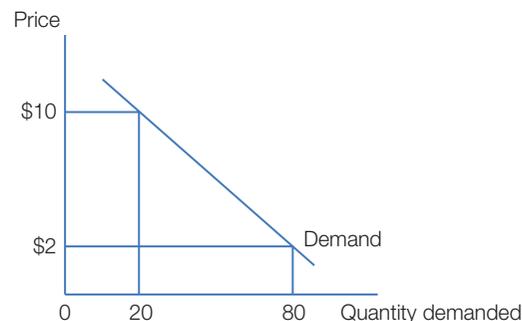


Figure 10.1 Demand curve



An open-air market

- **The price of competitors' products** – most businesses are in very competitive markets. If the products of businesses are very similar then consumers are most likely to buy the product that has the lowest price.
- **Changes in consumer income** – consumers can only buy products if they have the money to do so. If consumer income falls, for example if an employee loses their job, then they will have less money to spend. When consumers have less money to spend, they will buy what they need for living, for example water, food, shelter. They will spend less money on goods which might be considered a luxury, for example takeaway meals, mobile (cell) phones or holidays.
- **Changes in population size and structure** – if a country's population grows in size then this increases the size of the market. This could increase business sales. The structure of the population might also change over time. For example, in some countries there are fewer children being born, but people are living longer. We say that a country with more elderly people and fewer children has an 'ageing' population. The sale of products for children will fall, but the sale of products for older people will rise.
- **Changes in tastes and fashion** – it is easy to see the effects on sales of changes in clothing fashion. However, other products also become more, or less, popular with changes in consumer tastes and fashion. For example, in some countries consumers are more aware and concerned about healthy eating. This has increased the demand in these countries for healthier food and drink. Producers have responded by reducing the sugar or salt content of their products, for example Diet Pepsi.
- **Spending on advertising and other promotional activities** – almost all businesses spend money promoting their goods or services. Some national and multinational businesses spend huge amounts of money on a single advertising campaign. Most advertising and promotional activities of businesses are aimed at persuading consumers to buy their products instead of competitor products. Businesses also spend money on advertising to create a brand image. Consumers will often pay more for a product simply because of the brand name, even though there are similar much cheaper products on the market. A good example of how branding affects demand is the trainer (running shoe) market. Many consumers, especially the young, prefer to buy shoes manufactured by Nike and other well-known brands rather than the cheaper alternatives that do not have a strong brand image.

### ACTIVITY 10.1

Working in small groups, search through newspapers and magazines for advertisements for different products. See if you can find examples of advertisements for products for each of the factors discussed above.

Cut the advertisements out and for each factor make a poster for display in your Business Studies classroom or on your noticeboard.

**ACTIVITY 10.2**

ABC is a footwear manufacturer in Country X. It has been manufacturing shoes and other footwear items for almost 80 years. It sells its products to the final consumer through its own chain of shoe shops. The shops have very loyal customers who have valued the quality of ABC's footwear products and the high standard of service offered in its shops. The style of ABC's shoes has changed little over the past 40 years.

Country X has a growing population. Although at one time it might have been described as a developing economy, it is now a strong economy with low unemployment and most people earning very good wages and salaries. The younger generation are much more fashion aware than their parents and grandparents and are prepared to pay high prices to have the latest fashion items.

In recent years ABC has faced much greater competition from other footwear manufacturers, especially from those located in Country Y. Country Y is a low wage economy and this enables footwear manufacturers in Country Y to offer their products at much lower prices than those produced by ABC. These businesses are also spending more money on advertising their products than ABC, which is relying on its reputation to keep its loyal customers.

The directors of ABC are concerned about the latest sales figures for its shops. For the fourth year in a row, sales and revenue have fallen and if this trend continues then the business will soon be making a loss.

Identify the factors that affect the spending by consumers on footwear products produced by ABC.

**Changing customer needs**

From the earlier definition of marketing we can see that one of the purposes of marketing activity is to satisfy customer needs at a profit. If a business is to survive in the long run, it has to respond to any change in customer needs.

It is easy to see how and why a business that produces and sells fashion items, such as clothing, must constantly identify and satisfy the changing needs of its customers. However, as you learnt earlier, changes in tastes and fashion are not the only influences on consumer spending.

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**ACTIVITY 10.3**

Working in pairs and using your own country as a starting point, answer the following questions:

- 1 Can you think of any differences in consumer needs between the regions of your country?
- 2 Are you able to identify how consumer needs in your country are different from consumer needs in countries within the same part of the world?
- 3 Why might the needs of consumers in your country be different from the needs of consumers in a country on the opposite side of the world? Think of how things such as climate, tastes, wealth, religion and culture might create differences in needs.

**Why some markets become more competitive**

Almost all markets have some level of competition within them. However, some markets have seen a much greater increase in the level of competition than others. There are several reasons for this.

### Government intervention in markets

In many countries the government is an important influence on business activity. Governments can affect competition in markets through:

- Legal controls that prevent individual firms from dominating the market; for example many countries such as India have laws against anti-competitive behaviour.
- Selling off public sector organisations to the private sector. This is known as privatisation, for example the privatisation in 2012 of Glen Valley and Dikabeya farms, Tanzania.
- Deregulation – the removal of government controls from an industry, for example the deregulation of postal services in New Zealand.
- Providing financial and other assistance to new and small to medium-sized businesses; for example the Small Enterprise Development Agency (SEDA) in South Africa helped the owner of Inembe Food prove that their baby food porridge was full of multivitamins and minerals and safe for babies to eat. This helped the owner of Inembe Food to secure the financial support needed to set up production facilities. The product is now widely available in supermarkets across South Africa.



#### KEY TERM

**Free trade:** no barriers exist that might prevent trade between different countries.

### Growth of free trade between countries

Regional **free trade** agreements remove or reduce barriers to trade between countries.

### Development of e-commerce and social media networks

Many businesses have developed their own websites and use these to sell their goods to customers in other regions of their own country and to customers in other parts of the world. The development of e-commerce has increased the size of a business's market but it has also greatly increased the level of competition in that market.

Social media network sites such as Facebook are also being used by businesses to promote their products. Consumers have much more information about the suppliers of products and, while this has increased consumer choice, it has also increased competition within the marketplace.

### How businesses respond to changing spending patterns and increased competition

If businesses do not respond to changing consumer spending patterns and more competitive markets, they are unlikely to survive.

There are a number of actions a business can take to respond to changes in consumer spending patterns and increased levels of competition. These include:

- **Product development** – market research will identify how the needs and wants of consumers are changing. This information can be used to develop new products to satisfy the changing needs and wants of consumers. Developing new products will help a business to remain competitive.
- **Improve efficiency** – the efficient use of resources will help a business to reduce average costs. If average costs are reduced then a business will be able to reduce the prices of its products. You have already learnt that a decrease in price will



**Free trade:** see Chapter 26, page 327.



**E-commerce and social media networks:** see Chapter 13, page 186.



#### EXPLORE!

Use the internet, library and other printed material to research the different countries your country has trade agreements with. You may find the following website a useful source of information: [www.wto.org](http://www.wto.org).

**Product development:**

see Chapter 12, page 165.

**Efficient use of resources:**

see Chapter 15, page 203.

**Promotion:** see Chapter 13, page 182.**New markets:** see Chapter 14, page 193.

increase sales. In very competitive markets, price can be an important factor for consumers when choosing whether or not to buy a product and, if they do decide to buy, who they buy the product from.

- **Increased promotion** – increasing advertising to persuade consumers to buy your product and not that of competitors is another way a business might respond to changing levels of competition and consumer spending patterns. Other promotional techniques such as buy-one-get-one-free and money-off coupons may also be used to persuade consumers to purchase a firm's product instead of a competitor's product.
- **Look for new markets** – sometimes consumer spending patterns change so much, or the level of competition in a market becomes so great, that the better option is for a business to look for new markets for its products. Markets where there is less competition and where consumers are more likely to buy the product.

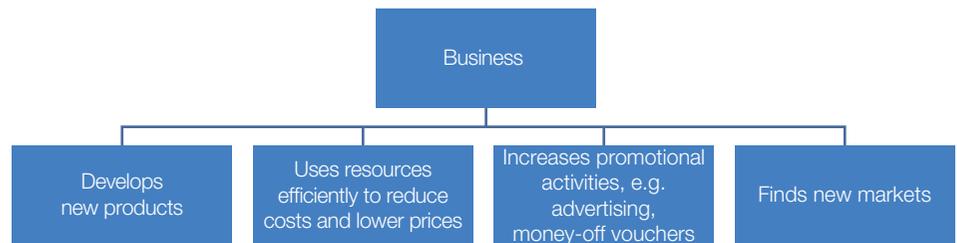


Figure 10.2 Ways businesses can respond to consumer spending patterns and increased competition

**TEST YOURSELF**

- 1 Why can consumers' needs change?
- 2 Explain **two** reasons for increased competition in some markets.
- 3 Why do businesses need to respond to changing patterns of consumer spending and competition?

## Niche marketing and mass marketing

In this section, we will look at two types of target markets – niche, or specialist, markets and mass markets.

### What is niche marketing?

A niche market is a very small part of the whole market. For example, a business that specialises in supplying hand-tailored suits is part of the much larger market for men's clothing. **Niche marketing** identifies the needs of this small part of the whole market and then develops products to satisfy those needs. Businesses in a niche market often sell high-priced and high-status goods, for example Rolex watches and Rolls-Royce motor cars. However, some businesses may target niche markets where the product is not particularly high status or high priced, for example wedding cakes.

**KEY TERM**

**Niche marketing:** developing products for a small segment of the market.

**KEY TERM**

**Mass marketing:** selling the same product to the whole market.

**TOP TIP**

Use examples from your own country to help you understand and remember the difference between niche markets and mass markets.

**What is mass marketing?**

**Mass marketing** is the opposite to niche marketing. This is where a business sells the same product to the whole market, for example flour. This type of marketing is less popular than it used to be. Most businesses now see the benefits of dividing the market and providing a slightly different product to each segment. This recognises that consumers do not all want the same product; for example toothpaste is produced for sensitive teeth, for children’s teeth and in different flavours. Dividing the market so that products better meet the needs of different types of consumers can help to increase sales, revenue and profits.



Manufacturers target different sections of the market

**Benefits and limitations of niche marketing and mass marketing**

The tables below outline the benefits and limitations of these two approaches to marketing.

Benefits of niche marketing	Limitations of niche marketing
Small firms are able to survive and earn profit even in markets that are dominated by larger firms.	The opportunity to earn high profits might attract competitors and this will reduce prices and future profits.
There is less competition in these markets. Firms do not waste scarce resources responding to competitor actions.	The small size of the market means that economies of scale are unlikely to be achieved. This means that unit costs are higher than they would be if the product was sold to a mass market.
Consumers will usually pay more for a high-status, exclusive product. This offers firms the opportunity to charge high prices and earn high profit margins.	Small changes in consumer spending patterns could have a very significant impact on firms operating in niche markets.

Table 10.1 Benefits and limitations of niche marketing © Fisher et al. 2018

## Avitourism in South Africa

Birding is one of the fastest growing nature-based tourism activities worldwide and is experiencing similar growth in interest and popularity in South Africa.

An estimated 3 million international trips are taken each year, specifically for the purpose of bird-watching. The size of the international avitourism market for South Africa is between 8000 and 16 000 avitourists per annum.

Avitourists have higher than average income levels.

*Source:* Adapted from DTI for Republic of South Africa report Avitourism in South Africa, 2010



Avitourists in South Africa

### TASK

Why might the avitourism market be described as a niche market?

Benefits of mass marketing	Limitations of mass marketing
Mass marketing requires large-scale production. Larger firms often benefit from economies of scale, which reduces unit costs.	There is much more competition in the market, which lowers prices and profit margins.
A much larger market has the potential for high sales and profits.	Not all markets are large enough to support a mass marketing approach.
Changes in consumer spending patterns might have less effect on firms selling to a mass market. This reduces the risk to firms who operate in mass markets.	Consumers today are often looking for something slightly different from that offered by same product mass marketing. This has led to greater division of the whole market and reduced the scope for mass marketing.

Table 10.2 Benefits and limitations of mass marketing

## Weetabix

Bright Food, one of China's largest food groups, has bought a 60% controlling share in the ownership of UK breakfast cereal brand Weetabix.

Chairman Zongnan Wang has been quoted as saying: 'With Bright Food's strong resources and our expertise in both the Chinese and broader international markets, we are excellently placed to develop the Weetabix business.'

*Source:* Adapted from [www.bbc.co.uk/news/business-17935661](http://www.bbc.co.uk/news/business-17935661)

### TASK

Why might the market for Weetabix be described as a mass market?

## TEST YOURSELF

- 1 What is the difference between a niche market and a mass market?
- 2 Identify **two** limitations of niche marketing.
- 3 Identify **two** benefits of mass marketing.



## TOP TIP

When thinking about segmentation, who you are selling to will have a big influence on the price and the product, and how it is sold.

## Market segmentation

One of the main limitations of mass marketing is that it may not give individual consumers exactly the products they want. Market segmentation gives businesses the opportunity to produce products that meet the needs of different groups of consumers.

### What is market segmentation?

Nowadays one group of consumers often wants something different from other groups of consumers. There are several reasons for this including differences in culture, religious beliefs and consumer tastes. The whole market can, therefore, be divided into different parts according to the different wants of each group of consumers. Each part of the whole market is known as a **market segment**.

Dividing the whole market into different segments is called **market segmentation**. In Figure 10.3 the market has been divided into four segments. Each segment represents part of the whole market.

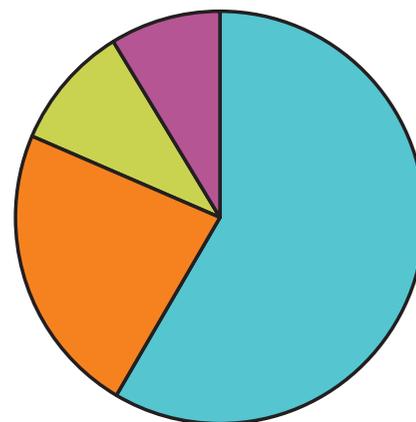


Figure 10.3 Market segmentation

### How markets can be segmented

The main methods of market segmentation are:

- geographic segmentation
- demographic segmentation
- psychographic segmentation.

#### Geographic segmentation

**Geographic segmentation** recognises that consumers in one location may have different needs from consumers in another location. The locations may be:

- different regions within the same country
- different regions of the world
- different countries in the world.

The geographical differences may be due to cultural reasons, religious beliefs or even different climates.



## KEY TERMS

**Market segment:** a part of the whole market in which consumers have specific characteristics.

**Market segmentation:** dividing the whole market into segments by consumer characteristics and then targeting different products to each segment.



## KEY TERM

**Geographic segmentation:** dividing consumers in the market by geographic area.

## KFC in Africa

In a recent press interview, KFC's general manager of new African markets, Bruce Layzell, said: 'Taking a blanket approach to doing business in Africa does not work. A Zambian is as different from a Nigerian as an Italian is different from a Russian, and people need to start to understand that.'

'People are different, and that means tastes are different, cultures are different, religions are different. As a result, how we take our products to these different people needs to obviously be different. We need to meet them at their needs.'

KFC reflects the local culture on the walls and in its advertising. Murals on the walls depict customers – they have Zambians on the wall in Zambia and Nigerians on the wall in Nigeria.

KFC's core product – original recipe chicken – is standard in all of its restaurants. However, in countries where spicy food is popular, it puts hot and crispy chicken on the menu as standard. In Nigeria, jollof rice is on the menu. In Kenya, it has a product called ugali, so that is on the KFC menu. KFC will put its own spin on these local products so that they become unique to the KFC brand.

Source: Adapted from <http://bizmag.co.za/kfc-to-expand-steadily-into-africa>

### TASK

- Use the article to explain how KFC uses geographic segmentation.
- Identify **two** ways geographic segmentation affects the goods and services provided by KFC.
- Explain the benefits to KFC of geographic segmentation.
- Do you think there are any additional costs to KFC of segmenting markets this way? Justify your answer.



### KEY TERM

#### Demographic segmentation:

dividing consumers in the market by factors such as age, gender, income, ethnic background and social class.

### Demographic segmentation

**Demographic segmentation** is a method of dividing the whole market according to the characteristics of the population. The diagram below illustrates the main factors that may be used to segment a market using population characteristics.

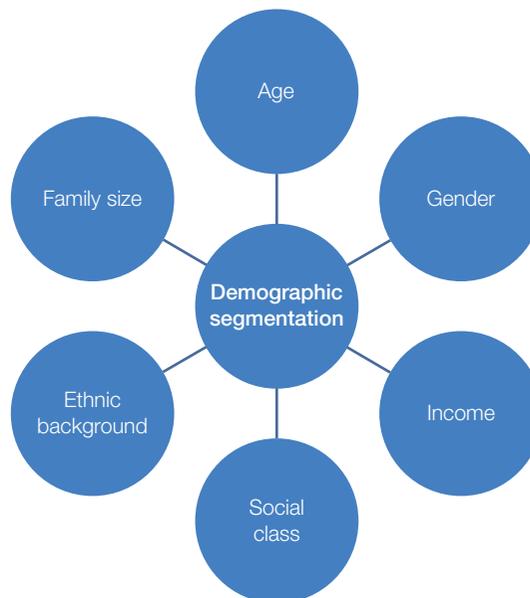


Figure 10.4 Demographic segmentation factors

These factors are often combined when segmenting a market; for example the Australian Tourist Commission divides the travel market into specific segments, including:

- independent adventurers aged 25–34 (primary market)
- young independent travellers (YITs) aged 18–24 (secondary market)
- independent adventurers aged 45–65.

### Psychographic segmentation

**Psychographic segmentation** is a method of dividing the whole market according to the lifestyles, personalities and attitudes of consumers.

### Benefits of segmentation to business

All these methods divide the whole market into smaller groups. Whichever method is used to separate consumers into different segments or groups, segmentation has many benefits.

- Goods and services can be designed to meet the specific needs of consumers in each segment. This is likely to increase sales.
- Small firms which may not be able to compete in the whole market are able to operate in one or two segments – perhaps a niche market.
- Segmentation of the whole market sometimes identifies a segment of consumers who have very specialised needs that are not currently being satisfied. This presents an opportunity for niche marketing.
- Marketing strategies can be better targeted at each segment. This reduces the waste of scarce resources. For example advertising can be directed at the target market and not wasted on trying to sell the product to the whole market.
- It may be possible to charge higher prices for very similar products in one segment than in another. This is known as price discrimination. For example, air travel will often have three types of passenger: first class, business class and economy class. They all travel on the same aeroplane, but pay very different prices. This enables the airline to earn higher profits from those passengers prepared to buy first or business class tickets.

### Choosing a method of segmentation

There is no one correct method of market segmentation. Very often the method chosen will depend on the type of product or service that a business wants to offer to the market.

A holiday destination for families



#### KEY TERM

#### Psychographic segmentation:

dividing consumers in the market by lifestyles, personalities and attitudes.

For example, a holiday company might use demographic segmentation to divide the market for its products according to the family size of consumers. Consumers with young children will probably be looking for a completely different holiday from a single 24-year-old, or a retired married couple.

#### ACTIVITY 10.4

Consider the market for the following goods and services:

- hotel accommodation
- footwear
- motor cars
- rail travel
- hairdressing.

Working in pairs, discuss how you would segment the market for these goods and services. You must justify your choice.

#### TEST YOURSELF

- 1 Identify **two** benefits of market segmentation to businesses.
- 2 Explain **two** methods of market segmentation.

## Revision checklist

- Marketing is used to identify and satisfy consumer needs and this helps to build customer relationships and loyalty.
- Businesses need to understand why and how consumer spending patterns change and what they need to do in response so that they are able to remain competitive.
- Businesses will often have to respond to the changing competitive nature of markets in which they operate.
- There are benefits and limitations to businesses of niche and mass marketing.
- There are several methods and benefits to a business of market segmentation.

## Exam-style practice questions

- 1** Magda is an optician. Magda tests people's eyes and then sells them spectacles (eye glasses) if needed. However, customers do not have to buy their spectacles from Magda. Many customers have their eyes tested by Magda but then buy their spectacles from other spectacle suppliers. Many of these suppliers use e-commerce. These businesses have a good customer base because they are not only cheaper, but also offer a wider choice of spectacles than Magda.
- a** Define 'customer base'. [2]
  - b** Identify **two** ways Magda is not meeting the needs of her customers. [2]
  - c** Outline **two** factors that influence consumer decisions when buying products such as spectacles. [4]
  - d** Explain **two** effects on Magda's business of e-commerce. [6]
  - e** Recommend **two** ways Magda could respond to the competition from other suppliers of spectacles. Justify your answer. [6]
- 2** Gloria's Garments (GG) is a company that designs and manufactures fashion clothing. The majority of its output is for the mass market. However, the company also provides a specialist service – the design and manufacture of bridal gowns. This is a niche market.
- a** Define 'niche market'. [2]
  - b** Identify **two** ways that GG could segment its market for fashion clothing. [2]
  - c** Outline **two** benefits to GG of mass marketing. [4]
  - d** Explain **two** ways changing consumer needs might affect GG's sales and profits. [6]
  - e** Do you think it is a good idea for GG to operate in both niche and mass markets? Justify your answer. [6]

**Total available marks 40**

# 11

## Objectives

*In this chapter you will learn about:*

- the role of market research
- methods of market research
- how market research results are presented and used.



### KEY TERM

**Market research:** the process of collecting, recording and analysing data about the customers, competitors and market for a product.



**Promotion, packaging and distribution methods:** see Chapter 13, pages 179 and 182.



### KEY TERMS

**Unique selling point:** the special feature of a product that sets it apart from competitors' products.

**Market-orientated:** products are developed based on consumer demand as identified by market research.

**Product-orientated:** the firm decides what to produce and then tries to find buyers for the product.

# Market research

## Introduction

The success of marketing activities and the effectiveness of marketing decisions depend on how well businesses research their markets and find out what consumers want. In this chapter you will learn how a business can research the market for its products and the benefits of doing so.

## The role of market research and methods used

**Market research** provides businesses with important information about the markets in which they operate, or are planning to operate in. It involves collecting and recording data about customers, competitors and the market for a product, and then analysing the results. Market research gives a business information about:

- its customers
- its competitors
- its market.

The information obtained from market research helps a business to:

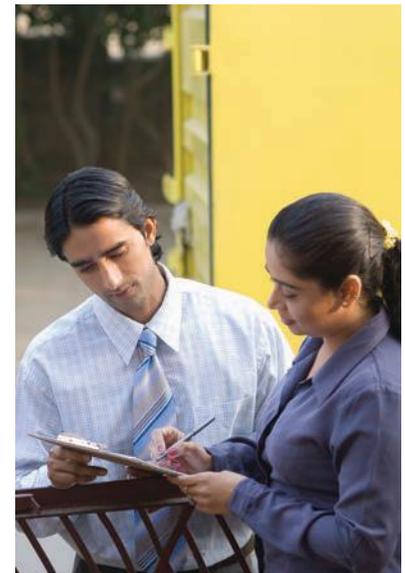
- find out what consumers like and dislike about its products
- identify consumer tastes and preferences
- decide on the best promotion, packaging and distribution methods for its products
- identify the main competitors and what is special about their products – this is known as the product's **unique selling point**
- know the size of the market
- explain the reason for the sales of its current products
- predict how the demand for its products may change in the future.

## Market-orientated businesses

In today's business world most firms are **market-orientated**. This means that the decision about what to produce is based on consumer demand for products as identified by market research. This is a very different approach from **product-orientated** businesses. With this approach it is the business which decides what to produce and after doing so it tries to find customers who want to buy the product.

There are two main benefits of a market-orientated approach.

- The risk of new products failing is reduced because they have been produced following market research which identified the needs of consumers.



A market researcher at work

- Products that meet the needs of consumers are likely to last longer in the market than goods which have been produced using a product-orientated approach. This leads to higher sales and profits.

### Uses of market research information

Market research information can be used by a business to:

- Identify consumer needs. This reduces the risk when developing and launching new products because the products have been designed and produced based on the market research information provided by potential consumers of the product.
- Discover the current and future market size for the product.
- Provide information about the business’s existing products and markets.
- Identify the strengths and weaknesses of competitor products. This information can be used to make sure that any new product development builds on the strengths of competitors’ products while improving on the weaknesses. The aim is to produce a better product than competitors and lead to a successful launch of the product into the market.
- Decide on how to price and promote the product and how best to distribute the product to customers.
- Predict how changes and trends in consumer tastes and fashion may affect the future demand for products.

### Primary research and secondary research

The collection of market data can be divided into two main types:

- **Primary research** (sometimes called field research) involves collecting data first-hand, for example interviewing people in the street about their views on local shopping facilities. This is data collected by an organisation for the first time and for its own specific needs.
- **Secondary research** (sometimes called desk research) uses data that already exists, for example data that a business holds in its records about existing customers. However, most secondary data has usually been collected by another organisation and for a different purpose.

The most commonly used sources of secondary data are shown in Figure 11.1.



Figure 11.1 Sources of secondary

**KEY TERMS**

**Primary research:** the collection of first-hand data for the specific needs of the firm.

**Secondary research:** the collection of data from second-hand sources.

- **Internet** – data and information about almost any topic are available on the internet and can easily be found using search engines such as Google. Many businesses have their own websites which may also be a useful source of information. However, care must be taken to make sure that the data obtained is valid and not out of date.
- **Government publications** – most governments publish data and information related to their own country, for example population statistics and the support available for businesses. Increasingly this information is available from official government websites such as the Kenyan government’s website [www.e-government.go.ke](http://www.e-government.go.ke).
- **Newspapers and magazines** – these report information about the local, national and international economies. Most newspapers have a business section and many magazines are specific to a particular industry, for example the *Oil and Gas Journal*.
- **Libraries** – large towns and cities in many countries have public libraries giving free access to printed materials and often internet access.
- **Market research agencies** – these are companies whose business is the collection and analysis of market data which they sell to other businesses, for example RNB Research which has Pan-Asia coverage including China, India and the UAE.
- **Business records** – businesses collect information about their customers, which they might keep on a computer database. These records might include information such as the customer’s name, address, what they purchased and when they last made a purchase from the business. Past financial records might also be a useful source of secondary information, for example for comparing profit trends over the past few years of trading.

**TOP TIP**

Don’t confuse primary and secondary research with primary and secondary sectors.

### Benefits and limitations of primary and secondary research

Table 11.1 considers the benefits and limitations of primary and secondary research.

	Benefits	Limitations
Primary research	Data is up to date.	It is costly to collect.
	Data is collected for a specific purpose which is directly relevant to the business.	It is time-consuming.
	It is not available to other businesses. This may provide a competitive advantage.	There is a risk of the data being inaccurate or containing bias, for example if the interviewer asks a question that leads the interviewee to give an answer which they might not have intended. Also, if the sample chosen to be surveyed does not represent the whole population then the results will not reflect everyone’s opinion.
Secondary research	It is fairly cheap to obtain.	It may have been collected some time ago, so is not up to date.
	It is easier and quicker to obtain than primary research data.	It has not been collected for the specific purpose required by the business so may not be as reliable or as useful as primary data.

Table 11.1 Benefits and limitations of primary and secondary research



## KEY TERMS

**Quantitative research:** the collection of numerical data that can be analysed using statistical techniques.

**Qualitative research:** the collection of information about consumers' buying behaviour and their opinions about products.

## Methods of primary research

There are two types of primary research.

- **Quantitative research** produces numerical data which can be presented in tables, graphs or charts. It can be further analysed using statistical techniques.
- **Qualitative research** aims to find out consumers' opinions about products and the factors that influence their buying decisions.

Businesses can collect market research information in several different ways.

All of the methods shown in Figure 11.2 can be used to collect both quantitative and qualitative data, except for focus groups which are used to collect qualitative data only.

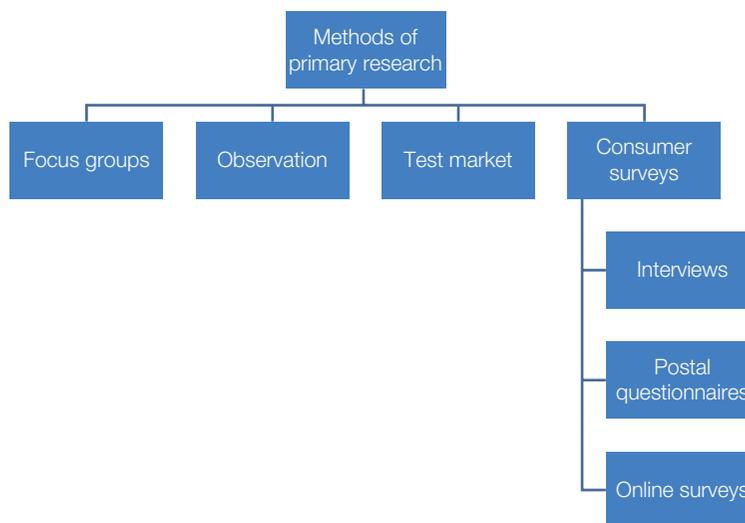


Figure 11.2 Methods of primary research

### Focus groups

This method of research is most often used by manufacturers of consumer products, for example hair shampoo, to collect qualitative data. A group of consumers is invited to discuss topics such as new products, packaging, brand names and advertisements. The discussions are often recorded or filmed.

Focus groups are a very good way for a business to find out from 'typical' consumers what they think about a product and its marketing. For example, a hair shampoo manufacturer can find out what consumers think of the colour, smell, name and packaging of a new shampoo. The results of the focus group might then be used to change one or more of these features to try to improve its successful entry into the market.

The main limitations of this method are that it can be time-consuming to arrange and there is no numerical data collected, which makes statistical analysis impossible.

### Observation

The behaviour of consumers is secretly observed and recorded by market researchers. This method of primary research is often used by large supermarkets who observe the behaviour of customers as they select their products from the many options available on the shelves.



Supermarkets often use observation to see the behaviour of customers

The main advantage of observation in primary research is that what consumers do is often more accurate than what they say they do when answering questions asked by interviewers or on a questionnaire. Some businesses also use observation to check the quality of service they are providing to customers. For example a hotel might use a 'mystery guest' to visit and stay at the hotel and report back to management about their experience.

The main problem with this method of research is that it is often more expensive than other methods because of the need to have trained observers to analyse customer behaviour and there is no opportunity to ask consumers why they behaved as they did.

### Test market

A limited quantity of the product is produced and sold in a carefully selected area of the market. The test market is chosen to represent the total market. Feedback from consumers is used to make changes to the product or other elements of the marketing mix, such as pricing, promotion and place where the product is sold, before launching the product to the main market.

The main advantage of test marketing is that the cost of any problems is limited to a smaller output – the quantity produced for the test market. Identifying and solving problems in the test market increases the chance of a more successful introduction of the product into the main market.

The main limitations of test marketing are that it takes longer to get the product to its main market and the cost of producing products for the test market makes this method of primary research more expensive than other methods.

### Consumer surveys

Surveys can collect both qualitative and quantitative data, often with the aid of a questionnaire. There are several methods used to survey consumers or potential consumers including:

#### Interviews

A trained interviewer asks questions to an interviewee and records their answers. The interview might take place in the street, in the businesses premises, for example a supermarket, or in the interviewee's own home. Some interviews may be conducted by telephone.

The main advantages of interviews are that the interviewer can explain any questions that the interviewee does not understand and they can often tell if the interviewee is replying honestly – if not then their responses can be ignored and this reduces the risk of collecting inaccurate data.

One of the main limitations of interviews as a primary research method is that it is more expensive than some of the other methods if trained interviewers are used. If trained interviewers are not used then there is a greater risk of the data collected containing bias. This is because the interviewer asks questions in such a way that makes the interviewee give an answer which does not represent their true feelings.

#### Postal surveys

Questionnaires are posted to people's homes and they are asked to complete and return them.

This is a good way of getting the views of a population spread over a wide geographical area and is much cheaper than the interview method.



**Marketing mix:**  
see Chapter 12, page 164.

**TOP TIP**

Make sure you know the advantages and disadvantages of each method of market research, as well as when they should be used. Think about the type of company wanting the information and how much time and money it might have, as well as what it needs the information for.

However, postal surveys are often seen as 'junk mail' and thrown away. This produces a very low response rate. The results of postal surveys might also contain bias because only those people with a real interest in the subject of the survey bother to reply.

**Online surveys**

Many businesses now use the internet and their own websites to carry out surveys.

The main advantage of online surveys is that they cover a very wide geographical area – anyone with internet access can take part. Also, the results are typed into an online questionnaire and can be instantly collected and analysed.

The main limitations of online surveys are similar to those for postal surveys. They are often seen as 'electronic junk mail' and the risk is that only those with a real interest in the subject take part and the results cannot be relied upon as representing the views of the whole population.

## Kellogg's Crunchy Nut brand extension



Kellogg's packaging

### Kellogg's development of a new Crunchy Nut brand extension

For the development of Crunchy Nut Bites, Kellogg's used different methods of research including both primary and secondary methods.

Focus groups were used to provide qualitative research. This primary research helped Kellogg's to find out how new products could be developed and what consumers were looking for in terms of new flavours and textures. At the end of this research, Kellogg's had a number of new food ideas.

In addition, Kellogg's used secondary research. Market research agencies collect a range of data which they process and

use to provide organisations like Kellogg's with research.

Following the completion of both primary and secondary research Kellogg's developed four product recipes and these prototypes were then tested with representative groups of consumers. This enabled Kellogg's to select the best one. The packaging designs were also tested with consumers, which enabled Kellogg's to select the final packaging design for Crunchy Nut Bites.

Kellogg's launched Crunchy Nut Bites in September 2008. Sales data shows it was one of the best performing brands to launch in the breakfast cereal market.

Source: Adapted from <http://businesscasestudies.co.uk/kelloggs/new-products-from-market-research/conclusion.html#ixzz2VeucP8Bn>

**TASK**

- What is the difference between primary research and secondary research?
- Identify **one** advantage and **one** disadvantage of secondary research.
- Why do you think Kellogg's used focus groups in its market research?
- Explain **two** benefits to Kellogg's of test marketing.

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**KEY TERM**

**Sample:** a representative sample of the target market selected to take part in market research.

## The need for sampling

When carrying out primary research it is often too expensive and too time-consuming to get the views of every consumer in the market. This problem can be overcome by selecting a **sample** from the total market. There are different methods of sampling, such as random sampling, stratified sampling and quota sampling. The method chosen must produce a sample which is representative of the whole population. If the sample chosen is not representative of the population then this may produce results which are biased and misleading.

**EXPLORE!**

You are going to carry out some market research involving students in your school.

Your class might choose their own research topic. For example, if you were setting up a shop in school, what products would fellow students want to buy? How much would they spend in the shop per day/week? How many times a week would they use the shop? Alternatively you could use the following questionnaire as a guide.

1 How do you usually travel to school?  
 Walk     Car     Bus     Train     Other (specify)

2 If you could only do one of the following activities, which one would you choose?  
 Listen to music     Go to the cinema     Play a sport     Watch a sport     Go shopping

3 On average, how many hours of TV do you watch during a school day?  
 0-1     1-2     2-3     3-4     4+

4 Do you own a mobile phone?     Yes     No  
 If yes

5 Which brand of mobile phone do you own?

You can add more questions, or change the questions, but remember that people do not like answering questions which are too personal, for example about how much money they have to spend each week. As a class you should survey between 50 and 100 students. Remember, the bigger the sample size, the more representative the results are likely to be of the whole school population. When you select your sample you should also make sure that it is representative of the whole school, so it should include all ages and both male and female – unless yours is a single-sex school.

Once you have completed your survey you need to present the results in tables, charts or graphs. You could publish your findings in your school magazine if you have one, or on school noticeboards.

Finally, write an account of your experiences. You should cover the following points:

- Which survey method did you use and why?
- How did you select the sample?
- What problems did you have when carrying out your market research?
- What are the main findings of your research?
- If you were to do this exercise again, would you do anything differently? If so, what and why?

## Accuracy of market research data

We have seen how important it is for businesses to collect, record and analyse market research data to help in the decision-making process. However, it is important for users of market research data to recognise that the data may sometimes be inaccurate. This can be due to one or more of the following reasons:

- The sample chosen may be too small or not representative of the population.
- The business may have chosen the wrong type of method to collect the data.
- People who are interviewed as part of the market research process may not answer questions truthfully.

- When a survey involves an interview, the interviewer may ask questions in a way that encourages the interviewee to give an answer that does not reflect their true view.
- The language used by the interviewer, or used in a questionnaire, may be unclear or difficult to understand.
- The data may be recorded incorrectly, or numerical analysis may be carried out incorrectly.
- Secondary data may be out of date.
- Secondary data may have been collected for a different purpose to the one it is now being used for.

Any of these factors can result in market research data being biased and inaccurate. If this is the case, then using the data is likely to result in poor or incorrect decisions being taken.

### TEST YOURSELF

- 1 Explain how and why a manufacturer of ice-cream products should be 'market-orientated'.
- 2 Using examples, explain the difference between qualitative market research methods and quantitative market research methods.
- 3 Explain **three** reasons why the results of market research may not be useful.

## Presentation and use of market research results

Once the market research has been carried out, the results need to be presented and analysed.

- Qualitative research, such as that obtained from a focus panel or test market, is usually presented in the form of written reports. Managers use these when making decisions about what to do next, for example whether the product design should be changed, or whether they need to change the colour of the packaging.
- Quantitative research consists of data, usually lots of numbers. On their own the numbers have little meaning. So the data has to be presented in a way that users will understand and be able to use. This includes tables, charts, graphs and pictograms.

### Tables

Data is often presented in a table, such as the one shown in Figure 11.3. The advantages of tables are:

- A large amount of data can be grouped and presented more clearly.
- It is easy to extract numerical data.

The main disadvantages are:

- They lack visual impact.
- Too much data in the table can make it difficult for users to understand.

These disadvantages can be overcome by presenting numerical data in charts and graphs.

	Yes	No
Male <25	86	14
Female <25	67	33
Male 25–50	81	19
Female 25–50	44	56
Male >50	79	21
Female >50	18	82

Figure 11.3 A table

### Bar charts

The data is shown as bars or columns. The bars can be drawn vertically or horizontally. The height of each bar shows the size of each answer. The height or

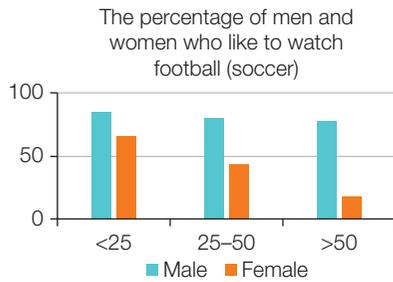


Figure 11.4 A bar chart

Percentage of women who like to watch football (soccer)

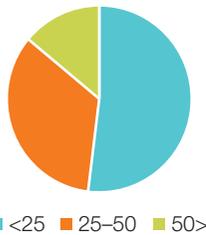


Figure 11.5 A pie chart

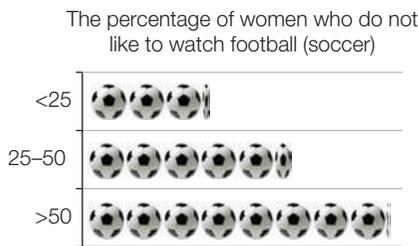


Figure 11.6 A pictogram

length of bars can be easily compared. The data in Figure 11.3 has been used to draw a vertical bar chart.

The advantages of a bar chart are:

- You can easily see the importance of each piece of data.
- You can read numerical values from the axis.

However, there are also disadvantages, such as:

- When the data values of the parts are very similar, it is difficult to compare the different parts and the chart loses visual impact.

## Pie charts

Pie charts are drawn as circles. Each part of the data is shown as a 'slice' of the pie. Each 'slice' shows the relative importance of each part of the data. Some of the data in Figure 11.3 has been used to draw the pie chart in Figure 11.5.

The advantages of pie charts include:

- They show how important each part of the data is compared to the other parts.
- They are easier to understand for people who dislike numerical values, as there are no numbers.

The disadvantages of pie charts include:

- If there are too many 'slices' then it is difficult to see the relative importance of different parts of the data.

## Pictograms

This method uses pictures or symbols to represent data. Every picture or symbol has a numerical value; for example in Figure 11.6 every football has a value of 20.

The advantages of pictograms include:

- Data is represented by pictures and not numbers and this helps people who are less numerate.

But there are disadvantages, such as:

- It is difficult to show exact quantities using pictures.

## Line graphs

This type of graph shows the relationship between two variables. They are useful to show trends – how data has changed over time.

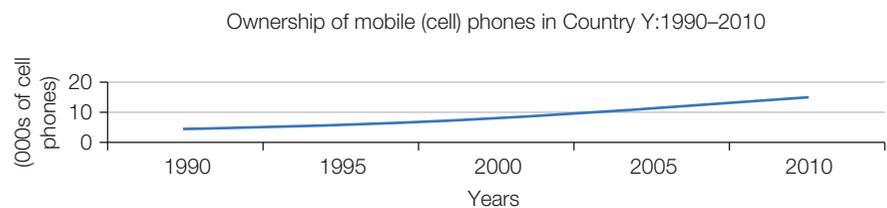


Figure 11.7 A line graph

Advantages of line graphs are:

- They clearly show trends.
- Values can be read off from both axes.
- Data can be added for future time periods.

### TOP TIP

Always remember to give a title and label the axes if you are asked to draw a chart.

However, there are also disadvantages, such as:

- They can be difficult to draw and accuracy depends on choosing appropriate scales for both axes.

### Analysing market research

Using the above presentation methods makes it easier to analyse, and draw simple conclusions from, market research data. For example bar charts, pie charts and pictograms make it easier to see the relative importance of different parts of the data. Line graphs are useful when comparing the trend of data over time.

#### ACTIVITY 11.1

Joseph makes scented candles. He has carried out some market research about three new candles he is thinking of adding to his product range. He surveyed a sample of 50 of his existing customers to find out what they thought about the scent of each candle. The results of his research are presented in the bar chart below.

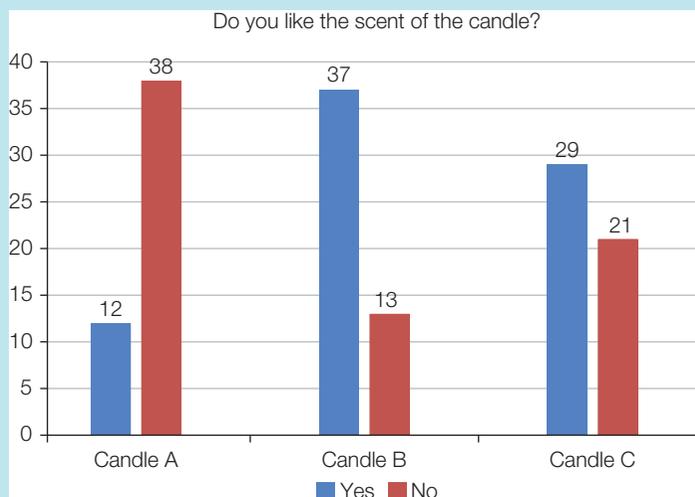


Figure 11.8 Bar chart of Joseph's scented candle research

- Define 'sample'.
- Identify **two** methods Joseph might have used to survey his customers.
- Which candle did the sample decide had the least popular smell?
- Calculate the percentage of people in the sample that said they liked the smell of candle B.
- Using Joseph's approach to marketing as an example, define 'market-orientated'.
- Explain **two** other methods Joseph could have used to present the results of his research.
- Do you think Joseph's market research data is useful? Justify your answer.

#### TEST YOURSELF

- Explain one benefit of presenting market research data as a bar chart.
- The market for a product was divided into 15 groups and a sample was taken from each group. Why would it not be appropriate to use a pie chart to present the market research data of these 15 groups?

## Revision checklist

- Most businesses operate in competitive markets and so need to use a market-orientated approach.
- Businesses need to carry out market research so that they can identify consumer wants and needs. They could do this using primary or secondary research methods.
- Both primary and secondary research methods have advantages and limitations that a business needs to be aware of when choosing which method to use.
- The results of market research need to be presented in the most appropriate way for the user of the data. This might be written reports for qualitative research data, or tables, graphs and charts for quantitative research data.

## Exam-style practice questions

- 1 Bibi is thinking of setting up a children's nursery. She knows she needs to carry out market research before opening her business, but is unsure whether this should be primary research or secondary research.
  - a Define 'market research'. [2]
  - b Identify **two** ways Bibi could present the results of her market research. [2]
  - c Outline **two** primary research methods Bibi could use to collect market research data. [4]
  - d Explain **two** benefits to Bibi of market research. [6]
  - e Bibi could use primary research or secondary research to collect data about her proposed business. Which do you think is better for her? Justify your answer. [6]
  
- 2 Company Y manufactures household cleaning products. It has recently developed a new range of cleaning products for cleaning and polishing glass, wood and ceramic tiles.
 

The marketing manager is going to use a focus group and survey a selected sample of the market to collect both qualitative and quantitative research data about these new products.

  - a Define 'focus group'. [2]
  - b Identify **two** methods the marketing manager of Company Y could use to select the sample to be used in the market survey. [2]
  - c Outline **two** benefits of sampling in market research. [4]
  - d Explain **two** benefits to Company Y of using a test market. [6]
  - e Do you think the marketing manager is right to collect both qualitative and quantitative market research data? Justify your answer. [6]

**Total available marks 40**

# 12

## Objectives

*In this chapter you will learn about:*

- marketing mix
- the costs and benefits of developing new products
- the role of packaging
- the product life cycle
- pricing methods
- price elasticity.

### KEY TERMS

**Marketing mix:** four marketing decisions needed for the effective marketing of a product.

**Four Ps:** the right product at the right price with the right promotion in the right place.

**Product:** the goods and services produced to satisfy a customer need or want.

**Brand:** a name, image or symbol that distinguishes a product from competitors' products.

### TOP TIP

Don't forget that product means goods **and** services.

# Marketing mix: product and price

## Introduction

Over the next two chapters you are going to learn about the different parts of the **marketing mix**. The marketing mix is the four key decisions that a business must take in order to market products effectively. These four decisions are often called the **Four Ps**. The first two of these decisions are what *product* the business is producing and selling and the *price* the business is going to charge customers who want to buy the product. You will learn how each of these elements of the marketing mix can influence sales.

## Product

When a new **product** is launched on to the market, consumers may see it advertised and buy it once. The business may also sell the product at a low price to encourage consumers to buy. But if the product is not 'right', because it does not meet the needs and expectations of customers, they will not buy it again. Successful products are bought over and over again by customers. This helps to build the **brand** and develop both customer loyalty and brand loyalty.



Figure 12.1 A new product will attract interest, but developing customer loyalty is not so easy



**Changing markets:**  
see Chapter 10, page 141.

**Market research:**  
see Chapter 11, page 153.



**Capital expenditure:**  
see Chapter 19, page 245.

**Economies of scale:**  
see Chapter 16, page 219.

## Costs and benefits of developing new products

Most businesses operate in very competitive and/or fast-changing markets. The survival and continued success of these businesses depends on developing new products to meet the changing needs and expectations of customers. They may need to:

- develop new products
- change an existing product to meet the changing tastes of customers
- change an existing product to enter a new market.

New product development can be very expensive. Even if a product is developed following market research, this does not guarantee success.

The costs and benefits of developing new products are shown in Table 12.1.

Costs of new product development	Benefits of new product development
Market research needs to be carried out to identify customer needs. This can be very expensive.	In fast-changing markets, such as those involved with hi-tech products, a business will not survive unless it meets the changing needs and expectations of customers.
The development of a new product often requires large capital expenditure.	Developing a new product before competitors will bring competitive advantages. The business may be able to charge a high price and achieve high sales producing high profits.
There is no guarantee that a new product will be a success. Some products never make it to market.	New products developed for new markets increase potential sales, revenue and profit.
If the investment in a new product is financed by borrowing and the product is not a success, then this could threaten the survival of the business.	Developing new products to add to those already being produced by the business spreads risk.
	The development of new products might help to achieve growth and bring benefits from economies of scale.

Table 12.1 Costs and benefits of new product development

## Brand image

A brand is the name given by a business to its product or range of products. It allows a business to distinguish its products from those of its competitors. Creating a **brand image** increases a business's sales and revenue because:

- Consumers recognise its product more easily when looking at similar products.
- Its product can be priced higher than less well-known brands.
- It is easier to launch new products on to the market because consumers already know and trust the brand and so are more likely to try it than if it was from an unknown brand – they have customer loyalty.



### KEY TERM

**Brand image:** the general impression of a product held by consumers.

# Samsung



Samsung electrical products

## R&D at Samsung

Innovation is crucial to Samsung’s business. As new technologies are being constantly introduced to the market, speed is essential for remaining competitive in today’s digital era, and new markets have to be pioneered continuously.

Innovation is a global enterprise at Samsung. Our research and development network spans six Samsung centres in Korea and 18 more in nine other countries, including the United States, the

United Kingdom, Russia, Israel, India, Japan and China, as well as other research centres and universities.

A critical way that Samsung responds to the highly uncertain business environment and the increasingly competitive marketplace is through our commitment to research and development (R&D). Each year we invest at least 9% of our revenue in R&D activities.

Source: [www.samsung.com](http://www.samsung.com)

### ACTIVITY 12.1

Look at the brands below. All of them except for one is listed in the world’s top 100 brands by revenue earned. Can you identify what each brand sells? Why do you think they are successful?

- |          |         |
|----------|---------|
| Vodafone | Hitachi |
| Shell    | FedEx   |
| HP       | Canon   |
| Kodak    | Hyundai |
| Nike     | Tata    |

## The role of packaging

Most products bought by consumers are packaged. The design and materials used in the packaging of products can be important in promoting the product. Poorly designed or poor quality packaging may influence consumers so they think the product inside is not very good. Well-designed, imaginative packaging, using good quality materials sends the message to consumers that ‘this is a good-quality product’.

### ACTIVITY 12.2

Choose one of the following products:

- Toothpaste
- Coffee jar
- Breakfast cereal
- Chocolate bar

Look at the packaging of your chosen product. What do you think is the role of the packaging for the product you have chosen?

Packaging is an additional cost which increases the final price of the product. Businesses must not spend too much money on packaging as this may increase the price above the level consumers are willing to pay.

In recent years consumers have become more aware of environmental issues. This has led to many businesses using recycled materials in their packaging, or the packaging itself can be recycled.

In Activity 12.2 you should have identified the following roles of packaging:

- to protect the product
- to provide information about the product
- to help consumers recognise the product.

You may have identified other purposes of the packaging which are also important in helping to promote and sell the product such as:

- The packaging might have a use once the product has been used up, for example a coffee jar might be a storage jar.
- To keep the product fresh once the packaging has been opened, for example the inside packaging of breakfast cereals.

## The product life cycle

All products have a life cycle. The life cycle represents the sales of the product over time. The **product life cycle** is divided into four main stages, as shown in Figure 12.2.

- **Introduction stage** – the product is introduced into the market. Sales are low. The product might be making a loss in this stage because of the cost of heavy advertising to gain product recognition.
- **Growth stage** – the product is becoming better known to consumers. Sales are increasing. The product usually starts to earn profit during this stage.

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Cambridge University Press



#### TOP TIP

Packaging is sometimes referred to as the ‘fifth P’. This is often thought of as a separate element of the marketing mix.



#### KEY TERM

**Product life cycle:** the pattern of sales of a product from introduction to its withdrawal from the market.

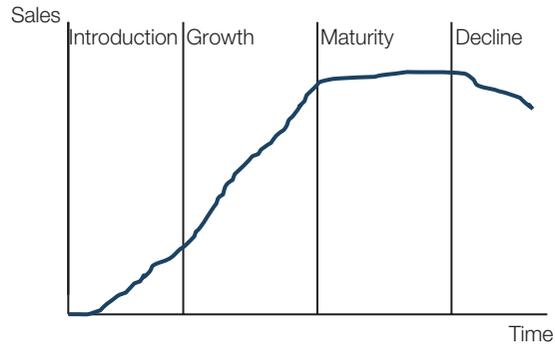


Figure 12.2 The stages of a product life cycle

- **Maturity stage** – sales are no longer growing but are not falling. This is the most profitable stage in a product’s life cycle.
- **Decline stage** – sales are falling. The product eventually becomes unprofitable and is withdrawn from the market.

The length of each stage of a product’s life cycle varies from product to product. The overall life cycle of different products also varies. For example, when Apple introduces a new iPhone, it spends very little time in the introduction and growth stages compared to less hi-tech products.

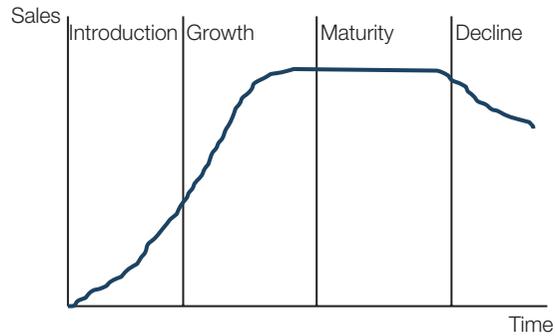


Figure 12.3 Example of a hi-tech product life cycle

**! TOP TIP**  
The product life cycle does not tell you how long a product will last in the market, or how long it will spend in each stage. It only tells you the stages it might pass through.

Fashion clothing has a much shorter life cycle than a motor car. Fashion clothing is introduced into the market and quickly grows and reaches maturity. It might only be in the market for a few weeks or months before it goes into decline as it is replaced with the ‘latest’ fashion.

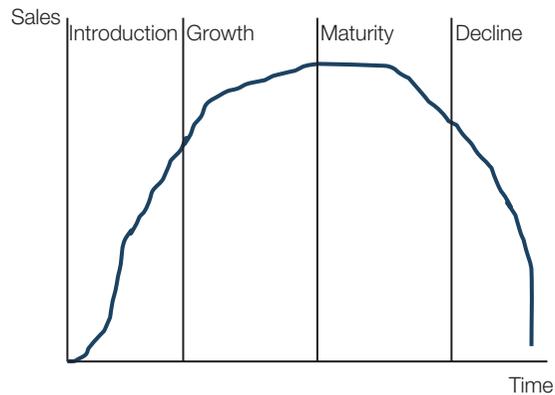


Figure 12.4 Example of a product life cycle for fashion clothing

Motor cars will have a longer life cycle and will take longer to reach maturity. They will eventually be replaced by a ‘newer’ model, but this could be two to five years after their introduction to the market.

**ACTIVITY 12.3**

Using newspapers, magazines, the internet or television, or your own experience as a consumer, identify one product for each stage of the product life cycle.

Draw a product life cycle diagram and enter the products on the diagram at their life cycle stage and explain why you believe these products to be at the stage of the life cycle you have identified.

- 1 Do you think that the products which you have identified as being in the introduction stage will be a success? Justify your answer.
- 2 Why has the product you have identified as in the decline stage become less popular with consumers?

**KEY TERM**

**Extension strategies:** marketing activities to extend the maturity stage of a product.

**TOP TIP**

Extension strategies are not just another promotional technique. They are specifically aimed at prolonging the life of the product, for example by finding new uses or new markets for the product.

**Extension strategies**

The maturity stage is the most profitable stage of a product's life cycle. A business will want to keep the product in this stage for as long as possible. It tries to do this by using **extension strategies**.

Extension strategies include:

- **Finding new markets for the product** – owners/managers will look to see if there are other markets for their product, perhaps entering foreign markets.
- **Finding new uses for the product** – the research and development team might look to see if the product can be used for something other than what it was originally intended for, for example a fizzy drink which is promoted as having benefits as a sports drink.
- **Adapting the product or the packaging to improve its appeal to consumers** – very often the product does not change but the packaging is redesigned by the business to give it a 'fresh' and more up-to-date appeal.
- **Increased advertising and other promotional activities** – the marketing function looks at other ways of promoting the product to perhaps appeal to a new market, or to remind the existing market that the product is still available.

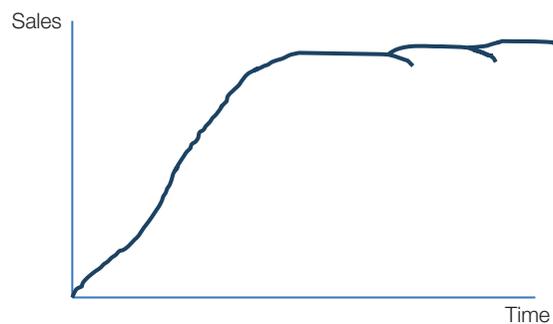


Figure 12.5 Diagram of extension strategies

**How the product life cycle influences marketing decisions**

Each stage of the product life cycle may require a different marketing mix. For example advertising and other promotional activity is likely to be a lot higher when a product is being introduced into the market than when it is entering the decline stage.

The influence that different stages of the product life cycle might have on marketing decisions about product, pricing, promotion and place is shown in Table 12.2.

	Introduction	Growth	Maturity	Decline
Product	Only a basic model of the product is available.	Changes might be made to the product as a result of feedback from consumers in the test market.	Extension strategies might be used to keep the product in this, the most profitable stage of its life cycle.	The product and packaging are not altered.
Price	Prices might be lower than competitor prices to attract consumers, or they might be high if the product has no immediate competition.	Brand image helps to create customer loyalty. The price, if originally low, can be increased to one which is similar to that of competitor products.	Price will remain similar to that of competitor products. However, if the original price was high due to the uniqueness of the product, then it will probably need to be decreased as competitors will have introduced similar products.	The price might be reduced to maintain sales or sell off the remaining inventory before withdrawing the product from the market.
Promotion	High promotional activity, such as advertising, to create product awareness and inform consumers that the product is on the market.	Promotional activity is still high to continue to persuade existing consumers to buy the product again and to attract new consumers.	Promotional activities are aimed at reminding consumers that the product is still available in the market and how it differs from competitors' products. However, there might be an increase in promotional activities for a short period of time if this is used as an extension strategy.	The only promotional activity is to advertise the lower price of the product or other promotions aimed at selling the remaining inventory.
Place	The product will be offered for sale in specially selected outlets. This might be used as a 'test market'.	The product is more widely available, which helps to increase sales.	The product is now available for purchase through a wide distribution network.	The product is only available in profitable outlets.

Table 12.2 The influence different stages of the product life cycle can have on marketing decisions

**TEST YOURSELF**

- 1 Why do businesses develop new products?
- 2 How can packaging affect the sales of a product?
- 3 What are the **four** stages of the product life cycle?
- 4 Explain why a business may use extension strategies.



**KEY TERMS**

**Price:** the amount paid by the customer to the supplier when buying a good or service.

**Product quality:** the product meets the needs and expectations of customers.

**Price**

Does the price of a product help you to decide whether to buy it?

**Price** is a very important part of the marketing mix because it is often the most important influence on customer demand for a product.

The market for most goods and services is very competitive. Consumers often base their buying decision, in part, on the price of the product. If there is very little difference between **product quality** and function then the consumer



Price is a very important part of the marketing mix

is likely to buy the lower-priced product. Even if consumers think a product is better than a similar product, they may not be able to afford the higher price for the better product. Some consumers will only buy a product if the price charged is very high! This is because being able to afford such products gives the consumer a certain status, for example very expensive items of jewellery, one-off designer clothing and top-of-the-range sports cars.

The price of a product might also be affected by the availability of supply; for example if a product becomes scarce, perhaps due to a poor harvest, then this will cause the price to rise.

### ACTIVITY 12.4

Choose a market that interests you. It could be the market for mobile phones, motor cars, shoes, fast food – in fact any good or service, as long as you are able to research this market in the area where you live.

List at least **six** different suppliers, their product and the price of the product available to consumers in your area.

Use your research to complete the following tasks.

- 1 Explain why there are at least **six** similar products for your chosen market.
- 2 Explain why there is a difference between the product with the highest price and the product with the lowest price.

### Pricing methods

Businesses use several different methods for setting the price of products. The most common pricing methods are shown in Figure 12.6.

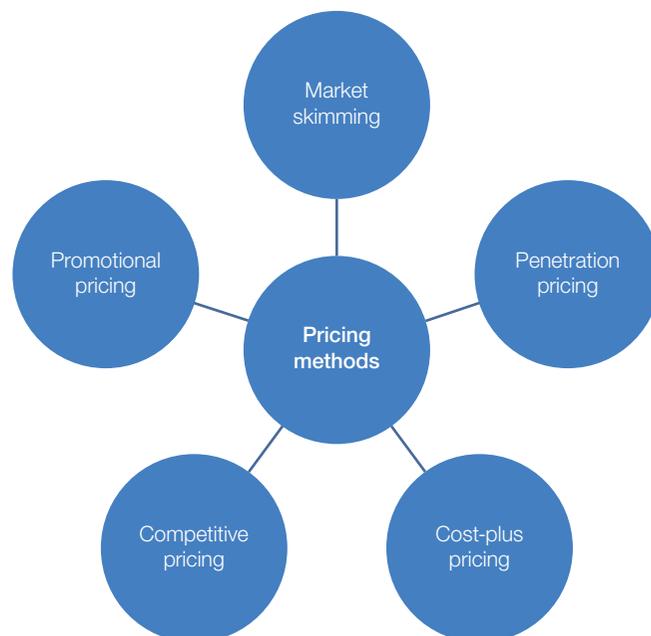


Figure 12.6 Pricing methods



Businesses can charge more for the latest technology

#### KEY TERMS

**Market skimming:** setting a high price for a new product that is unique or very different from any other product on the market.

**Penetration pricing:** setting a low price to attract customers to buy a new product.

**Competitive pricing:** setting a price similar to that of competitors' products which are already established in the market.

### Market skimming

A business may decide to set a high price for a new product which is unique or very different from anything on the market. This is known as **market skimming**. For example, when Google introduced its Google glasses, it was able to charge a very high price because it is a unique product and consumers are willing to pay more for the very latest technology. Consumers may also want the status of owning the latest version of a product and are prepared to pay a high price for this.

The development of new medicines also attracts skimming pricing. The companies who develop these new medicines are given legal protection from any other company copying their product for a certain period of time. During this time they are able to charge a very high price for the product they will have spent many millions of dollars researching and developing.

The profit earned when using market skimming is very high. Businesses sometimes need a large profit to get back the high costs of research and development of the product.

### Penetration pricing

**Penetration pricing** is also used for new products. The price is set at a lower level from similar products already on the market. The low price may encourage consumers to try the product. Once the business has built up some customer loyalty for the product it usually increases the price to a level similar to that of its main competitors.

### Competitive pricing

In many markets the level of competition is very high and firms selling in these markets will often charge similar prices to each other. This is because the products are often very similar with no strong brand advantage for any producers. If a business charges a higher price than its competitors it is likely that consumers will not buy its product because they can get similar for cheaper.

**Competitive pricing** is used for pricing both new and existing products.

- If a business has a good brand image and loyal customers, then it may use competitive pricing when launching new products which are similar to those already on the market. This is because consumers will believe the product to be of the same high quality as the firm's other products.
- Products that were introduced to the market using market skimming or penetration pricing methods will need a different method of pricing because eventually competitors will enter the market with similar products. The greater the competition in a market, the lower prices will be. They may be priced using competitive pricing.

Some industries are dominated by large companies. These companies will set the market price for their products. Smaller firms, producing similar products, will find it very difficult to set a price that is very different from that of the market leader. This is sometimes called **price leadership**.

### Promotional pricing

There are several methods of promotional pricing. They are used for different reasons but all involve pricing the product as low as possible for a limited period to get consumers to buy.

#### KEY TERM

**Price leadership:** smaller firms set their price based on the price set by the dominant firm in the industry.



## KEY TERMS

**Loss-leader pricing:** setting the price of a small number of products at below cost to attract customers into the outlet in the hope that they will buy other products priced to earn profit.

**Cost-plus pricing:** setting price by adding a fixed amount to the cost of making or buying the product.

- **Loss-leader pricing** is most often used by retailers, such as supermarkets. They offer a few products well below the normal price, sometimes even at a loss. These prices attract customers into the store who will also buy other products at their normal, profitable prices.
- Buy-one-get-one-free pricing is used to create product awareness and develop customer and brand loyalty.
- Discounting the normal price is also used to create product awareness and build up customer loyalty. Sometimes it is used by businesses wanting to sell off surplus inventory.

**Cost-plus pricing**

**Cost-plus pricing** is based on the cost of making the product or buying the product for resale to the final consumer. There are two main methods of cost-plus pricing:

- mark-up pricing
- full-cost pricing.

Both methods are very similar. The price is set by adding a fixed amount – usually a percentage – to the cost of making or buying the product.

**EXAMPLE**

Company X produces car batteries. The average cost of producing a battery is \$8. It wants to make a profit of 150% per unit sold. The selling price of each battery will need to be:

$$\begin{aligned} &\text{Cost} + 150\% \\ &\$8 + (150\% \times \$8) = \$20 \end{aligned}$$

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**ACTIVITY 12.5**

Paulo owns a local grocery store. He buys all of his goods from the local wholesaler. Paulo uses a mark-up of 30% on all tinned fruit. He buys tins of fruit from the wholesaler for \$0.40.

Calculate the price he charges in his grocery store for tinned fruit.

**ACTIVITY 12.6**

Work in pairs and discuss which method of pricing might be the most suitable for the following business situations:

- 1 the launch of a new chocolate bar by a leading manufacturer
- 2 the launch of a new electric car in your country
- 3 the opening of a new pizza takeaway in your nearest town or city
- 4 the room rate for a new luxury hotel in your country's capital city
- 5 a local supermarket which has seen a recent fall in sales due to the opening of a new store by a major competitor.

A summary of the main features, uses, benefits and limitations of the pricing methods is shown in Table 12.3, page 174.

Features	Uses	Benefits	Limitations
<b>Market skimming</b>			
<ul style="list-style-type: none"> <li>A high price is set to maximise short-run profits.</li> <li>When competitors enter the market with a similar product then this will cause a price to fall.</li> </ul>	<ul style="list-style-type: none"> <li>New products that are unique or very different from other products on the market.</li> </ul>	<ul style="list-style-type: none"> <li>The high price enables the firm to recover research and development costs which are often very high for products such as pharmaceutical products and hi-tech goods.</li> <li>The high price may help the firm to create a quality image for its products.</li> </ul>	<ul style="list-style-type: none"> <li>The high profits will eventually attract cheaper competitor products.</li> <li>Some customers who would like to buy the product are not able to do so because of the high price. This means a loss of sales.</li> </ul>
<b>Penetration pricing</b>			
<ul style="list-style-type: none"> <li>The price is set lower than similar products already on the market to encourage high volume of sales and build customer loyalty.</li> <li>Once customer loyalty has been gained for the product, the price will be increased to a level similar to that of competitors.</li> </ul>	<ul style="list-style-type: none"> <li>Used for new products that are competing with similar products already established in the market.</li> </ul>	<ul style="list-style-type: none"> <li>Attracts customers more quickly and helps the product to become established in the market.</li> <li>Can increase market share quickly.</li> </ul>	<ul style="list-style-type: none"> <li>Possible loss of revenue due to lower prices.</li> <li>Cannot recover any development costs quickly and if the life cycle is too short then development costs might never be recovered.</li> </ul>
<b>Competitive pricing</b>			
<ul style="list-style-type: none"> <li>The price is set at a level similar to that charged by competitors.</li> </ul>	<ul style="list-style-type: none"> <li>New products where the business already has a good brand image and loyal customers.</li> <li>Existing products that have previously been priced using market skimming or penetration (see above).</li> </ul>	<ul style="list-style-type: none"> <li>Prices are similar to those of competitors so the business can compete on things it might be better at such as quality of product, or customer service.</li> </ul>	<ul style="list-style-type: none"> <li>If the market has a price leader then this price would need to be followed otherwise customers and market share will be lost.</li> <li>Still need to find ways of competing in order to attract sales.</li> </ul>
<b>Cost-plus pricing</b>			
<ul style="list-style-type: none"> <li>Price is set by adding the required profit percentage on to the cost of making the product.</li> </ul>	<ul style="list-style-type: none"> <li>Retailers often use this method when deciding on the final price of the product to the consumer.</li> </ul>	<ul style="list-style-type: none"> <li>Quick and easy to work out the price.</li> <li>Makes sure that the price covers all of the costs.</li> </ul>	<ul style="list-style-type: none"> <li>Price might be set higher than those of competitors or than customers are willing to pay. This reduces sales and profits.</li> </ul>
<b>Promotional pricing</b>			
<ul style="list-style-type: none"> <li>The normal price is discounted, sometimes below cost – known as loss-leader pricing. Or consumers are offered more of the product for less than the full price – buy-one-get-one-free, or 25% extra ‘free’.</li> </ul>	<ul style="list-style-type: none"> <li>Loss-leader pricing is used by retailers to attract customers into the store. They buy not only the loss-leader but also other goods at their normal price.</li> <li>Other promotional pricing is used to create brand awareness and customer loyalty, or to sell off surplus inventory.</li> </ul>	<ul style="list-style-type: none"> <li>Good way to sell off unwanted inventory before it becomes out of date.</li> <li>A good way of increasing short-term sales and market share.</li> </ul>	<ul style="list-style-type: none"> <li>Revenue on each item is lower so profits may also be lower.</li> </ul>

Table 12.3 Features, uses, benefits and limitations of the main methods of pricing

**TOP TIP**

It is important to know when a business can use each pricing strategy. Not all strategies will be appropriate for all market situations. Look at the context of the question before you decide which strategy is most appropriate.

## Choosing a pricing method

How do businesses decide on the price of their products? When setting the price of a product businesses need to answer these questions:

- **Is it a new or an existing product?** When a product is new to the market it might be priced lower than a product in the growth or maturity stage. This is so it can gain sales and develop customer loyalty to the product. When a product enters the decline stage its price might be lowered to sell off the last remaining inventory.
- **Is the product unique?** A skimming strategy – charging a very high price – might be used for a product that has no close substitutes. For example, the latest model of iPhone or iPad is often launched on to the market at a very high price. Once similar products enter the market, the competition will cause prices to fall.
- **Is there a lot of competition in the market?** Very competitive markets will result in most firms charging very similar prices for their products as consumers will buy the least expensive if there is little to choose between them.
- **Does the business have a well-known brand image?** Companies such as Sony and Cadbury are able to charge a higher price for their products even though competitors have similar products on the market. This is because consumers trust the brand and consider the products to be of a better quality than cheaper alternatives.
- **What are the costs of making and supplying the product?** Clearly, the price has to be greater than the cost of making and marketing the product so that the business can earn profit.
- **What are the marketing objectives of the business?** If the business wants to increase market share by volume of sales then it might charge a lower price than competitors. However, if the objective is to maximise profit, then it might have a different pricing strategy.

## Price elasticity of demand

What would you do if the price of a cinema ticket increased by 10%? You might still go to the cinema but not as often.

Suppose the only safe drinking water in your country has to be bought in bottles. What would you do if the price of bottled water increased by 10%? You need water to survive so you will probably continue to buy bottled water, although you might try to reduce how much by taking greater care over how you use it.

In both of these cases the **demand** for the good or service will fall as a result of an increase in its price. However, the demand for cinema tickets will almost certainly fall by a greater amount than the demand for bottled water.

The opposite would also be true. If the price of cinema tickets decreased by 10% you would probably go to the cinema more often. However, if the price of bottled water fell by 10% you would not buy very much more because you are probably buying enough already. In both cases the demand will rise as a result of a decrease in price.

**KEY TERM**

**Demand:** the quantity of goods and services consumers are willing and able to buy.

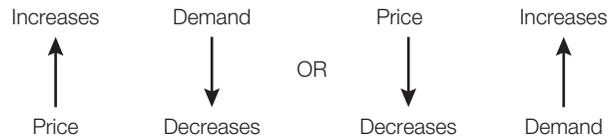


Figure 12.7 Price elasticity of demand

The relationship between price and demand can be shown on a demand graph like the one below.

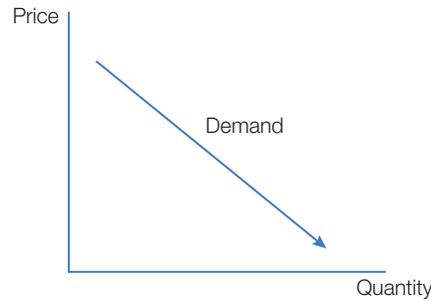


Figure 12.8 Simple demand curve



## KEY TERM

**Price elasticity of demand:**

measures by how much demand (sales) for a product changes when there is a change in its price.

**Price inelastic demand:** the percentage change in demand (sales) is less than the percentage change in price.

**Price elastic demand:** the percentage change in demand is greater than the percentage change in price.

As we have seen in the above examples of cinema tickets and bottled water, how much demand decreases or increases following an increase or decrease in price will not be the same for every product.

The demand for cinema tickets will change by a greater amount following a change in price than the demand for bottled water will. This is because the demand for some goods and services is more responsive to price changes than others. This is known as the **price elasticity of demand**.

Products that are not very responsive to changes in their price have **price inelastic demand**. This means that the percentage change in demand will be lower than the percentage change in price. This is the case for the demand for bottled water.

Products that are more responsive to changes in their price have **price elastic demand**. This means that the percentage change in demand is bigger than the percentage change in price. This is the case for the demand for cinema tickets.

## ACTIVITY 12.7

Read the following newspaper reports.

### Petrol prices set to rise by 5% by the end of next week!

The country's four main petrol retailers have announced that, due to shortage of supplies, petrol prices will rise by 5% in the next few days. A spokesman for one of the petrol retailers said: 'The price increase is outside of our control. We expect the effect of this increase to reduce our sales by around 2%.'

Car user Innocent Pfupa, when asked how he will be affected by the increase in petrol prices, replied: 'I need my car for work, so will just have to pay the higher price. However, I might try to reduce my petrol usage by using my car less for leisure journeys. It will also mean I have less money to spend on other goods and services, especially the little luxuries in life.'

### Theme park visitor numbers fall by 10%

One of the country's major tourist attractions has announced that visitor numbers in the first three months of the season have fallen by 10% compared to the same period last year. The management of the theme park increased entry prices by 3% for the current season.

- 1 Why is the 5% increase in petrol prices only expected to reduce sales by 2%?
- 2 Why has a 3% increase in the entry ticket to the theme park reduced visitor numbers by 10%?
- 3 Discuss how the information in the two articles might affect the demand for goods and services by consumers like Innocent Pfupa.

### Price elasticity of demand and pricing decisions

If managers know the value of the price elasticity of demand for their products, then they can calculate the effect on sales of any proposed increase or decrease in price.

We know that any increase in price will decrease sales and any decrease in price will increase sales. However, what is more important is how a change in price will affect **revenue**.

Table 12.4 shows the effect on revenue of changes in price for products with price elastic demand and price inelastic demand.

Price change	Price elasticity of demand	Effect on revenue
Increase price	Price inelastic demand	Increase revenue
Decrease price	Price inelastic demand	Decrease revenue
Increase price	Price elastic demand	Decrease revenue
Decrease price	Price elastic demand	Increase revenue

Table 12.4 The relationship between changes in price, price elasticity of demand and revenue

From the above table we can see that if the marketing objective is to increase revenue then this could be achieved in one of two ways:

- increasing the price if the product has price inelastic demand
- decreasing the price if the product has price elastic demand.

### TEST YOURSELF

- 1 Why is price important to both the producer and the consumer?
- 2 Why is it unlikely that a business will be able to use a market skimming strategy in the long run?
- 3 Why is the price elasticity of demand not the same for all products?

## Revision checklist

- The marketing mix is the four key decisions related to product, price, promotion and place that a business must take in order to market products effectively (the Four Ps).
- Successful businesses need to develop customer relationships to build customer loyalty and develop brand image.
- The product life cycle has four main stages – introduction, growth, maturity and decline – and each of these influences marketing decisions.
- Pricing is an important influence on consumer demand and businesses have a number of pricing strategies they can use to maximise the marketing potential of their products.
- The price elasticity of demand measures the response of consumer demand for a product as a result of a change in the product's price.

## Exam-style practice questions

- 1** Debbie is a clothing designer. She designs one-off dresses for people to wear on special occasions. The average cost of making one of her dresses is \$80. Debbie makes a profit of 300% on every dress she makes and sells.

Debbie is considering making clothing for babies and young children. She will design the clothing, but will have several of each design produced by a local factory. Debbie has not yet decided how to price this new range of clothing.

- a** Define 'profit'. [2]
- b** Calculate the price Debbie charges for her designer dresses. [2]
- c** Identify **four** factors that influence the demand for Debbie's designer dresses. [4]
- d** Explain **two** methods of pricing Debbie might consider using for the new baby and young children's clothing. [6]
- e** Do you think Debbie is right to develop these new products for her business? Justify your answer. [6]

- 2** Carmel makes fashion jewellery, which she sells at a local market. Most of her items have a short product life cycle so she is always looking for new ideas for her jewellery items. The market is very competitive and the demand for her products is price elastic. She prices all of her products by adding a 50% mark-up on cost. Carmel is considering setting up her own website.

- a** Define 'price elastic'. [2]
- b** Identify **two** stages of a product's life cycle. [2]
- c** Outline **one** benefit and **one** limitation to Carmel of selling her jewellery at the local market. [4]
- d** Explain **one** advantage and **one** disadvantage to Carmel of having her own website. [6]
- e** Do you think it is a good idea for Carmel to price her products by adding a 50% mark-up on cost? Justify your answer. [6]

**Total available marks 40**

# 13

## Objectives

*In this chapter you will learn about:*

- distribution channels (place)
- aims and forms of promotion
- the marketing budget
- technology and the marketing mix.

# Marketing mix: place and promotion

## Introduction

In the previous chapter you learnt about the first two elements of the marketing mix – product and price. In this chapter you will learn about the other two Ps: how the business is going to *promote* the product so that customers know it is available and are persuaded to buy it; and finally, the *place* where consumers will be able to buy the product from.

Although you will study each element of the marketing mix as separate concepts, you need to remember that the four elements are linked. This means that if a business changes one element of the mix then it is almost certain to affect at least one, if not all, of the other elements. For example, if a business decides to reduce the price of one of its products, then this will have to be communicated to the consumer. Communication with consumers is one of the activities of promotion.

You will also learn how technology has become a major influence on the way businesses market and sell products.

## Place – distribution channels

This element of the marketing mix involves a business in deciding:

- how to get the goods from the producer to the final consumer – known as the channel of distribution
- the place where the consumer will be able to buy the good or service, for example a shop or laundry.



### KEY TERM

#### Channels of distribution:

how a product gets from the producer to the final consumer.

Every business must decide the best way of getting its product to the final consumer. Businesses can use any of the **channels of distribution** shown in Figure 13.1 to achieve this.

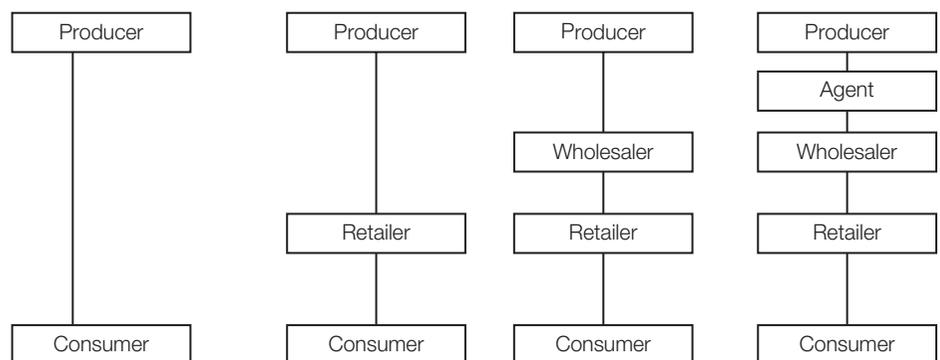


Figure 13.1 Channels of distribution

**KEY TERMS**

**Wholesaler:** a business that buys products in bulk from producers and then sells them to retailers.

**Retailer:** shops and other outlets that sell goods and services to the final consumer.

**Middlemen:** these are the intermediaries in the channels of distribution, for example wholesalers and retailers.

**Direct selling:** the product is sold by the producer directly to the final consumer without the need for any middlemen.

**TOP TIP**

It is important that you learn the difference between wholesaler and retailer.



**Costs of holding inventories:** see Chapter 15, page 205.

In the four channels of distribution shown in Figure 13.1 the agent, **wholesaler** and **retailer** are known as **middlemen**.

The first channel of distribution is where the producer sells the product directly to the consumer. This is known as **direct selling**.

In the second channel of distribution the producer sells the product to retailers. The retailers then sell the goods in their shops to the final consumer.

The third channel of distribution uses two middlemen – wholesalers and retailers. The producer sells large quantities of the product to the wholesaler. The wholesaler then sells the product in smaller quantities to retailers, who then sell the product to the final consumer.

The final channel of distribution uses an agent. This is most commonly used when a business enters a foreign market for the first time. The agent has specialist knowledge about the country and its markets and can help the producer to place its product with wholesalers and retailers. This saves the producer a lot of time and expense, but it does mean that another middleman enters the channel of distribution and this could reduce the amount of profit earned by the producer.

Each of the channels of distribution has advantages and disadvantages for the producer and the consumer. These are shown in Table 13.1, page 181.

**Choosing a method of distribution**

There are a number of factors that will influence the best method for the distribution of a business's goods such as:

- **Cost** – the cost of transporting goods to the customer needs to be considered. Does a business buy its own delivery vehicles and employ its own drivers to deliver the goods, or does it employ another firm to do this for it? Some methods of distribution are cheaper than others, but it is important that the goods arrive on time and in perfect condition. Cheaper alternatives might delay delivery or damage goods in transit.
- **Nature of the product** – some goods will need special delivery conditions; for example frozen foods and fresh fruit and vegetables will need special transport vehicles to maintain the correct temperature. Fragile items, such as televisions, need to be handled as few times as possible to reduce the risk of damage. Perishable goods, such as milk, need to get to the final consumer as quickly as possible so a long channel of distribution might not be appropriate.
- **The market** – markets that cover a wide geographical area are best served through wholesalers who can buy the product in bulk from the producer and then break this down into smaller units for retailers.

**ACTIVITY 13.1**

- Good4U Foods plc is a large manufacturer of breakfast cereals in Country Y.
- Compton is a sole trader in Country Y. He owns a poultry farm. His chickens produce an average of 500 eggs per week.
- Sunshine Holidays Ltd supplies overseas package holidays to consumers in Country Y.

**1** One of the above businesses uses only direct selling to get its products to the final consumer.

- a** Which business do you think this is likely to be and why?
- b** Explain **one** advantage to the owner(s) of this business of using direct selling.
- c** If this business grows, do you think direct selling will still be the best channel of distribution for its products?

- 2 Another of the businesses above uses the longest channel of distribution for its products.
- Which business is this likely to be and why?
  - Explain **one** advantage and **one** disadvantage to the management of the business of using this channel of distribution.
- 3 The other business uses **two** different channels of distribution.
- Identify this business.
  - Outline which **two** channels of distribution you think it uses.
  - Explain the benefits to the business of using more than one channel of distribution.

Channel of distribution	Advantages	Disadvantages
Producer → consumer	<ul style="list-style-type: none"> <li>■ All of the profit is earned by the producer.</li> <li>■ The producer controls all parts of the marketing mix.</li> <li>■ It is the quickest method of getting the product to the consumer. This might be important for goods that need to be consumed as soon after production as possible, for example fresh fruit and vegetables.</li> <li>■ The producer has direct contact with the consumer and this could provide useful market research opportunities.</li> </ul>	<ul style="list-style-type: none"> <li>■ Consumers are not always able to see or try the product before they buy, for example if purchased online.</li> <li>■ Delivery costs may be high if there are many customers over a wide area.</li> <li>■ All storage costs must be paid for by the producer.</li> <li>■ All promotional activities must be carried out and financed by the producer.</li> </ul>
Producer → retailer → consumer	<ul style="list-style-type: none"> <li>■ Consumers can see and try the product before they buy.</li> <li>■ The cost of holding inventories of the product is paid, in part, by the retailer.</li> <li>■ The retailer will pay for advertising and other promotional activities.</li> <li>■ Retailers are usually more conveniently located for consumers.</li> </ul>	<ul style="list-style-type: none"> <li>■ The retailer takes some of the profit away from the producer.</li> <li>■ Producers lose some control of the marketing mix.</li> <li>■ The producer must pay delivery costs to the retailers.</li> <li>■ Retailers usually sell competitors' products as well.</li> </ul>
Producer → wholesaler → retailer → consumer	<ul style="list-style-type: none"> <li>■ The wholesaler buys in bulk from the producer and then breaks this down into smaller quantities for retailers.</li> <li>■ Wholesalers will advertise and promote the product to retailers.</li> <li>■ The transport cost to the retailer is paid for by the wholesaler.</li> <li>■ Wholesalers will pay for the storage costs of the products purchased from the producer.</li> <li>■ Distribution of goods through wholesalers helps the producer to sell its goods to a larger market.</li> </ul>	<ul style="list-style-type: none"> <li>■ Another middleman – the wholesaler – takes part of the profit from the producer.</li> <li>■ The producer loses even more control over the marketing mix.</li> </ul>
Producer → agent → wholesaler → retailer → consumer	<ul style="list-style-type: none"> <li>■ The agent has specialist knowledge of the market – especially a foreign market. They find wholesalers and retailers who are prepared to buy the product from the producer.</li> </ul>	<ul style="list-style-type: none"> <li>■ Another middleman is added to the channel of distribution which reduces the profit to the producer.</li> </ul>

Table 13.1 Advantages and disadvantages of channels of distribution

**TEST YOURSELF**

- 1 What is the main advantage to producers of direct selling?
- 2 The profit per unit is less when a producer uses middlemen to distribute its products to the final consumer. However, the total profit earned is almost always higher. What is the explanation for this?

## Promotion

As a consumer, you are likely to know of many ways businesses promote their products. **Promotion** tells consumers about a product and tries to persuade them to buy it.

### ACTIVITY 13.2

In small groups, or as a class, make a list of the ways you have found out about different products, or been persuaded to buy products.



**KEY TERM**

**Promotion:** marketing activities used to communicate with customers and potential customers to inform and persuade them to buy a business's products.

### The aims of promotion

The main aim of promotion is to increase sales. Promotion does this by:

- attracting the attention of consumers by making them aware of the product, or reminding consumers that the product is still on the market
- persuading consumers to buy the product
- explaining how a product is better than competitors' products
- creating and developing brand image
- encouraging wholesalers and retailers to stock the product
- reassuring consumers, following a problem with the product.

### How promotion influences sales

Figure 13.2 shows the most common methods of promotion.

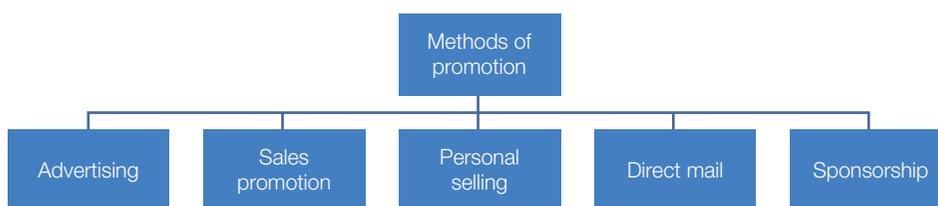


Figure 13.2 Methods of promotion



**KEY TERM**

**Advertising:** paid-for communication with consumers which uses printed and visual media. The aim is to inform and persuade consumers to buy a product.

### Advertising

**Advertising** involves communicating with the customer through media such as newspapers, magazines, radio, television and the internet. The advertising media used often depends on the available budget. Television advertising is much more expensive than newspaper advertising and is usually only afforded by larger businesses such



## KEY TERMS

**Informative advertising:**

information about the product communicated to consumers to create product awareness and attract their interest.

**Persuasive advertising:**

communication with consumers aimed at getting them to buy a firm's product rather than a competitor's product.

as a national supermarket chain. Newspaper advertising can be in local or national newspapers. A hairdresser and a taxi company are unlikely to advertise in national newspapers as their market is usually local. However, a business that sells its products throughout a country is more likely to use national newspapers, for example a car manufacturer. This type of promotion is sometimes called above-the-line promotion. Most advertising is aimed at the final consumer. However, some advertising tries to persuade wholesalers and retailers to stock the product.

There are two main forms of promotional advertising:

- **Informative advertising** provides information to potential consumers about the product. This can include information about the price of the product, what the product can be used for and the place the consumer can buy it. This form of advertising is often used when a new product is being launched on to the market or into a new market.
- **Persuasive advertising** is the most common form of advertising. The business uses this form of advertising to try to convince consumers that they need the product and that its product is better than competitors' products.

## ACTIVITY 13.3

In pairs or small groups, design an advertisement for your school. You might want to look at newspaper and magazine advertisements to get some ideas of the layout and the sort of information you need to include.



## KEY TERMS

**Below-the-line promotion:**

promotion that is not paid-for communication but uses incentives to encourage consumers to buy.

**Sales promotion:** incentives used to encourage short-term increases in sales or repeat purchases.

**Sales promotion**

This type of promotion is sometimes called **below-the-line promotion**.

There are a number of different activities that are forms of **sales promotion**.

These include:

- money-off coupons or vouchers
- point of sale displays in shops
- loyalty reward schemes
- competitions and games with cash or other prizes.

The main advantage of sales promotion is that it is usually very specific to the business or its products. The consumer must buy the product to use the vouchers or money-off coupons. Loyalty reward points are given when consumers spend money in a particular business. Supermarkets, coffee shops and airlines often have loyalty reward schemes.



## TOP TIP

Remember that increased sales will not necessarily mean increased profits. It will depend on whether the revenue from the increased sales is greater than the cost of the promotion to generate the extra sales.



Point of sale display

## Skywards

Skywards is a frequent flyer programme that rewards the loyalty of Emirates airline passengers with a range of travel and lifestyle benefits. In addition to the miles earned while flying, members can also accrue Skywards miles at partner businesses of Emirates, such as Le Meridien, Jumeirah, Citibank, Hertz, Damas, InterContinental Hotels, as well as other airlines. Travel privileges range from earning miles to hassle-free check-in to excess baggage allowance and access to the business lounge at Dubai International Airport. As well as using their miles to buy or upgrade flights, Skywards members can shop at the Emirates High Street, which has a choice of more than 400 products, ranging from incredible leisure experiences, to global luxury brands, to everyday lifestyle objects and accessories.

Source: www.emirates.com

### TASK

- Identify **two** benefits to consumers of the Skywards reward scheme.
- Identify **one** benefit and **one** limitation to Emirates airlines and its partners of operating the Skywards loyalty scheme.



### KEY TERM

**Personal selling:** sales staff communicate directly with the consumer to achieve a sale and form a long-term relationship between firm and consumer.

### Personal selling

**Personal selling** is most often used when selling expensive items that have a high profit per unit, for example cars. The salesperson has direct contact with the potential customer when they visit the showroom or other business premises of the seller. Sometimes the seller will visit the potential buyer in their own home, for example when selling home improvements. This enables the seller to build a relationship with the customer that can last after the completion of the sale and result in further sales in the future.

This can be an expensive form of promotion because more staff are needed to provide the level of personal service customers require. Also, to provide incentives to sales staff, the business will often pay bonuses, or a commission on any sales made. This reduces the profit to the business per item sold.

### TOP TIP

If a question asks for different types of media, do not give examples of the same type such as advertising in newspapers, television or radio.



### EXPLORE!

Collect direct mail that is delivered to your own home, or ask the school office if it has any that you can have.

Select one of the direct mail items and write a brief report on what is being sold. Is the business local or national? What message is it trying to get across to consumers in its direct mail? Do you think the direct mail is effective? Justify your answer.



Personal selling

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## KEY TERMS

**Direct mail:** also known as 'mailshots'; printed materials which are sent directly to the addresses of customers.

**Sponsorship:** payment by a business to have its name or products associated with a particular event.

**Direct mail**

**Direct mail** involves posting leaflets or other printed materials directly to the business offices or homes of potential customers. These potential customers have usually been identified through market research. This is a very good way of communicating with a large market over a wide geographical area. However, it is so widely used that there is a danger of it being considered 'junk mail' and thrown away before being read.

**Sponsorship**

**Sponsorship** is where a business will pay to have its name linked to an event, or perhaps to an individual or group of individuals who are in the public eye.

## CASE STUDY

## Sponsorship

Jordan Football Association (JFA) and PepsiCo-Jordan have signed a new agreement positioning PepsiCo-Jordan as the official beverage sponsor of national football teams.

Source: Adapted from <http://www.jfa.com.jo/DomesticNewsDetails.spx?NID=842&lang=en>

## TASK

Explain why PepsiCo-Jordan may have agreed to sponsor the Jordanian national football team.

185



## KEY TERM

**Marketing budget:** the amount of money made available by a business for its marketing activities during a particular period of time.

**The marketing budget and promotion decisions**

All marketing decisions require some level of spending. Money is needed for activities such as market research, changing a product or its packaging, or advertising a product to consumers. The funds for these activities come from the business's **marketing budget**, an amount of money available for promotional activities.

The size of the marketing budget affects promotion decisions. Television advertising, for example, is very expensive and can only be afforded by businesses with a large marketing budget. Smaller businesses may only have a marketing budget that allows them to advertise on local radio or in the local newspaper.

However, spending very large sums of money on promotion does not always guarantee success. A business needs to know that its marketing budget is spent cost-effectively. The main way of checking on the effectiveness of the use of the marketing budget is to see if it has achieved the marketing objectives.



## TOP TIP

You must understand when each type of promotion can be used. Consider factors such as cost, size of firm, life cycle stage the product is at. Look for clues in the question to help you.

**EXPLORE!**

Research local newspapers, magazines, radio, television and the internet to find examples of how businesses promote their products in your country.

Use your research above to produce a poster or PowerPoint presentation showing the different methods of promotion you have discovered. Use your poster or PowerPoint to give a short presentation of your research findings to your class.

**ACTIVITY 13.4**

Ali and Fatima are the owners of Impact Fitness Ltd (IF). They have successfully operated a fitness studio for the past seven years. Recently, they bought another fitness studio in the next town. This business was not very successful due to poor facilities and poor management. IF has installed the latest fitness equipment in the new studio. Fatima is in charge of its promotion. She has a marketing budget of \$2000 for the new studio. She is going to spend \$1000 on advertising in the local paper.

- 1 Define 'marketing budget'.
- 2 Identify **two** different types of advertising IF might use for its new studio.
- 3 Explain why a marketing budget is important to promotion decisions.
- 4 Explain **two** reasons why IF needs to promote the new fitness studio.
- 5 IF could use money-off vouchers or free T-shirts to promote its new fitness studio. Which do you think is better? Justify your choice.

**TEST YOURSELF**

- 1 What are the main aims of promotion?
- 2 Define 'sales promotion'.
- 3 Explain how a business might assess the effectiveness of its marketing budget.

## Technology and the marketing mix

The development of technology has affected many areas of business activity. In particular the internet and social media networks have changed the ways many businesses market and sell their products.

### E-commerce

Many businesses, from sole traders through to multinational companies, have websites. One of the main benefits of this is to help them to sell their products over the internet. For this to work, customers must be prepared to use the internet to buy goods and services. The good news for businesses is that more and more consumers are using the internet to make purchases of items such as their weekly family shopping, books, clothing, furniture and much more.

Examples of **e-commerce** are shown in Figure 13.3.

**KEY TERM**

**E-commerce:** use of the internet and other technologies by businesses to market and sell goods and services to customers.

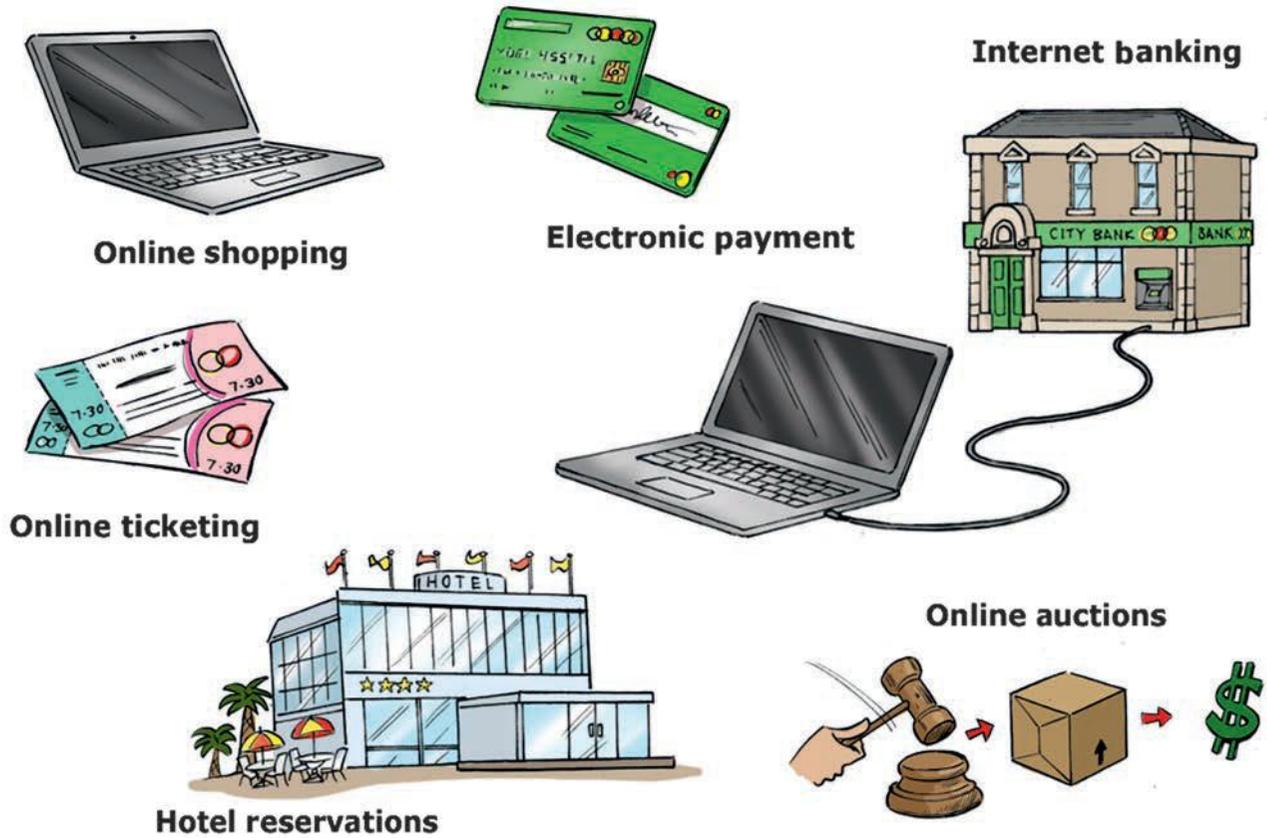


Figure 13.3 Examples of e-commerce

### Opportunities and threats of e-commerce

The most common opportunities of e-commerce for both businesses and consumers are shown in Table 13.2.

Opportunities of e-commerce for businesses	Threats of e-commerce for businesses	Opportunities of e-commerce for consumers	Threats of e-commerce for consumers
<b>Increased market</b> – the business is able to sell its goods and services to consumers throughout the world.	<b>Increased competition</b> – competitors can now be from any part of the world, not just the local market.	<b>Convenience</b> – consumers can order their products from the comfort of their own homes at any time of day.	<b>Fraud</b> – a website might take a consumer’s money and not deliver the goods.
<b>Reduced costs</b> – the staffing and other costs of shops are saved.	<b>Unfamiliarity</b> – consumers are less likely to buy products from new businesses they don’t know.	<b>Wider choice</b> – consumers are now able to buy goods which they would not have had access to if they were only able to use their local shops.	<b>Hacking</b> – a consumer’s personal details or bank account details might be ‘stolen’.
<b>Better information</b> – the website can provide potential consumers with all the information they need about the goods and services available.		<b>Lower prices</b> – competition is worldwide and this reduces prices.	<b>No personal service</b> – there is no face-to-face contact between the consumer and the seller.
		<b>Better information</b> – consumers are able to read about the goods and services available from the websites of the different businesses and also read reviews from consumers who have bought products from businesses.	<b>Returning items</b> – it can be inconvenient and expensive to return goods which do not meet the consumer’s needs, e.g. clothing that does not fit.

## E-commerce in Brazil

E-commerce is booming in Brazil. Brazil's e-commerce total revenue for 2011 was over \$11 billion. In total, 32 million consumers in Brazil bought at least once via the web in 2011.

The Brazilian start-up OLOOK is a good example of success in the fashion industry. OLOOK uses technology to build up the profile of a client who chooses her colour and style preferences from pictures of fashion items and celebrities. The website was launched in November 2011 and had over 400 000 users signed up in less than six months, with more than 1000 items sold.

*Source:* Adapted from [www.forbes.com/sites/ricardogeromel/2012/03/23/brazils-e-commerce-is-booming-record-breaking-figures-in-2011-growth-of-26-earnings-of-11-bi](http://www.forbes.com/sites/ricardogeromel/2012/03/23/brazils-e-commerce-is-booming-record-breaking-figures-in-2011-growth-of-26-earnings-of-11-bi)

### TASK

- a Define 'e-commerce'.
- b Explain **one** advantage and **one** disadvantage of e-commerce for OLOOK.

### Using the internet and social media networks for promotion

Apart from e-commerce, business websites have other uses. They can be used to promote a business and its products. In addition to its own website, a business may pay to place banner adverts, or 'pop-ups', on the websites of other businesses. This can advertise the business especially if the 'pop-up' or banner is placed on a related product's website; for example, a mortgage provider may pay to have a banner advert on the website of a builder of houses for private ownership.

Recently, businesses have seen the benefit of using social media networks such as Facebook, Twitter and YouTube to promote their business. This is known as social media marketing. This gives businesses access to a huge number of potential customers from around the world.

### ACTIVITY 13.5

Read the following article about internet advertising.

Spending on internet advertising topped \$100bn for the first time last year. This represents 20% of the total amount spent on all advertising.

Unlike with traditional TV campaigns, businesses can target online advertisements at the right sort of people, using sophisticated data tracking technology.

- 1 Calculate the total amount spent on advertising last year.
- 2 What is the benefit to businesses of being able to 'target online advertisements at the right sort of people'?
- 3 Apart from the advantage of online advertising mentioned in the article, explain **two** other advantages of using internet technology to promote business.

### TEST YOURSELF

- 1 'The benefits of e-commerce outweigh the costs.' Do you agree? Justify your answer.

## Revision checklist

- The marketing mix is the four key decisions related to product, price, promotion and place that a business must take in order to market products effectively.
- Businesses must choose the most appropriate channel of distribution for selling their products to the final consumers.
- There are several methods of promotion a business might use to increase consumer awareness about its products and persuade consumers to buy them instead of competitors' products.
- E-commerce and social media networking provide huge marketing opportunities for businesses to promote and sell their products in global markets.

## Exam-style practice questions

- 1** Excel Shoes is a manufacturer of footwear. It produces a range of shoes for children and adults. This market is very competitive.

The owner directors of Excel are considering entering the market for safety footwear. This is a niche market. They have provided the marketing manager with a marketing budget of \$30 000 of which 40% is to be used on promotion for the new safety footwear.

- a** Define 'niche market'. [2]
- b** Calculate the budget for promotional activities. [2]
- c** Identify **four** methods of promotion that Excel could use to promote its new safety footwear. [4]
- d** Explain **two** benefits to Excel of carrying out market research into the safety footwear market. [6]
- e** Do you think that Excel Shoes should enter the safety footwear market? Justify your answer. [6]

- 2** The Regal Pottery Company (RPC) is a manufacturer of pottery, such as plates and cups. It produces high-quality items that celebrate events such as the Olympic Games and royal occasions as well as items celebrating different festivals. It distributes its products to the final consumer through middlemen in its own country and abroad.

RPC has recently invested in a new website. It is keen to develop markets through e-commerce and social media networking.

- a** Define 'e-commerce'. [2]
- b** Identify **two** methods RPC could use to price its products. [2]
- c** Outline how RPC could use the internet to promote its products. [4]
- d** Explain **two** advantages to RPC of using wholesalers to distribute its products. [6]
- e** Do you think RPC is right to develop markets through e-commerce and social media networking? Justify your answer. [6]

**Total available marks 40**

# 14

## Objectives

*In this chapter you will learn about:*

- marketing strategies
- legal controls on marketing strategy
- opportunities and problems entering foreign markets.

# Marketing strategy

## Introduction

We have looked at how marketing decisions are based on the four parts of the marketing mix. But marketing decisions are not taken separately for product, price, promotion or place. In this chapter you are going to learn how businesses combine the four marketing decisions into a marketing strategy.

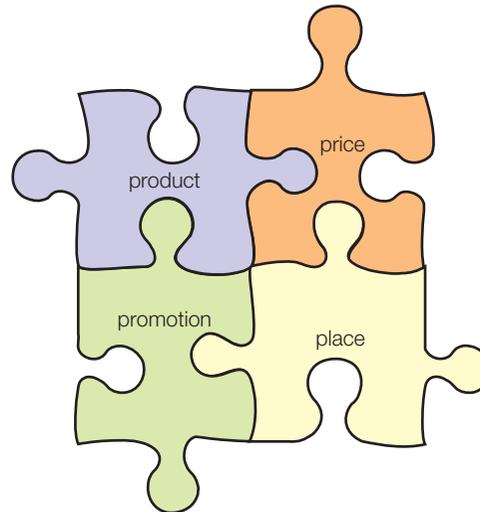


Figure 14.1 A combined marketing mix

### KEY TERM

**Marketing strategy:** a plan to achieve the marketing objectives using a given level of resources.



**Marketing budget:** see Chapter 13, page 185.

## Choosing a marketing strategy

A business produces a **marketing strategy** only after careful market research. The marketing strategy also contains details of the marketing budget.

### The marketing mix and consumer decisions

If a marketing strategy is to achieve a business's marketing objectives, then marketing decisions about product, price, promotion and place must be linked. This does not mean that each part of the marketing mix is of equal importance. How important each part of the marketing mix is in influencing consumers varies depending on the situation.

### ACTIVITY 14.1

Consider the following situations.

#### Situation A

The market for hair shampoo is very competitive. Most manufacturers' products are available in supermarkets. The prices of shampoo from the leading brands are very similar.

#### Situation B

A man is looking to purchase a piece of jewellery for his wife's birthday. He wants to buy something which is 'a little different' from the jewellery items he has seen in some of the larger jewellery retail outlets.

**Situation C**

A new mobile phone is soon to be launched on to the market by the market leader. The company will use market skimming to set the price.

**Situation D**

A large supermarket chain in Country X has announced that it will reduce fuel prices by 5% from next Monday. This will make its petrol and diesel much cheaper than all other major retailers.

Working in pairs, discuss which element of the marketing mix will be the most important to consumers in each situation.

**Deciding marketing strategy**

A business's marketing strategy is a plan to achieve its marketing objectives using a given level of resources.

Once a business has set its objectives then it will need to take decisions about product, price, promotion and place to achieve them. These decisions will depend to some extent on the marketing budget available and the stage the product is at in its life cycle.

**Product life cycle:**

see Chapter 12, page 167.

**ACTIVITY 14.2**

Cyber Software produces educational computer games aimed at children aged 5 to 11. It has developed a new game, Matrix, which is based on the adventures of a young boy who is able to travel backwards and forwards through time.

The marketing team has been asked to develop a strategy for the launch of Matrix. It has been allocated a promotional budget of \$20 000. The marketing director has set a sales objective of 5000 units in the first year.

The marketing manager has carried out market research using both primary and secondary research methods, including a focus panel of ten boys and girls from the target market who were given the opportunity to play the game and comment on what they liked and disliked. It was clear from the market research that Matrix could be a very popular product once one or two small changes had been made to the product and its packaging. However, the educational games market is very competitive. The marketing manager knows she will have to plan the marketing strategy for the launch of Matrix carefully if the marketing objective set by the director is to be achieved.

The marketing manager has decided to set a price which is almost the same as that of competitors' software products of a similar type.

Part of the budget for promoting Matrix will be used to place advertisements in children's magazines. She has asked another member of the marketing team to design a poster for display in shops that sell other Cyber Software products. She believes that Matrix can be distributed through existing channels of distribution.

Once the product has been launched, the marketing manager will monitor sales in the first few weeks to make sure that the strategy she has developed is working.

- 1 Why has the marketing manager carried out market research before the launch of Matrix on to the market?
- 2 Why did she decide to price the product 'close to competitors' prices'?
- 3 Why do you think the marketing manager decided to advertise Matrix in children's magazines and have a poster designed for shop display?
- 4 Why was Matrix not advertised on television?
- 5 What are the advantages to Cyber Software of using existing distribution channels for launching Matrix on to the market?
- 6 What is the benefit of monitoring the sales of Matrix in the first few weeks of it coming on to the market?

You should have learnt from Activity 14.2:

- the importance of market research in developing a strategy
- the need for a clear marketing objective(s)
- the need to consider each element of the marketing mix
- the constraint placed on a strategy by the marketing budget
- the importance of monitoring strategy to make sure it is working and will lead to the achievement of the marketing objective(s).

Using this experience you should now be able to develop a marketing strategy for other business situations.

### ACTIVITY 14.3

For this activity you should work in small groups.

The management of a large hotel in your country is considering ways of increasing room occupancy during the five off-peak months of the year. The hotel has very good leisure facilities, including a spa with heated indoor pool and beauty treatments. It has a very large room that is only used for wedding receptions about 30 times during the year. The hotel's restaurant has a very good reputation for food quality and providing value for money.

Develop a marketing strategy that might be used by the hotel to increase room occupancy during the five off-peak months of the year.

### TEST YOURSELF

- 1 Define 'marketing strategy'.
- 2 Why does a marketing strategy need SMART objectives?



#### KEY TERM

**Legal controls:** laws that control the activity of businesses.



#### EXPLORE!

Using the internet, newspapers and government publications, identify the legal controls that protect consumers in your country.

## Legal controls related to marketing

All areas of business are affected by **legal controls**. These controls are the laws and regulations of the country in which a business operates. Legal controls vary from country to country, but most countries have laws that protect consumers from unfair or dangerous business activity. The common legal controls on businesses which affect the marketing function are ones that:

- protect consumers from faulty and dangerous goods
- prevent businesses from using advertising to mislead consumers
- protect consumers from being exploited in industries where there is little or no competition.

### Impact of legal controls on marketing strategy

The first impact on businesses of any legal controls to protect consumers is that they will increase their costs. Products may need to be changed to meet minimum quality standards, or prevent any health and safety issues.

A large company that dominates a market may face legal controls, such as anti-trust or competition laws, if it is considered to be exploiting consumers by charging high prices or providing poor-quality goods or services.

Advertisements may have to be withdrawn and redesigned if they are found to contain misleading or inaccurate information. The business may have to advertise its product again. It may also be required to issue statements of apology in the newspapers and in the worst case might be fined for deliberately misleading consumers. All of these actions increase a business's costs.

#### ACTIVITY 14.4

Sugar 'n' Spice plc is a large manufacturer of confectionery products in Country Z.

The directors of Sugar 'n' Spice have decided to expand the business by entering new markets. Market research suggests that there is a good market for its products in Country Y. However, it will have to make some changes to its products to satisfy the legal controls in Country Y, which protect consumers from inappropriate business activity.

- 1 Define 'legal controls'.
- 2 Explain how legal controls in Country Y might affect Sugar 'n' Spice plc.
- 3 Explain **two** ways legal controls might protect consumers in Country Y.

#### TEST YOURSELF

- 1 Why are legal controls on the activities of businesses important to consumers?
- 2 Explain **two** legal controls placed on business activity in your country.

## Opportunities and problems of entering new foreign markets

E-commerce has enabled many businesses, of all sizes, to enter new foreign markets. However, this expansion does not have to be through e-commerce and there are many examples of businesses which now export their goods and services to other countries using traditional distribution channels.

### Growth potential of new markets in other countries

One of the reasons for businesses expanding into new markets in other countries is that the market in their own country has reached maturity, or might even be in decline. Other countries can offer huge marketing opportunities for increased sales, revenue and profits.



**Distribution channels:**  
see Chapter 13, page 179.



**Maturity and decline:**  
see Chapter 12, page 168.



Figure 14.2 There may be the potential for increased sales in other countries

**KEY TERM**

**Barriers to trade:** usually taxes, quotas or bans that one country places on the goods of other countries to prevent or increase the cost of them entering that country.

The increase in international marketing has been made possible because of developments in technology, for example the internet, better transport and communication links and agreements between different countries, which have reduced some of the **barriers to trade** between foreign countries.

**EXPLORE!**

Using newspapers, magazines, the internet or other media sources, find examples of businesses that have recently located in your country, or are looking to set up in your country.



**Barriers to trade:**  
see Chapter 26, page 328.

**Fuji Xerox sees big Burma opportunity**

A growing number of Japanese firms are now increasing their presence in Burma.

Photocopying giant Fuji Xerox is one such company aiming to boost its business in Burma.

The company's Asia Pacific president recently said that Burma offers big opportunities for his business.

## Problems of entering foreign markets

Although entering new foreign markets offers huge marketing opportunities, there may also be problems for businesses entering foreign markets. Figure 14.3 identifies the main problems a business may face when making the decision to sell its products in foreign markets.



Figure 14.3 Problems of entering foreign markets

### Differences in language and culture

It is easy to understand the difference in language between countries, but much more difficult to know the differences between cultures. However, both language and cultural differences can cause problems for a business wanting to sell its goods and services in another country.

Some words do not translate from one language to another, or may have a completely different meaning in another language.

Businesses must also consider cultural differences; for example, colours, numbers and symbols have different meanings and importance in different places. In some countries, for religious or other reasons, it would not be appropriate to use certain images in advertisements.

### Economic differences

The average income of consumers differs widely between countries. The cost of selling goods and services in foreign markets is often higher because of transport and other exporting costs. This might mean that the price charged to overseas consumers is higher than those in the **domestic market**. Consumers must have the income to be able to afford the prices charged. This problem is most noticeable when a business in a developed economy wants to sell its goods and services into a developing economy.

### Social differences

In some countries social factors such as the age structure of the population, the importance of family and the role of women all have an impact on business activity. For example, countries where the population has a high proportion of young

#### KEY TERM

**Domestic market:** the market for goods and services in the business's own country.

**Developed and developing economies:** see Chapter 2, page 23.

people, such as Indonesia, will have different needs and wants from countries where the population has a higher proportion of older people, such as the UK.

### Differences in legal controls to protect consumers

As mentioned above, countries have their own laws and regulations to protect consumers from unfair or dangerous business activity. These might be very different from the legal controls in the business's own country. Before a business decides to enter foreign markets it must make sure that its products and the way it conducts business satisfy the laws of the countries it is looking to expand into. This may mean changing its product, packaging or advertisements, all of which increase costs.

### Lack of market knowledge

Entering new markets for the first time presents two problems for most businesses:

- The business does not know the market.
- The market – consumers – does not know the business.

Some of the 'missing' knowledge relates to the factors discussed above. However, knowledge about market size, competitors, brand image and customer loyalty to existing products, consumer tastes and preferences, sources of media for promotion and channels of distribution is essential knowledge about the country and its markets.

These problems need to be fully understood if a business is to succeed when entering a new market in another country. A good example of how a business which is very successful in its home market might fail to succeed in entering foreign markets is the UK leading supermarket retailer Tesco.

### Tesco profits fall as supermarket pulls out of US

The UK's biggest supermarket, Tesco, has confirmed that it is pulling out of the US. As a result, the company's annual profits have fallen for the first time in nearly 20 years.

Tesco is exiting its US chain of 199 Fresh & Easy shops, which have never made a profit, at a cost of £1.2bn.

Tesco is also exiting Japan, and plans to take a more measured approach to its growth in China.

A spokesperson for Cass Business School has said that Tesco's failure to understand the differences between the retail landscapes of the UK and the US is at the heart of the problem.

Source: Adapted from [www.bbc.co.uk/news/business-22179255](http://www.bbc.co.uk/news/business-22179255)

### Methods to overcome problems of entering foreign markets

Many of the problems that a business may face when entering new markets in another country can be overcome by detailed market research. However, this can be costly.

Other options for expanding into international markets include:

- franchising
- licensing
- joint ventures.



**Franchising:** see Chapter 4, page 50.

### International franchising

International franchising is similar to franchising in the same country and the benefits of this form of business organisation were discussed in Chapter 4. This method of entry into new markets in other countries is often used by Subway.

## Subway opens 100th outlet in UAE, 44th in Kuwait and 41st in Saudi Arabia

**18 Oct 2010** – Subway restaurant chain, the world's largest submarine sandwich franchise, today announced the opening of its landmark 100th store in the UAE, 44th in Kuwait and 41st in Saudi Arabia.

Subway has also unveiled plans to add three new stores in Kuwait and two in Saudi Arabia by the end of 2010.

Source: Adapted from [www.zawya.com/story/ZAWYA20101017080927/](http://www.zawya.com/story/ZAWYA20101017080927/)

### Licensing

A business in one country permits a firm in a foreign country to produce its branded product 'under licence'; for example the New Zealand company Donovan Group manufactures a range of products for the construction industry under licence. The main benefit of this method of international marketing is that the goods are produced in a country by a firm that understands the local market. All of the problems of entering foreign markets are removed, except perhaps the lack of consumer knowledge about the product.

However, the limitation of licensing is the risk of poor quality or other problems that could damage the reputation of the business whose product it is.

### Joint ventures

Sometimes it is beneficial to two or more businesses to work closely together on a particular business opportunity. The main reasons for this close working relationship, known as a **joint venture**, are:

- It reduces risk and cuts costs.
- Each business brings different expertise to the joint venture.
- The market potential for all the businesses in the joint venture is increased, especially if each business operates in different geographical regions/countries.
- Market and product knowledge can be shared to the benefit of the businesses in the joint venture.

However, joint ventures have limitations, such as:

- Any mistakes made will reflect on all parties to the joint venture. This may damage the reputation of all firms in the joint venture, even if they were not the cause of the mistake.
- The decision-making process may be ineffective due to different business culture or different styles of leadership within each of the joint venture partners.



#### KEY TERM

**Joint venture:** an agreement between two or more businesses to work together on a project.

## Gerdau joint venture

**RIO DE JANEIRO** – Gerdau SA, Latin America's biggest steelmaker, wants to expand in India, where it may also consider a move into iron ore.

Gerdau will start up its first Asian venture in India later this year (2012), producing some 300 000 metric tons a year of rolled

specialty steel and construction rebars for the local market, in a joint venture with Kalyani Steels Ltd, at a plant near Bangalore.

The Gerdau group may also look to mine iron ore in India, where there are large reserves of this main steelmaking ingredient.

*Source:* Adapted from [www.4-traders.com/GERDAU-SA-6492877/news/Brazil-s-Gerdau-CEO-Says-India-Is-Beachhead-For-Asian-Expansion-14398475/](http://www.4-traders.com/GERDAU-SA-6492877/news/Brazil-s-Gerdau-CEO-Says-India-Is-Beachhead-For-Asian-Expansion-14398475/)

### TASK

- a Define 'joint venture'.
- b Using the information in the case study, explain the benefits to Gerdau and Kalyani Steels Ltd of entering into a joint venture.
- c Do you think there are any disadvantages to either company of entering into a joint venture?

### TEST YOURSELF

- 1 Explain **two** reasons why a business might want to expand into other countries.
- 2 Explain **two** problems a business might face when expanding into other countries.

## Revision checklist

- A marketing strategy requires a combination of the elements of the marketing mix with an appropriate level of resources to achieve marketing objectives.
- Marketing activities are influenced and constrained by legal controls aimed at protecting the consumer.
- Entering foreign markets can present huge marketing opportunities for businesses, but they should be aware of the potential limitations of such expansion.

## Exam-style practice questions

- 1** Sublime is a well-known chocolate manufacturer in Country Y. The company has developed a new chocolate bar. It wants to launch this product on to the market in two months' time. The marketing director has set a marketing objective for the new product of 2 000 000 units of sales in the first year.
- a** Define 'marketing objective'. [2]
  - b** Identify **two** methods of promotion Sublime could use for the launch of the new chocolate bar. [2]
  - c** Outline **two** methods of pricing Sublime could use when launching its new chocolate bar. [4]
  - d** Explain **two** reasons why it is important for Sublime to develop new products. [6]
  - e** The Marketing Director believes that product and price are the two most important elements of the marketing mix. Do you agree? Justify your answer. [6]
- 2** Sung Song, the owner of a new Chinese takeaway outlet, is disappointed with sales in the first three months of business. There are several takeaway competitors locally. His prices are a little higher than his closest competitor. However, the customers who have bought his food say it is the best in town.
- He has asked a small business adviser to help him improve sales. The adviser has made the following recommendations:
- Develop a marketing strategy.
  - Set a marketing budget.
  - Increase sales promotion.
- a** Define 'sales promotion'. [2]
  - b** Identify **two** features of a marketing strategy. [2]
  - c** Outline the importance to Sung Song of setting a marketing budget. [4]
  - d** Explain how sales promotions might increase the sales of Sung Song's business. [6]
  - e** Do you agree with the business adviser's recommendation that a marketing strategy will increase Sung Song's sales? Justify your answer. [6]

**Total available marks 40**

## Exam-style case study

### Teen Fashions

Teen Fashions is a manufacturer of clothing aimed at fashionable young females. The company has a strong brand image in Country X, which is where all of its products are sold. Its current channel of distribution is shown in Appendix 1.

Shaun, the recently appointed marketing director, suggested in a recent board meeting that Teen Fashions should consider e-commerce for the business. 'Many of our competitors have an online presence and we are in danger of losing market share if we don't do the same,' he said.

The operations director was not in favour of Shaun's suggestion (see Appendix 2).

Sharee, the CEO of Teen Fashions, thinks that the company needs to consider expansion. She has identified two possible options:

#### Option 1

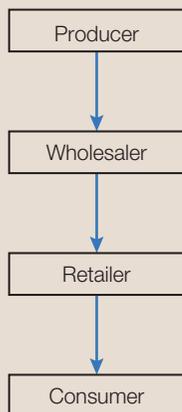
Manufacture clothing for females in the 25–40-year-old age bracket. Many of these women will have bought clothing manufactured by Teen Fashions when they were younger so they are aware of the brand. Teen Fashions' marketing manager has been asked to carry out market research for this proposed new market.

#### Option 2

Enter foreign markets. Sharee has just returned from a trade mission organised by the government of Country X, to several countries in the region. She has identified Country Y as a possible market for this expansion. An extract from her report to other members of the board is shown in Appendix 3.

#### Appendix 1

##### Current distribution channel



#### Appendix 2

##### Email from the operations director to Shaun

*In addition to operational factors such as higher inventories and setting up a department to handle e-commerce sales, we will also require a new website to be designed and created. All of this will be very expensive and I am not sure it will give our shareholders a good return on their investment.*

#### Appendix 3

##### Extract from report on visit to Country Y prepared by Sharee

- Country Y has a large percentage of the population under the age of 25.
- Despite the recession in most parts of the world, Country Y's economy has been growing rapidly and as a result consumers have high levels of disposable income.

The CEO is aware of the problems Teen Fashions might face when entering this new market, but feels that, with careful planning, these can be overcome.

- 1 a** Explain **two** benefits to Teen Fashions of having a 'strong brand image'.

Benefit 1:

Explanation:

Benefit 2:

Explanation:

[8]

- b** Consider how the following **three** factors influence the demand for Teen Fashions products.

Which factor do you think is the most important? Justify your answer.

Price of Teen Fashion products:

Consumer income:

Quality of Teen Fashion products:

Conclusion:

[12]

- 2 a** Explain **one** advantage and **one** disadvantage to Teen Fashions of its current channel of distribution shown in Appendix 1.

Advantage:

Explanation:

Disadvantage:

Explanation:

[8]

- b** The marketing director and the operations director disagree about the benefits to Teen Fashions of e-commerce. Consider their views and recommend whether or not Teen Fashions should develop e-commerce activities. Justify your answer.

Marketing director's view:

Operations director's view:

Recommendation:

[12]

- 3 a** Explain **two** benefits to Teen Fashions of the marketing manager carrying out market research for Option 1.

Benefit 1:

Explanation:

Benefit 2:

Explanation:

[8]

- b** The Board of Directors has agreed that Teen Fashions needs to expand the business. Consider Option 1 and Option 2.

Which option do you think it should choose? Justify your answer.

Option 1:

Option 2:

Recommendation:

[12]

- 4 a** Explain **two** methods of promotion Teen Fashions might use if it chooses Option 1 to expand the business.

Method 1:

Explanation:

Method 2:

Explanation:

[8]

- b** Explain how each of the following **three** factors might influence the success of Teen Fashions entering Country Y.

Which of these factors do you think is likely to be the most important? Justify your answer.

Social differences:

Differences in language:

Differences in legal controls to protect consumers:

Conclusion:

[12]

## Section 4: Operations management

All businesses in the private sector have profit as their main objective. They cannot achieve this objective if they don't produce and sell products. In this section you will learn about the production process and how businesses combine inputs to produce a saleable output. Before a business can begin to produce goods and services it must decide on a location. Factors affecting location decisions, including the role of legal controls, are considered in this section. There are different methods of production a business may use and the decision as to which is best is something you will consider.

The importance of productivity and how this might be improved through the development of employees or the use of technology is also something you will learn about in this section. Efficient production requires management to carefully control business costs. The classification of costs and how this might be used in break-even charts and in making production decisions is an important element of your learning in this section. You will also learn about the importance of quality and how this might be achieved in different sectors of business activity.

# 15

## Production of goods and services

### Objectives

*In this chapter you will learn about:*

- the production process
- production methods and how these are influenced by technology
- the difference between goods and services
- how to explain, measure and increase productivity
- why businesses need to hold and control inventories.

### Introduction

All businesses in the private sector provide goods and services to customers with the primary objective of earning profit. These goods and services are the output of a production process. In this chapter you will learn about the different production methods used by businesses and the factors that influence their choice. You will also learn how businesses measure and improve the effectiveness of their production processes and the impact that technology has on these processes. The chapter looks at the importance of inventories to the production process and business costs.

### What is production?

The traditional view of **production** was the making of inputs such as land, labour and capital into physical goods such as motor cars, clothing and computers. Since the decline of the secondary sector and the growth of the tertiary sector in many countries, the term now includes production of goods and services from all businesses in the primary, secondary and tertiary sectors.

#### KEY TERM

**Production:** the process of converting inputs such as land, labour and capital into saleable goods, for example shoes and cell phones.

**Primary, secondary and tertiary sectors:** see Chapter 2, page 20.

### Managing resources to produce goods and services

#### The production process

Operations management involves managing business resources – known as inputs – throughout the production process so as to produce finished goods, services and components – known as output – that can be sold to other businesses or customers. For example, a baker (labour) will take ingredients such as flour and water to his kitchen (land) and use mixers and ovens (capital) to make bread (the output), which he will sell in his shop to customers.



Figure 15.1 The production process

Operations management must:

- use resources in the most cost-effective way
- produce the required output to meet consumer demand
- meet the quality standard expected by consumers.

### ACTIVITY 15.1

Using Figure 15.1 as a template, draw similar diagrams for three different products produced by primary, secondary and tertiary business activity. You should identify the resources used and the good or service produced.



#### KEY TERM

**Productivity:** a measure of the efficiency of inputs used in the production process, especially labour and capital.

### Difference between production and productivity

It is important not to confuse production with **productivity**. Production involves changing inputs into output. It can be measured by the number of units produced in a given period of time – this is the level of production. Productivity is a measure of how efficiently the inputs are changed into output, which is the number of units of output produced for every unit of input.

The productivity of labour (employees) is measured as follows:

$$\text{Labour productivity} = \frac{\text{Total output}}{\text{Number of production employees}}$$

### Benefits of increasing efficiency and how to increase it

All businesses will try to increase productivity because this usually reduces average costs – the cost of producing each unit of output.

#### How to improve labour productivity

If you look again at the formula for labour productivity above, you will see that if a business wants to improve its labour productivity it can do this by:

- increasing output with the same number of employees
- keeping output at the same level but with fewer employees.

To increase total output with the same number of employees means that, on average, each employee needs to produce a greater output. This means they must become more productive. Increasing the productivity of employees could be achieved by:

- improving the skill level of employees
- improving the motivation of employees
- introducing more automation and more or better technology
- improving the quality of management decisions.

### ACTIVITY 15.2

In pairs or small groups discuss:

- 1 How could a business achieve each of the four 'improvements' identified above?
- 2 Why do larger businesses find it easier to achieve improvements in productivity than smaller businesses?

**TOP TIP**

Productivity should always be linked to the effect on cost per unit of output. They will move in opposite directions. A business will always want productivity to rise because this will mean a fall in cost per unit.

**KEY TERM**

**Inventories:** the stock of raw materials, work-in-progress and finished goods held by a business.

All of the ways of improving productivity will add to a business's costs, for example the cost of training programmes, introducing schemes to motivate employees or purchasing new machinery. The main reason for improving productivity is to reduce unit costs, so the increase in output must be greater than the increase in costs.

**Why businesses hold inventories**

Almost all businesses hold **inventories** of:

- raw materials and components – these are needed as inputs for the production process
- work-in-progress – that is, part-finished goods that have not yet completed the production process
- finished goods ready to be sold or sent out to customers.

**Inventories**

Holding inventories adds to a business's costs, such as:

- **Warehousing costs** – the business will need to rent or purchase a warehouse to store the inventories.
- **Handling costs** – inventories need to be moved into and out of the warehouse.
- **Shrinkage costs** – damaged, lost or stolen inventories will need to be replaced.
- **Insurance costs** – these will cover the cost of losses from shrinkage.
- **Obsolescence** – the business may not be able to sell out-of-date goods.
- **Opportunity cost** – working capital is 'tied-up' in inventories which could be used more profitably by the business.



**Opportunity cost:** see Chapter 1, page 12.

If holding inventories is costly, then why do businesses hold them?

- The production process needs raw materials or components. If these are not available when required then the process must stop. Employees and machinery will stand idle and there will be a loss of output.
- If the business does not have finished goods in stock, then customers' orders cannot be met and the business will lose sales. This could result in the loss of current and future sales, affecting both the short-term and the long-term profitability of the business.
- Businesses often benefit from economies of scale when they buy inventories in large quantities because they receive a discount from the supplier. The supplier may not offer discounts for smaller quantities.

Businesses have to balance the costs of holding inventories with the costs of not holding inventories in order to minimise inventory costs.

### Lean production

Earlier in this chapter we looked at the benefits to a business of improving productivity and how this can reduce the cost of producing each unit of output. This can be used to reduce the final price of the product and enable the business to be more competitive. This is particularly important for businesses operating in global markets as the level of competition is likely to be much greater than that for those businesses that operate in more local markets. However, lower costs and prices must not lead to a reduction in the quality of the business's products, otherwise it may lose customers and its competitiveness and profitability will suffer.

Many businesses use **lean production** methods in order to improve their competitiveness. Lean production aims to lower the costs of production by reducing waste to a minimum while maintaining, or even improving, the quality of the finished product. At the same time, inputs to the production process must be used efficiently.

The main sources of waste in business are shown in Figure 15.2.

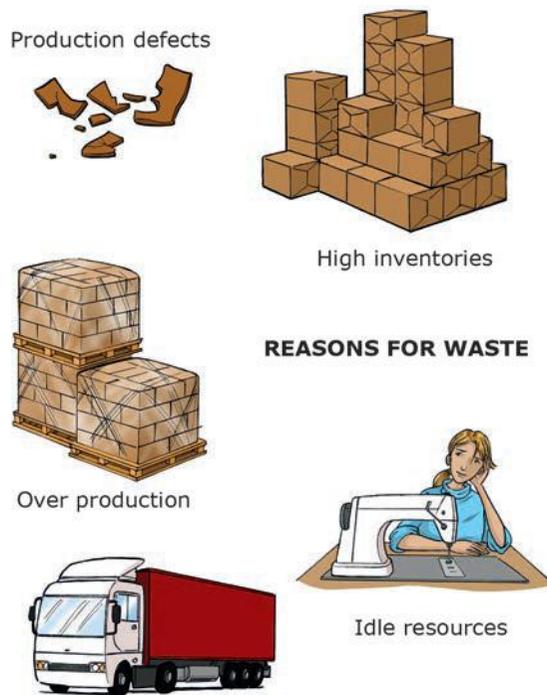


Figure 15.2 Sources of business waste



**Economies of scale:** see Chapter 16, page 219.

**Working capital:** see Chapter 20, page 263.



**KEY TERM**

**Lean production:** the production of goods and services with the minimum waste of resources.

All of these sources of waste increase a business's costs which, in turn, will reduce its competitiveness and profitability. Therefore, the introduction of lean production techniques such as just-in-time inventory management and Kaizen (continuous improvement) will bring the following benefits:

- New products can be brought to the market more quickly.
- Quality is improved.
- Wastage of time and other resources is reduced or eliminated.
- The costs of holding inventories are eliminated.
- Unit costs are reduced, which will increase the profit made on each unit sold or enable a business to reduce its prices and be more competitive. This will increase sales, revenue and profits.

### Just-in-time (JIT) inventory control

The just-in-time (JIT) inventory control system means that no inventories are held by the business. Raw materials and components arrive from suppliers just as they are needed by the production process. As soon as finished goods leave the production process, they are delivered to the customer. JIT inventory control reduces business costs by removing the costs of holding inventories.

However, for JIT to be successful it must also remove the costs of not holding inventories which we looked at earlier. To achieve this, businesses need to have an excellent relationship and good communication with suppliers. The raw materials and components have to be delivered on time and be of the required quality and quantity. In addition, both the employees and the machinery used in production must be flexible – that is, they must be able to switch from one product to another at short notice.

### ACTIVITY 15.3

The new operations director of Practical Plastic Products (PPP) wants to introduce JIT inventory control. He believes that it will bring important benefits to the company. At a recent board meeting, he said, 'The introduction of JIT inventory control will save \$40 000 per year in warehousing costs and there will be other cost savings too.'

The marketing director was worried about the risk to the company's reputation if it failed to meet customer deliveries. The finance director was concerned about the extra costs of new technologies required to improve communications with suppliers. The human resources director wondered how the introduction of JIT could affect some employees.

- 1 What other costs savings do you think the introduction of JIT inventory control could bring to PPP?
- 2 Do you think the marketing director is right to be worried about the risk to PPP's reputation if JIT is introduced?
- 3 What are the 'new technologies' mentioned by the finance director, and why are they needed to improve communications with suppliers?
- 4 How do you think the introduction of JIT could affect some of PPP's employees?

### Kaizen

Kaizen is a Japanese term meaning 'continuous improvement'. The Kaizen approach gives all employees the opportunity to make suggestions about how to improve quality or productivity. Employees are doing the tasks every day and so they may know better than managers how to change the production process to make it more efficient. The changes suggested by individual employees may be very small, but all of these small improvements can lead to big improvements in efficiency.

## TEST YOURSELF

- 1 Define 'production'.
- 2 With the aid of examples, explain the difference between 'goods' and 'services'.
- 3 State **three** ways of improving labour productivity.
- 4 What is the main objective of lean production?

## The main methods of production

The production of goods and services has traditionally used one of the following methods:

- job production
- batch production
- flow production.

### Job production

In **job production** an individual item is completed before another is started. This method is normally used for the production of single or one-off/unique items, large or small, such as a ship or a designer dress. Job production usually needs highly skilled employees and specialised equipment.



Job production

#### KEY TERM

**Job production:** the production of items one at a time.

#### KEY TERM

**Batch production:** the production of goods in batches. Each batch passes through one stage of production before moving on to the next stage.

### Batch production

In **batch production** a group of items is completed one stage of the production process at a time, through to completion. A good example of batch production is the making of bread in a bakery (Figure 15.3). Once stage 1 of the process has been completed, the baker can use the mixer to start the production of another batch of products such as a different type of bread, or a different product altogether such as doughnuts.

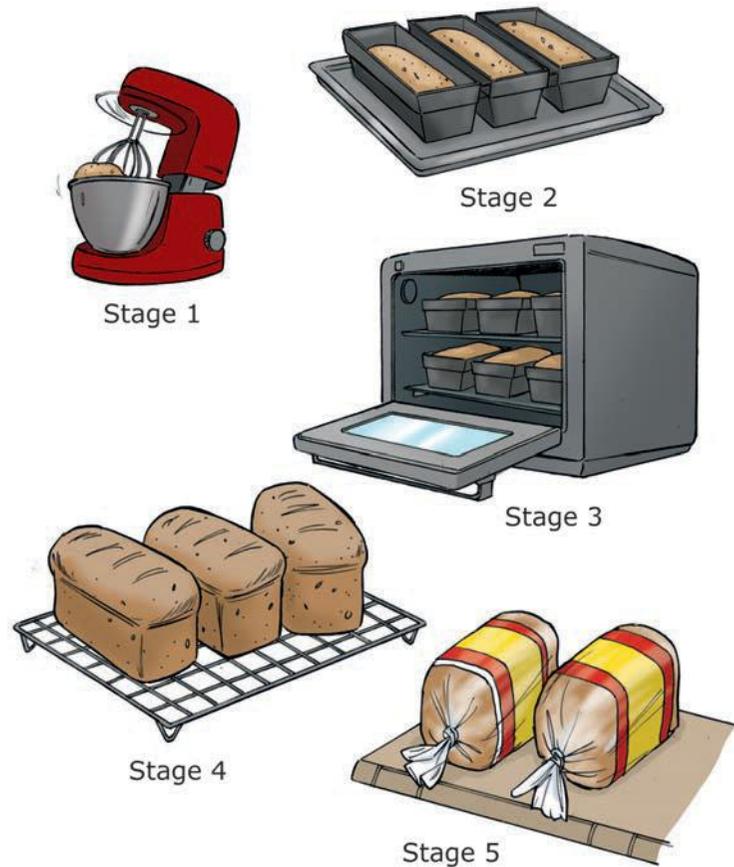


Figure 15.3 Stages of bread production

**KEY TERM**

**Flow production:** the production of very large quantities of identical goods using a continuously moving process.

### Flow production

The process of **flow production** involves products moving continuously along a production line. At each stage of production additional features are added until the product reaches its finished state. This type of production is used where a large output of identical, standardised products is required, to meet high consumer demand, for example bars of chocolate. This is why flow production is also known as mass production.



Mass production  
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The main features of flow production are:

- large quantities are produced
- standardised products
- employees are relatively unskilled
- high degree of automation
- large inventories of raw materials and work in progress.

Each of these methods has its benefits and limitations – see Table 15.1.

Method of production	Benefits	Limitations
Job	<ul style="list-style-type: none"> <li>■ Unique, high-quality products are made.</li> <li>■ Employees are often more motivated and take pride in their work.</li> </ul>	<ul style="list-style-type: none"> <li>■ Uses skilled labour rather than machinery, so selling prices are usually higher.</li> <li>■ Production can take a long time and can be expensive, for instance if special materials or tools are required.</li> <li>■ Economies of scale are not possible, often resulting in a more expensive product.</li> </ul>
Batch	<ul style="list-style-type: none"> <li>■ Since larger numbers are made, unit costs are lower.</li> <li>■ Offers the customer some variety and choice.</li> <li>■ Materials can be bought in bulk, so they are cheaper.</li> </ul>	<ul style="list-style-type: none"> <li>■ Employees are often less motivated because the work becomes repetitive.</li> <li>■ Goods have to be stored until they are sold, which is expensive.</li> </ul>
Flow	<ul style="list-style-type: none"> <li>■ More <b>capital intensive</b> than job or batch production, which lowers the labour cost.</li> <li>■ Materials can be purchased in large quantities, so they are often cheaper due to bulk-buying economies of scale.</li> <li>■ Large number of goods are produced.</li> </ul>	<ul style="list-style-type: none"> <li>■ Requires very large capital investment in production line technology.</li> <li>■ Employees are not very motivated, since their work is very repetitive.</li> <li>■ It is not a very flexible method as production lines are difficult to change.</li> <li>■ If one part of the production line breaks down, the whole production process will have to stop until it is repaired.</li> <li>■ High levels of raw materials, work-in-progress and finished goods inventories are held. This increases business costs.</li> </ul>

Table 15.1 Benefits and limitations of job, batch and flow production

### Choosing the method of production

Firms choose their method of production based on a number of factors, such as:

- the amounts they are likely to sell
- the product they are making
- the costs of production
- the variety of goods expected by customers.

**KEY TERM**

**Capital intensive:** production process that uses a high quantity of capital equipment compared with labour input.

**EXPLORE!**

Find a member of your family, a friend or a neighbour who works for a business involved in manufacturing. Ask them to explain how the product(s) are produced. Is it batch or flow production? What is their role in the process? Do employees specialise in one task, or do they do a variety of tasks? Ask them if they enjoy their work – if they do, why? If not, why not? Does the production process use more employees than machines? Are employees paid piece-rate or hourly rate and do they receive a bonus?

The most appropriate method of production will depend on:

- the size of the market
- the type of good being made.

#### ACTIVITY 15.4

Clarendon Fashion manufactures women's clothing. Its large factory is divided into three areas, each of which uses different methods of production. The company's main customers are:

- a large fashion retailer with many outlets in Country Y
- small independent clothing retailers in Country Y
- a bespoke service for wedding dresses, which are designed and then produced by the company's designers following a meeting with the customer.

- 1 What are the advantages to Clarendon Fashion of having three different types of customers?
- 2 What do you think is the main benefit to the company of the bespoke design and production of wedding dresses?
- 3 Discuss the most appropriate methods of production for each of Clarendon Fashion's main markets.

#### TEST YOURSELF

- 1 State **two** differences between job production and flow production.
- 2 State **two** factors that influence the choice of production method.

## How technology has changed production methods

Recently, there has been a move towards more modern production methods. These 'new' methods of production combine the advantages of the traditional methods outlined above, while at the same time avoiding many of their limitations. They have been influenced by developments in technology and, in particular, the development of computer-aided design (CAD), computer-aided manufacturing (CAM) and computer-integrated manufacturing (CIM).

The use of computers in design has enabled businesses to develop products much more quickly than in the past. Products can be designed and displayed in three dimensions (3D) on computer screens. Special computer software can be used to test different features of the product's design, for example to check the product's safety. Any changes can be easily and quickly made. Being able to design and test products using computer technology saves businesses money. They do not have to build and rebuild expensive prototypes until they have produced on screen what they think is close to the finished product.

The development of 3D printers is the latest technology to aid the production process. For some time these printers have been used to produce prototypes, but they are now being used to produce finished products in materials such as metals, plastic and rubber.

Once a product has been designed and tested it can be produced much more quickly with the aid of computer technologies. In computer-aided manufacturing (CAM), computers control the machinery and equipment used in the production process. Manufacturing is more capital intensive, which reduces the need for labour and, therefore, reduces production costs.



#### EXPLORE!

To find out more about the future of 3D printers in the design and manufacturing process go to the following websites:

- [www.youtube.com/watch?v=CP1oBwccARY](http://www.youtube.com/watch?v=CP1oBwccARY)
- [www.bbc.co.uk/news/22293523](http://www.bbc.co.uk/news/22293523)



Computer-integrated manufacturing

In some industries, for example car manufacturing, computer-integrated manufacturing has completely changed the production process. The use of robots and other technologies has enabled some manufacturers to have production lines or their entire factory controlled by computers. Computer-controlled robots are able to complete simple or complex task very quickly and more accurately than employees.

Technology has not only changed the way goods are manufactured, but has also influenced the provision of services. Many large electrical items, such as washing machines, dishwashers and televisions, have built-in technologies that diagnose faults. Banking services such as cash deposits, cash withdrawals and moving money between different accounts are almost always done these days with the aid of computers.

Many retailers use electronic funds transfer at the point of sale (EFTPOS) to enable customers to buy goods using debit or credit cards instead of paying by cash or cheque. Larger retailers, especially supermarkets, use an electronic point of sale (EPOS) system not only to calculate the amount purchased by consumers, but also to manage their inventory levels of each item.

Many retailers use electronic funds transfer at the point

**TOP TIP**  
Focus on how new technology affects businesses in terms of capital costs and opportunities for cost savings as well as how stakeholders such as employees and customers might be affected.

### Advantages and disadvantages of new technology

You have learnt how technology has changed not only the way goods are manufactured, but also the way services are provided to consumers. It is clear that technology brings many advantages to both business and consumers. However, technology does have some disadvantages for businesses and also employees.

The main advantages and disadvantages to businesses, employees and consumers are shown in Table 15.2.

	Advantages	Disadvantages
Businesses	<ul style="list-style-type: none"> <li>Reduces the costs and time taken to design new products.</li> <li>Increases productivity.</li> <li>Reduces costs of production.</li> <li>Improves quality and reduces waste.</li> </ul>	<ul style="list-style-type: none"> <li>Can be very expensive.</li> <li>When technology is rapidly changing it will need to be changed often if the business is to remain competitive.</li> <li>May need to spend money training employees, which increases costs.</li> </ul>
Consumers	<ul style="list-style-type: none"> <li>Better quality products.</li> <li>Lower prices.</li> <li>Products with more features are easier to develop and produce.</li> </ul>	<ul style="list-style-type: none"> <li>Products may become out of date more quickly.</li> <li>When the product develops a fault it can be expensive to repair.</li> </ul>
Employees	<ul style="list-style-type: none"> <li>Technology completes simple and repetitive tasks that employees find boring.</li> <li>The work is easier with the aid of technology.</li> <li>A business that uses the latest technology is likely to be more successful so provides job security.</li> </ul>	<ul style="list-style-type: none"> <li>Technology often reduces the need for employees, resulting in redundancy.</li> <li>Technology could make the work less interesting.</li> <li>A smaller workforce reduces opportunities for promotion.</li> <li>The development and manufacture of new technology products provide employment opportunities.</li> </ul>

Table 15.2 Advantages and disadvantages of new technology for businesses, consumers and employees

For both businesses and consumers the advantages of new technology are usually greater than the disadvantages. For employees it is less clear. For some employees the advantages will outweigh the disadvantages. However, for others, especially those who lose their job as a result of the introduction of new technology, the disadvantages are clearly greater.

## CASE STUDY

## Brakes on India's car market

Current car sales in India are in sharp contrast to the 20–30% annual growth rate of recent years. Such growth encouraged huge investment in India by foreign car manufacturers into building new factories, equipped with the latest in computer-aided design and manufacturing processes.

The same manufacturers are now seeing the Indian market shrink. Ford reported its February 2013 Indian sales fell to 4490 units, while GM's sales were down to 7106 units. To reduce inventories, some car manufacturers are considering adopting lean production techniques such as just-in-time inventory management.

The one bright spot has been sales of sport utility vehicles (SUVs). SUV purchases soared by 35% in February. French carmaker Renault has done particularly well with its Duster SUV. Its sales increased significantly to 6723 units in February from 4127 the previous month.

### TASK

- a Calculate how many more cars GM sold in February 2013 than were sold by Ford in the same period.
- b Calculate the percentage growth in Renault SUV sales between January 2013 and February 2013.
- c Define 'inventories'.
- d Define 'computer-aided manufacturing'.
- e Explain **one** advantage and **one** disadvantage to car manufacturers of computer-aided design.
- f Do you think car manufacturers in India should introduce just-in-time inventory management? Justify your answer.

### TEST YOURSELF

- 1 Define 'computer-aided design'.
- 2 Explain **one** advantage and **one** disadvantage to a business of new technology.

## Revision checklist

- The production process takes inputs such as land, labour and capital and converts these into goods and services for use by other businesses or for sale to the final consumer.
- The process of converting inputs into outputs might use job, batch or flow production methods.
- The introduction of lean production techniques and new technology into the production process has brought many advantages, and some disadvantages, for businesses, consumers and employees.
- Productivity measures the efficiency of labour or capital and any improvement in productivity will reduce the cost of producing each unit of output.
- Most businesses hold inventories. The level of inventories held needs careful management to minimise the costs of holding and not holding them.

## Exam-style practice questions

- 1 The table below shows the data for two companies which manufacture printers for use with computers. Both companies use flow production techniques.

Production data	Company A	Company B
Units produced per week	8000	9600
Number of employees	25	40
Labour productivity	See Question 1(b)	240 units per week
Average weekly wage	\$160	\$150
Profit per unit	\$24	\$23

The directors of Company B are deciding whether or not to introduce new technology into the production process. They have a report from the operations director explaining the advantages and disadvantages of doing so.

- Define 'flow production'. [2]
  - Calculate the labour productivity for Company A. [2]
  - Outline **one** advantage and **one** disadvantage of flow production. [4]
  - Explain **two** possible reasons why the labour productivity for Company B is lower than that for Company A. [6]
  - Do you think the directors of Company B should introduce new technology into the production process? Justify your answer. [6]
- 2 Nice 'n' Spicy produces ready-made meals using the batch production method.

The company has been asked to supply a large national supermarket chain with one of its most popular dishes. The supermarket would need 5000 units per week for the next 12 months and, if the product proved popular, further orders would be placed.

Nice 'n' Spicy would need to invest in a new flow production line for this order.

The operations director, Nasreen, realises this new order will increase the raw materials she needs for production. She is thinking about introducing just-in-time inventory management.

- Define 'inventories'. [2]
- Identify **two** inputs of the production process. [2]
- Outline **two** advantages to Nice 'n' Spicy of batch production. [4]
- Explain **two** benefits to Nice 'n' Spicy of just-in-time inventory management. [6]
- Do you think Nice 'n' Spicy should accept the order from the supermarket chain? Justify your answer. [6]

**Total available marks 40**

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# 16

## Objectives

*In this chapter you will learn about:*

- the different classifications of business costs
- the usefulness of cost data in business decision-making
- economies and diseconomies of scale
- break-even analysis.

# Costs, scale of production and break-even analysis

## Introduction

Businesses have to make many decisions. Most business decisions require managers to have accurate data about the costs involved. In this chapter you will learn about the different ways of classifying costs.

The classification of costs helps in business decision-making. You will learn how the classification of costs is important when using the techniques of break-even analysis. This is a technique that is used by many businesses when analysing the relationship between their revenue, costs and volume of output.

You will also study the effect of the scale of production on business costs and how these might change as a business grows.

## How are costs classified?

The main classifications of cost are:

- fixed costs
- variable costs
- total costs
- average costs.

Fixed costs, variable costs and total costs are usually explained by linking them to the level of a business's output.

### Fixed and variable costs

**Fixed costs** do not change with output. In other words, a fixed cost will be the same amount when output is zero or when the firm is producing its maximum output – this is known as capacity. Good examples of a fixed cost are factory rent, or the salary of managers.

**Variable costs** change with output. If output increases by 50%, then the variable costs will also increase by 50%. A good example of a variable cost is raw materials.

**Total cost** is all the costs of making a certain level of output. If the fixed costs of producing 2000 units of output is \$3000 and the total variable costs of producing 2000 units is \$5000, then the total cost of producing 2000 units is \$8000 (\$3000 + \$5000).

$$\text{total cost} = \text{fixed costs} + \text{total variable costs}$$



### KEY TERMS

**Fixed costs:** costs that do not change with output.

**Variable costs:** costs that change in direct proportion to output.

**Total cost:** all the variable and fixed costs of producing the total output.

**ACTIVITY 16.1**

Khaliq, the owner of The Casual Shoe Company (TCSC), knows that it is important to classify costs properly when making business decisions. He has asked you to help him classify the following costs. Copy and complete the table below. The first cost has been completed as an example.

	Fixed	Variable
Factory rent	√	
Leather used in making some shoes		
Electricity used to power machinery		
Machinery maintenance		
Advertising		
Production workers' wages		
Operations manager's salary		
Delivery of finished goods to customers		
Safety equipment for production workers		

**KEY TERM**  
**Average costs:** the cost of producing a single unit of output.

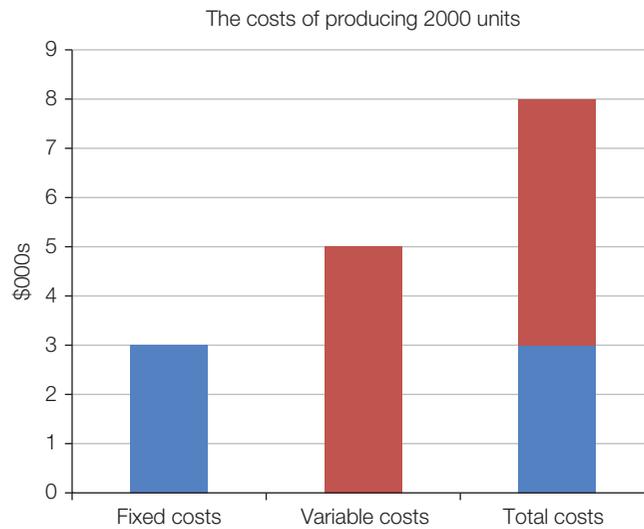


Figure 16.1 Total cost = fixed costs + total variable costs

**EXAMPLE**

TCSC has monthly fixed costs of \$2000. The variable cost per pair of shoes is \$3. In January TCSC makes 1000 pairs of shoes. The total variable cost of producing 1000 pairs of shoes in January will be:

$$1000 \times \$3 = \$3000$$

TCSC's total costs for January will be:

$$\begin{aligned} &\text{monthly fixed cost} + \text{total variable costs for January} \\ &\$2000 + \$3000 = \$5000 \end{aligned}$$

**Average cost** is the cost of making one unit of output. It is calculated as follows:

$$\text{average cost} = \text{total cost} / \text{output}$$

This is an important cost concept because businesses often use average cost as the basis for calculating a product's price. We can calculate TCSC's average cost of producing one pair of shoes in January.

$$\$5000 / 1000 = \$5$$

## ACTIVITY 16.2

The following are the costs of The Casual Shoe Company at different levels of output.

Output (pairs of shoes)	Fixed Costs	Variable Costs \$3 per pair of shoes	Total Costs
	\$	\$	\$
0	2000		
1000	2000	3000	
2000	2000		
3000			11 000
4000			

- 1 Copy and complete the table.
- 2 Draw a graph showing the relationship between TSCS's output and costs. (Output is on the x-axis and costs on the y-axis.)

## ACTIVITY 16.3

The data below shows the total costs at different levels of output for The Casual Shoe Company.

Output	Total Costs	Average Costs
	\$	\$
1000	5 000	
2000	8 000	
3000	11 000	
4000	14 000	
5000	17 000	
6000	20 000	

- 1 Copy and complete the table.
- 2 Why do you think the average cost per pair of shoes decreases as output increases? (Clue: think about how total cost is calculated.)

**TOP TIP**

Note that fixed costs do *not* start from zero, whereas variable costs do. This means that total costs will *not* start from zero either.

### Using cost data to make simple cost-based decisions

A business can use cost data for a variety of different uses, for example setting prices, break-even analysis and decisions about whether to continue or stop producing a product. The use of cost data to set prices was covered in Chapter 12 and you will learn about break-even analysis later in this chapter.

Cost data can be used in making decisions about whether a business should continue or stop producing a loss-making product.

**EXAMPLE**

A business manufactures two products. The revenue, cost and profit data for each product are shown below.

	Product A	Product B	Total
	\$000	\$000	\$000
Revenue	20	50	70
Fixed costs	10	15	25
Total variable costs	12	18	30
Total costs	22	33	55
Profit	(2)	17	15

Table 16.1 Revenue, cost and profit data for the production of Products A and B

**Note:**

Profit is the difference between revenue – the amount a business earns from selling its products – and total costs.



**Revenue:** Chapter 21, page 268.

We can see from the data in Table 16.1 that Product A has made a loss of \$2000. The marketing manager thinks that the company should stop selling Product A, but the company’s accountant disagrees. Who is right?

You have already learnt that fixed costs do not change with output. Even when output is zero, fixed costs still have to be paid. So, if the company stops producing Product A, it will still have to pay the fixed costs of \$10 000. It will not have any variable costs but will lose the revenue from the sales of Product A.

The amended data for each product and the company in total is shown below.

	Product A	Product B	Total
	\$000	\$000	\$000
Revenue	–	50	50
Fixed costs	10	15	25
Total variable costs	–	18	18
Total costs	10	33	43
Profit	(10)	17	7

Table 16.2 Revenue, cost and profit data for the production of Product B only

We can see that if the company decides to stop producing Product A, profit will fall from \$15 000 to \$7000. Therefore, the accountant is right to continue the production of Product A. However, a business will not want to continue producing a loss-making product forever. When a business no longer has the fixed costs of the product then it will stop its production.

**TEST YOURSELF**

- 1 Using suitable examples, explain the difference between fixed costs and variable costs.
- 2 Define ‘average cost’.
- 3 How do you calculate average cost?

## ACTIVITY 16.4

EasyAir is a budget airline operating internal flights in Tanzania. One of its most popular routes is Dar es Salaam to Kilimanjaro. Each aircraft used on this route has a capacity for carrying 140 passengers. The average price for a one-way ticket is \$160. All passengers, adults and children, must pay the same ticket price. EasyAir's fixed costs for a single journey are \$14 000. The variable cost per passenger is \$10.

The number of flights and the passengers carried by EasyAir on this route during the first two quarters of 2013 are shown in the table below.

	Number of flights	Total passengers carried
January–March	25	1925
April–June	38	4408

- 1 Define 'fixed costs'.
- 2 Calculate the average number of passengers per flight for the first quarter of 2013.
- 3 The average number of passengers carried on a flight in the second quarter was 116. Calculate:
  - a the total variable cost per flight
  - b the total cost per flight
  - c the average cost per passenger per flight.
- 4 The average cost per passenger per flight in the first quarter was \$191.82. Why does EasyAir continue flights when the average cost per passenger is less than the revenue per passenger?

## Economies and diseconomies of scale

### Economies of scale

The term 'scale' simply means the size of business operations – it is a measure of a business's output. As output grows, a business often benefits from reduced average costs due to **economies of scale**. Businesses may benefit from different types of economies of scale, as shown below.

#### KEY TERM

**Economies of scale:** the reduction in average costs as a result of increasing the scale of operations.

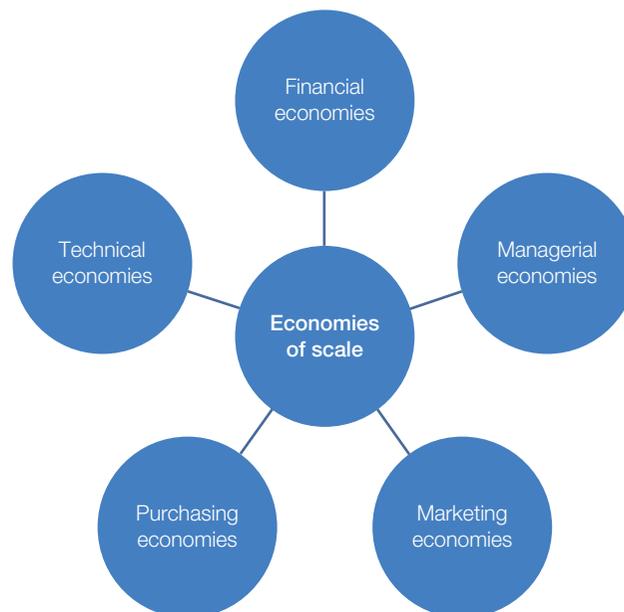


Figure 16.2 Different types of economies of scale  
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### Financial economies

Lenders, such as banks, often prefer to lend to large businesses because they consider them less of a risk than smaller businesses. As a result, large businesses find it easier to borrow money and often do so at a lower rate of interest than smaller businesses.

### Managerial economies

As a business grows, it often employs specialist managers for the different functional areas of the business such as marketing, finance, operations and human resources. Specialist managers improve the quality of business decisions and make fewer mistakes than non-specialist managers.

### Marketing economies

While total marketing costs rise as a business gets larger, they do not rise at the same rate as sales output. So, if a business doubles its output and sales, it will not need to double its marketing costs. This means that the average cost of marketing falls as output and sales increase.

### Purchasing economies

Large businesses usually buy greater quantities of raw materials and goods than smaller businesses. Suppliers often offer discounts on large, or bulk, purchases. Small businesses do not benefit from discounts. Purchasing economies are sometimes called 'bulk-buying economies'.

### Technical economies

Large businesses usually use flow production to produce their output. This method of production often uses the latest technology, such as computer-aided manufacturing (CAM). Such technology may be very expensive and only very large businesses can afford the level of investment required. The technology enables businesses to produce very high levels of output at lower unit costs than smaller businesses.



**Computer-aided manufacturing (CAM):**  
see Chapter 15, page 211.



Large container ships carry more containers than smaller ships at a lower unit cost

### ACTIVITY 16.5

Ronaldo owns a business that manufactures cardboard boxes used by other companies when packaging their goods. The capacity of Ronaldo's current factory is too small for him to take on all of the orders he receives. He has decided to relocate to a larger factory.

Explain **three** economies of scale that Ronaldo might benefit from as a result of expanding his business.



#### KEY TERM

**Diseconomies of scale:**  
factors that cause average costs to rise as the scale of operations increases.

### Diseconomies of scale

Sometimes, a business grows so large that it loses the benefits of economies of scale. Instead, it experiences the opposite – **diseconomies of scale**.

Diseconomies of scale are all due to the problems faced by management in trying to control a business that has become too large. The main causes of these problems are:

- poor communication
- lack of commitment from employees
- weak coordination.



**Productivity:** see Chapter 15, page 204.



**Quality:** see Chapter 17, page 229.



#### EXPLORE!

Choose two businesses close to your school which are in the same industry. One business should be small and the other much larger, for example a local shop and a supermarket.

- 1 Compare the two businesses and identify how the larger one might benefit from economies of scale.
- 2 How does the size of each business affect the range of goods or services offered and the prices it charges?
- 3 Why do you think the smaller business is able to compete in the same market as the larger business?

### Poor communication

If a business becomes too large, managers may no longer be able to communicate directly with employees. This can lead to slow and poor decision-making and an increase in mistakes.

### Lack of commitment from employees

In very large businesses, managers may no longer have day-to-day contact with employees. This can lead to lack of commitment from employees who feel that they are no longer a valued part of the business. Employees become demotivated and this can lead to high labour turnover, poor quality and a fall in productivity.

### Weak coordination

As a business grows, so too will the number of departments, products and production units. The control and coordination of these can present managers with many problems, especially where production units are located in other countries. The business's average costs may rise as a result of managers in different departments or different production units working towards different objectives. Also, there is a greater risk that work will be duplicated and this, of course, is a waste of resources and increases costs unnecessarily.

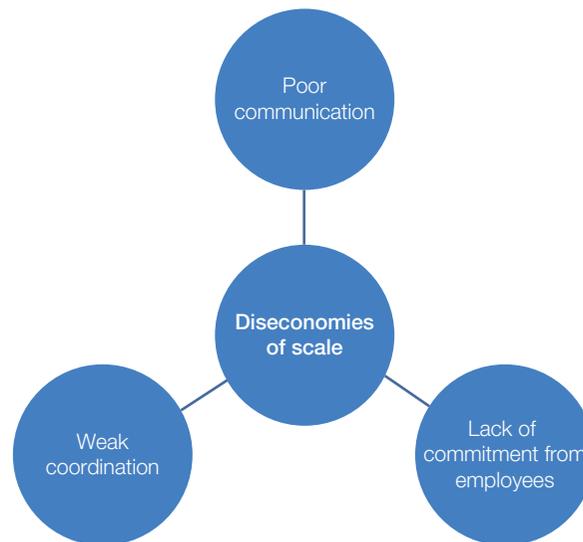


Figure 16.3 Diseconomies of scale

## The importance of economies and diseconomies of scale

Economies of scale reduce average costs and diseconomies of scale increase average costs. The relationship between average costs and scale of operation is shown in Figure 16.4, page 222.

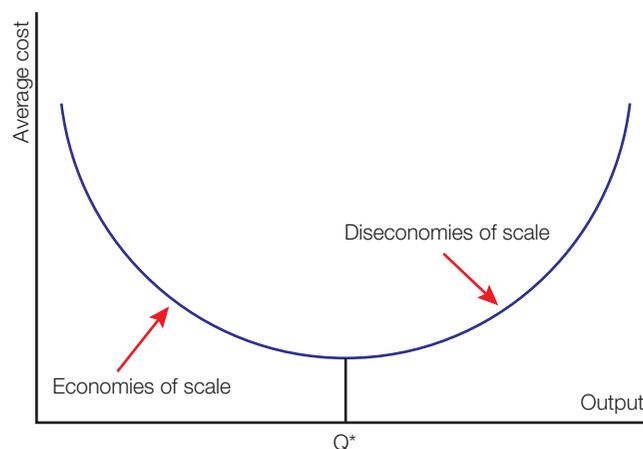


Figure 16.4 Average cost curve showing economies and diseconomies of scale

You can see that as output increases, unit costs fall and continue to do so until diseconomies of scale occur and the unit costs begin to rise. The ‘best’ scale of operation is where unit costs are at their lowest – the bottom of the curve at the point Q.

The fact that most businesses will eventually experience diseconomies of scale, as the scale of operation grows, explains why most industries are not dominated by just one or a few firms.

### TEST YOURSELF

- 1 Explain the importance to a business of economies of scale.
- 2 Explain how a business could experience diseconomies of scale.

### CASE STUDY

## ‘You need it, we’ve got it!’

Nakumatt Holdings Limited is East Africa’s leading supermarket chain. The company was established in 1987 and since then has grown to over 40 stores in Kenya, Uganda, Rwanda and Tanzania. The company has plans to continue its expansion into the wider East Africa region.

Nakumatt’s store formats range from convenience stores and supermarkets to hypermarkets that showcase distinct world-class shopping floor layouts and amenities. All branches hold a range of over 50 000 quality products.

Source: [www.nakumatt.co.ke](http://www.nakumatt.co.ke)

### TASK

- a Explain **three** economies of scale Nakumatt Holdings Limited may have achieved as a result of its expansion since 1987.
- b Explain how the expansion of Nakumatt Holdings might benefit consumers.
- c If Nakumatt continues to expand, why might it experience diseconomies of scale?

**KEY TERM**

**Break-even:** the level of output where revenue equals total costs; the business is making neither profit nor loss.

## Break-even analysis

**Break-even** describes a situation where a business is not making a profit or a loss from the production and sale of its products. In other words, the revenue a business earns from selling its output exactly equals the total costs of producing the output. If the revenue a business earns from selling its output is greater than the total costs of producing it, then the business earns profit. However, if the revenue earned is less than the total costs then the business will make a loss. These three situations are shown in Figure 16.5.

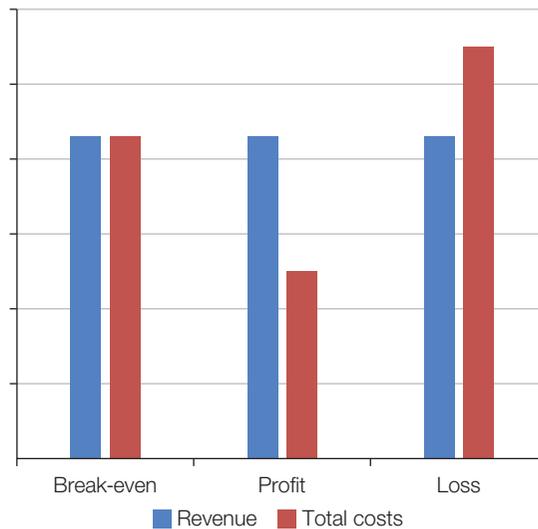


Figure 16.5 Break-even, profit and loss

### The concept of break-even

Break-even analysis is a business technique that shows the relationship between revenue, costs and volume of output/sales. A business might use break-even analysis to:

- calculate how many units it needs to sell before it starts to make a profit
- calculate the effect on profit of increasing or decreasing the price of a product
- calculate the effect on profits of an increase or decrease in business costs.

### Simple break-even charts

The purpose of a break-even chart is to show the relationship between a business's revenue and costs at different levels of output. The chart can be used to work out the level of output that must be produced and sold to earn revenue which exactly equals the total costs of producing that level of output. This is known as the break-even output.

To produce a break-even chart, a business needs to know its:

- revenue at zero output and at its maximum output (capacity)
- total costs at zero output and at capacity output
- fixed costs at zero output and at capacity output.

The revenue and cost information at these two output levels is then used to produce a break-even chart similar to that shown in Figure 16.6.

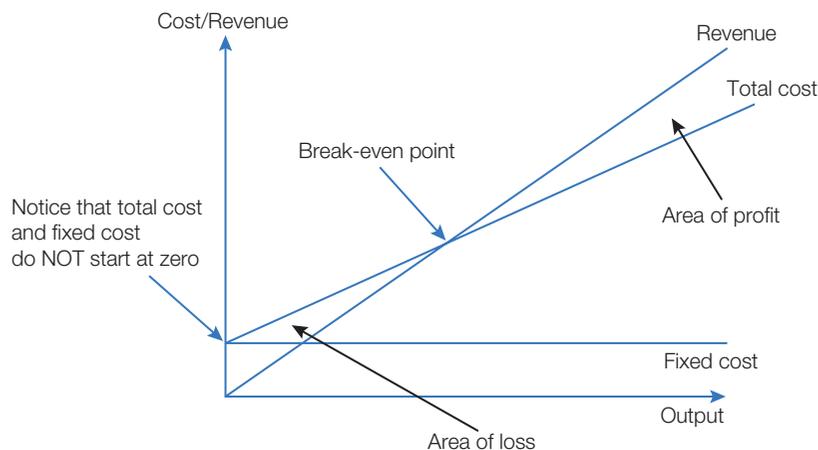


Figure 16.6 A simple break-even chart



**KEY TERM**

**Margin of safety:** the difference between the current level of output and break-even output.

**Margin of safety**

The margin of safety is the amount by which actual sales exceed the break-even level of output.

$$\text{margin of safety} = \text{actual sales} - \text{break-even output}$$

This is a measure of the amount by which sales can fall before losses are made. The higher the margin of safety, the lower the risk of a loss being made.

**EXAMPLE**

Molly has decided to open a takeaway pizza shop in her local town. She has calculated that the average variable cost of producing each pizza will be \$1. Molly estimates her fixed costs per week will be \$600. Molly plans to sell her pizzas for \$2.50 each. She has worked out that the maximum number of pizzas she could produce is 800 per week.

Molly carried out market research before setting up her business. She estimates that she will be able to sell 600 pizzas per week.

We are going to use the above information to draw a break-even chart for Molly's business. First, we need to calculate the following figures at zero output and capacity output:

- revenue – the amount earned from selling pizzas (the price × output)
- fixed costs – these are \$600 per week
- total variable costs – this will be \$1 × output
- total costs – the fixed costs + total variable costs.

Note: Molly's capacity is the maximum number of pizzas she is able to produce per week. We are told this is 800.

	Zero output	Capacity output (800)
Revenue	$\$2.50 \times 0 = \$0$	$\$2.50 \times 800 = \$2000$
Fixed costs	\$600	\$600
Variable costs	$\$1 \times 0 = \$0$	$\$1 \times 800 = \$800$
Total cost	$\$600 + \$0 = \$600$	$\$600 + \$800 = \$1400$

Table 16.3 Information for Molly's business

We now have the information needed to construct a break-even chart for Molly's business.

**ACTIVITY 16.6**

- 1 On a piece of graph paper:
  - a Draw and label:
    - i the x-axis from 0 to 800, labelled 'Output and sales of pizzas'.
    - ii the y-axis from \$0 to \$2000, labelled 'Cost and revenue'.

Make sure you use an appropriate scale for both axes.
  - b Plot the revenue at zero output and capacity output. Use a ruler to join these two points together.
  - c Repeat for both the total costs and the fixed costs data.

Your chart should look similar to the one shown in Figure 16.6.

- 2 Now that you have a break-even chart for Molly's business, you can use this to work out how many pizzas she needs to sell each week for her business to break even. This will be where the revenue line crosses the total cost line.
  - a Mark this on your chart as the break-even point.
  - b Using a ruler, draw a line down from the break-even point to the x-axis and read off the value of the break-even output/sales.

If you have drawn your chart correctly you should have a break-even output of 400 pizzas per week.

Now draw a line from the break-even point to the y-axis.

- c Read off the value for the revenue and total costs at break-even.

If you have done this correctly you should have an answer of \$1000.

So, we can say that Molly needs to sell 400 pizzas per week to break even. Remember, at this output she will not make a profit, but nor will she be making a loss.

Now that we have the break-even chart for Molly's business we can use it to calculate her profit and margin of safety at different sales levels.

**ACTIVITY 16.7**

You are now going to use your break-even chart to calculate Molly's weekly forecast profit based on sales of 600 pizzas.

- 1 Draw a vertical line from an output/sales level of 600 to meet the total costs line. Draw a line across to the y-axis and read off the value for total costs at an output level of 600 pizzas.
- 2 Continue your vertical line from an output/sales level of 600 pizzas to the revenue line. Draw a line across to the y-axis and read off the value for revenue at a sales level of 600 pizzas.
- 3 Deduct the total costs figure from the revenue figure to calculate Molly's profit at a sales level of 600 pizzas per week.
- 4 Use your break-even chart to calculate Molly's weekly profit if she only sells 500 pizzas per week.

Once a break-even chart has been produced it can be used to show the effect of changes in the business's revenue or costs. This could be useful if a business is considering changing its price, or if it knows that it is likely to have a change in costs. For example, a supplier may increase the price of raw materials it supplies to the business.

### ACTIVITY 16.8

Molly's first three months of trading have been disappointing. She realises that her price of \$2.50 per pizza is more than competitors in the town. She has decided to reduce the price of her pizzas to \$2 each.

- 1 Use this new price to draw a new revenue line on the graph you prepared earlier. (Remember to recalculate the revenue at zero and the capacity using the new selling price.)
- 2 How many pizzas must Molly now sell to break even?
- 3 What is Molly's profit at the new price of \$2 per pizza?

#### Benefits

- Easy to construct and interpret.
- Provide businesses with useful information about the output that must be sold to cover all costs and how different sales volumes affect the margin of safety and profitability.
- Can show the effect of a decision to change costs or revenues.
- Can help with other important business decisions such as the location and relocation of a business.

#### Limitations

- Assume that all costs and revenues can be represented by straight lines.
- It is not easy to separate costs into fixed and variable.
- Assume that all output is sold – do not allow for inventories and the costs of holding these.

Table 16.4 Benefits and limitations of break-even charts

### TEST YOURSELF

- 1 Define 'break-even'.
- 2 State **two** uses of break-even charts.
- 3 State **one** benefit and **one** limitation of break-even analysis.

### ACTIVITY 16.9

My Villa Hotel is a budget hotel in Kuala Lumpur, Malaysia. The hotel has 30 rooms. The average rate per room per night is \$45. The hotel is open 50 weeks of the year, 7 days a week.

My Villa Hotel has annual fixed costs of \$180 000. The variable cost per room per night is \$9. In 2012 the hotel had a room occupancy of 60% (the number of nights rooms had people staying in them). The hotel needs to have 5000 rooms occupied per year to break even.

- 1 Using appropriate examples, explain the difference between fixed costs and variable costs.
- 2 My Villa Hotel's weekly capacity is 210 rooms. Calculate its capacity for the year.
- 3 In 2012 it sold 60% of its total room capacity. Calculate the number of nights the hotel had guests during 2012.
- 4 To what extent is break-even analysis useful to the owners of My Villa Hotel? Justify your answer.

## Revision checklist

- The costs of business can be classified into fixed costs, variable costs, total costs and average costs and these classifications are useful when making cost-based decisions.
- The average costs of a business will usually change as the business grows because of economies or diseconomies of scale.
- Businesses can use break-even analysis to show the relationship between costs, revenue, output and profit and how changes in costs or revenues might affect profits.

## Exam-style practice questions

- The operations manager of Company Y has produced the following break-even chart for Product X. The average monthly sales for Product X are 4200 units.
  - Identify the lines labelled as A and B on the chart in Figure 16.7. [2]
  - Calculate the percentage difference between the monthly sales for Product X and the monthly break-even sales. [2]
  - Outline **two** ways of classifying the costs of producing Product X. [4]
  - Explain **one** benefit and **one** limitation of break-even analysis to the management of Company Y. [6]
  - Company Y's senior management do not think break-even analysis is important to the success of the business. Do you agree? Justify your answer. [6]

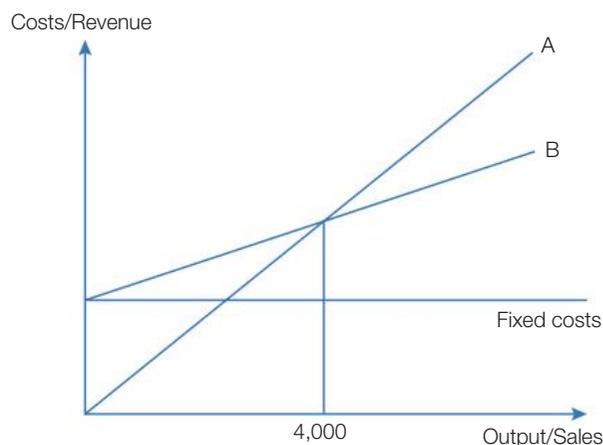


Figure 16.7 Break-even chart for Product X

- 2 Solar Enterprises (SE) is a manufacturer of solar panels. SE has seen a steady growth in sales over the past five years. In 2012 sales were 18 000 units and it expects a 15% increase in sales for 2013. This growth has enabled SE to benefit from economies of scale.

SE's accountant keeps a tight control of both fixed and variable costs. She uses cost information to produce break-even charts for its most popular products. The managing director thinks that producing break-even charts is a waste of time and effort.

- a Define 'break-even'. [2]
- b Calculate SE's expected sales for 2013. [2]
- c Using examples, outline the difference between SE's fixed costs and its variable costs. [4]
- d Explain how SE may have benefitted from any **two** types of economies of scale. [6]
- e Do you agree with the managing director when he says 'producing break-even charts is a waste of time and effort'? Justify your answer. [6]

**Total available marks 40**

# 17

## Objectives

*In this chapter you will learn about:*

- why quality is important to businesses
- quality control
- quality assurance.

# Achieving quality production

## Introduction

How do businesses keep the customers they have and also attract new customers? The answer lies mainly in the quality of the products they produce and sell. Businesses that provide poor-quality products or poor customer service may quickly lose customers and eventually close down.

In this chapter you will learn the meaning and importance of quality and understand how businesses can achieve quality production. You will look at quality control and quality assurance.

## Why quality is important

### What quality means

When we talk about a 'quality product' we do not mean that it is the best possible product, which has been made by the most advanced production methods using the highest-quality raw materials. It also does not mean that the most expensive product is always the best.

Instead, we need to think of 'quality' as 'free from defects'. When you buy a product you want it to work in the way that you expect. For example, if you buy a calculator you expect it to work out calculations correctly. In other words, a quality product is one that meets the needs and requirements of the consumer.

Businesses usually find out about the needs and requirements of consumers through market research. Once they know what these needs are, the business can set the **quality standards** that are expected by consumers.

Quality standards can be divided into design standards and process standards. Design standards help a business create the best possible product, which consumers find more valuable than other products in the market. Process quality standards help a business to produce its goods and services at the lowest cost. Combining design standards and process standards helps a business gain a competitive advantage and gain market share.

### The importance of quality to all businesses

Quality is important to businesses because it helps them to:

- **Develop a strong brand image** – building a strong brand image based on quality makes it easier for a business to introduce new products to the market. Customers will know the reputation a business has for quality products and they will assume that any new product is of the same quality. For example, Sony has an excellent reputation for producing high-quality personal entertainment products. If it introduces a new product into the market, it will attract customers quickly. Customers will even be prepared to pay a premium price because they know the product will be of high quality.



A quality inspector at work  
Cambridge University Press

### KEY TERMS

**Quality:** ensuring a good or service that meets the needs and requirements of its consumer.

**Quality standards:** the minimum standard of production or service acceptable to consumers.

**Market research:** see Chapter 11, page 153.



**Brand image and customer loyalty:** see Chapter 12, page 164.



**Wholesalers and retailers:** see Chapter 13, page 180.



**Product life cycle:** see Chapter 12, page 167.



**TOP TIP**

Make sure you understand why quality is important for the marketing of products.

- **Keep customers and attract new customers** – this is known as customer loyalty. When a business has a reputation for producing quality products it is easier for it to keep its existing customers and attract new ones. The long-term success of any business relies on getting customers to ‘repeat purchase’ – to keep coming back for more of the product, for example McDonald’s, Toyota and Samsung.
- **Reduce costs, customer complaints and returns** – products that do not meet the needs and expectations of customers will be returned. The product will have to be replaced or the customer may want the money they paid for the item refunded. Returns from customers increase costs and reduce profits. If a large number of customer complaints and returns are made then this could damage the business’s reputation. Existing customers will stop buying the firm’s products and the firm will also find it difficult to attract new customers.
- **Charge a premium price** – many consumers are prepared to pay a higher price for a product that is seen as being of better quality than similar products on the market. If a business is able to charge a higher price for its product compared to that of competitors then this may increase its profitability, for example Apple computers.
- **Encourage wholesalers and retailers to stock the product** – most manufacturers need middlemen, such as wholesalers and retailers, to help distribute their product to the final consumer. If a product is of good quality then both wholesalers and retailers will want to stock the item because they know that consumers will want to buy it. They will sell more of the product and this will increase their revenue and profits.
- **Lengthen product life cycles** – products that are good quality will continue to meet the needs of customers. These products will have a longer life cycle than poor-quality products, which consumers will not continue to buy. If a product has a long life cycle then it will stay in the most profitable maturity stage much longer.



Figure 17.1 Why quality is important to businesses

## Volkswagen

Volkswagen AG, which sells more cars in China than any other foreign firm, will recall 384 181 vehicles there to fix a long-standing gearbox problem, China's quality watchdog said on Wednesday.

Volkswagen confirmed the recall in the following emailed statement.

'In a very few cases, an electronic malfunction in the control unit or a lack of oil pressure inside the gearbox mechatronics

may result in a power interruption,' Volkswagen said in its statement.

'The most important vehicle systems, such as steering and braking, along with other relevant systems will not be affected,' it said.

Volkswagen, which makes its cars in China, sold 2.81 million cars in the country last year. It plans to almost double production capacity in the country to 4 million in the next five years.

Source: Adapted from Reuters March 2013, <http://in.reuters.com/article/2013/03/20/volkswagen-china-recall-idINDEE92J04I20130320>

### TASK

- a Why has Volkswagen AG decided to recall almost 400 000 vehicles if, as stated in the email from Volkswagen, the problem only occurs 'in a very few cases'?
- b What does this article tell you about the importance of quality to companies such as Volkswagen?

### TEST YOURSELF

- 1 What do you understand by 'quality'?
- 2 How do consumers influence quality?
- 3 State **three** benefits to a business of producing quality products.

## How businesses achieve quality production

### Quality control

**Quality control** is the traditional method businesses use to check the quality of products. It aims to ensure that only quality products reach the consumer.

Businesses employ trained quality inspectors to check products, usually at the end of the production process. Sometimes products are checked at different stages of the process. It is rarely possible to check every item produced as it is time-consuming and therefore may be too costly for a business to do this. The quality checking process may also require the inspector to dismantle the product or to test the product's strength by using force to break it! It would be too expensive to test every product in this way. Quality control, by inspection, usually uses sampling. This means that not every product is checked for quality and there is always a chance of a poor-quality product finding its way to the final customer.



#### KEY TERM

**Quality control:** checking the quality of goods through inspection.



Read the following article.

### Tea testing goes hi-tech with electronic tongue

Kenyan tea producers will no longer need to rely on the human tongue to test the quality of their tea leaves. A new electronic instrument has been developed which is said to be better than the human tongue.

The 'electronic tongue' is filled with sensors which are able to analyse flavour compounds present in tea – known as theaflavins – which contribute to the taste and brightness of tea.

Source: Adapted from <http://in2eastfrica.net/tea-testing-goes-hi-tech-with-electronic-tongue>

Using this article, or through your own research of newspaper/magazine articles and internet websites, explain how and why technology is being used in the quality control process.

#### Problems of quality control by inspection

Apart from the cost of inspecting for quality, there are other problems with this method of quality control.

- The work can be repetitive and boring and this may demotivate the inspectors, resulting in them not performing their tasks efficiently.
- If inspection only takes place at the end of the process, then problems with quality that occur at the beginning are not found soon enough. Resources are wasted completing a product that should have been rejected much earlier in the production process.
- The use of quality inspectors takes any responsibility for quality away from the employees. Employees do not see quality as their responsibility and may not try to ensure that quality is maintained throughout the production process.

#### Quality assurance

Problems with quality control have led many businesses to move away from quality control to **quality assurance**. This method focuses on preventing poor quality. It makes sure that:

- raw materials, components and other resources are of the required standard before they enter the production process
- quality standards are agreed for every stage of the production process
- products are designed to minimise quality issues – many businesses use computer-aided design (CAD), which is more accurate than hand-drawn designs and can be used to improve the quality of products by using computer software to 'test' the product without the need to produce a physical model, so any changes that need to be made to the design following testing can be made quickly and easily
- employees know they have a responsibility for ensuring the quality of their work.

#### Benefits of quality assurance

Businesses benefit from quality assurance.

- It encourages teamwork and this can act as a motivator for employees.
- It reduces the cost of wastage and faulty products.



#### KEY TERM

**Quality assurance:** a system of setting agreed standards for every stage of production.



#### TOP TIP

Quality is just as important to small and medium-sized businesses as it is for large businesses. They must select a level of quality which they are able to meet within their limited resources.



**Motivator:** see Chapter 6, page 77.

- Quality issues are found when they occur and not at the end of the production process. This means that resources are not wasted completing a product that will later fail quality checks.
- Although a business may inspect goods at the end of the production process, the time spent by inspectors will be less and the business's inspection costs will be reduced.
- Businesses that have a quality assurance system of quality control find it easier to obtain industry quality awards such as ISO 9000. These awards can bring marketing benefits to a business. Customers have greater trust in products with quality awards and this helps to increase revenue and profits.

## CASE STUDY

### Toyota's approach to quality

Toyota has achieved a reputation for the production of very high-quality vehicles in all countries around the world. This has been achieved by an approach to quality control and quality assurance which is unique to Toyota and has been developed over many years.

Toyota considers quality control a key part of the activities to produce products or services economically and of a standard which exceeds customer needs.

To achieve total quality control, Toyota makes each employee responsible for the quality of their work. If a problem is found then the employee can stop the production process, allowing time to investigate and confirm the quality before continuing.

Careful recruitment and selection along with continuous training have resulted in the company having a workforce that is multiskilled, flexible and highly motivated; committed to maintaining and improving the company performance.

The quality of the completed vehicle is greatly dependent upon a reliable supply of high-quality parts and materials. Toyota works closely with its suppliers to make sure that any materials or components they supply satisfy or exceed the high standard required.

*Source:* Adapted from [www.ehow.com/about\\_6604332\\_quality-system-toyota.html](http://www.ehow.com/about_6604332_quality-system-toyota.html)



Inspecting for quality at Toyota

233

#### TASK

- a Define 'quality assurance'.
- b Explain how any **two** stakeholders affect the quality of Toyota's products.
- c Explain **three** reasons why quality is important to Toyota.
- d Do you think the additional costs involved in Toyota's approach to quality control and quality assurance are worthwhile? Justify your answer.

#### TEST YOURSELF

- 1 Explain 'quality control'.
- 2 Why are quality inputs important to quality products?

## Revision checklist

- Quality is an important business concept which is concerned with producing goods and services that meet consumer expectations.
- Quality is important to businesses because it helps to reduce costs and improve marketing opportunities such as premium pricing and brand development.
- Businesses can use quality control processes and quality assurance processes to achieve desired quality standards.

## Exam-style practice questions

- 1 Zebtech produces components used in the manufacture of medical equipment. Component Y is used in heart surgery. Every unit of Component Y is inspected before despatch to customers to make sure that it satisfies quality standards. The following data has been collected about Component Y for 2011 and 2012.

	2011 data	2012 data
Total output	1800 units	2150 units
% defective	0.5%	2%
Number of Component Y returned by customers as faulty	4	2

Table 17.1 Data about Component Y

- a** Define 'quality standards'. [2]
- b** Calculate the actual number of defects in 2012. [2]
- c** Outline **two** disadvantages of Zebtech's process of quality control. [4]
- d** Explain **two** ways Zebtech might reduce the number of defectives. [6]
- e** Do you think the management of Zebtech should be worried about the data relating to the production of Component Y? Justify your answer. [6]
- 2 PP manufactures digital cameras. The company employs workers to inspect the quality of finished products before they are despatched to customers. The quality control inspectors check a sample of all output.

The senior managers of PP are concerned about the level of customer complaints. The company has sold 46 000 digital cameras in the past six months. It has received complaints from 1.5% of customers about the poor quality of its products. Senior managers are considering introducing a process of quality assurance.

- a** Define 'quality'. [2]
- b** Calculate the number of customer complaints received by the company over the past six months. [2]
- c** Identify **four** reasons why quality is important to firms such as PP. [4]
- d** Explain **two** possible causes of the increase in customer complaints about the poor quality of PP's products. [6]
- e** Do you think senior managers of PP should introduce quality assurance? Justify your answer. [6]

**Total available marks 40**  
Cambridge University Press

# 18

## Location decisions

### Introduction

The decision about where to locate a new business, or relocate an existing business, is one of the most important decisions most businesses make. The decision can be the difference between business success and business failure. This is because the place where a business is located can affect its operation costs, as well as how it makes sales and delivers customer service. Once a location decision is taken, it is often difficult and costly for a business to change location.

In this chapter you will look at what influences location decisions and learn how businesses choose the right location.

### Objectives

*In this chapter you will learn about:*

- what influences the location decision of manufacturing businesses and service businesses
- why businesses may decide to locate their operations in another country
- how legal controls affect location decisions.

### Factors influencing location and relocation decisions

A supermarket chain plans to open a branch in your area. Is there a site where it can be built? Where will its customers come from? Will it be able to attract people to work at the supermarket? Are there good transport links to the site? Are there other supermarkets nearby? These are some of the questions that the managers of the business will need to answer before they can decide where to locate the supermarket in your area, if at all.

From this, you can see that there are several factors that may influence the location of a new business or the relocation of an existing business. Manufacturing businesses may have different questions to ask than the service business of the supermarket above. For example, they might need more and better **infrastructure** such as water, power and telecommunications, as well as access to sea, air and rail links for transporting raw materials and finished goods. They might also need a more skilled workforce.

### Location decisions of manufacturing and service businesses

Businesses need to consider a variety of factors when choosing a location for a new business or relocating an existing business. These factors can be divided into quantitative factors and qualitative factors.

#### Quantitative factors

- Cost of site
- Availability and cost of labour
- Transport costs
- Market potential
- Issues

#### Qualitative factors

- Site of site
- Legal controls
- Infrastructure



**KEY TERM**

**Infrastructure:** the basic facilities, services and installations needed for a business to function, for example water, power, transport links.



**EXPLORE!**

Use library resources or the internet to investigate the help that the government in your country provides to encourage businesses to locate in particular areas. Can you find examples of businesses that have located in a particular area because of government incentives?



**TOP TIP**

Don't give two examples of the same type of factor. For example, water, power and telecommunications are all support services, so mentioning two of these will only be credited once.



**KEY TERM**

**Government incentives:**

usually finance such as interest-free loans or grants provided to a business to help when locating in a country or an area of a country.

**Quantitative factors**

Quantitative factors can be measured in financial terms and will directly affect the costs, revenues and profitability of a site.

Quantitative factor	Explanation
Cost of site	How expensive the land and buildings are to rent or buy.
Labour costs	What is the average wage paid to employees in the area? This will be influenced by the supply of employees, the skill level required and competitors for the labour concerned.
Transport costs	How close to suppliers is the proposed site and what will be the cost of transporting goods to and from the site? How easy is it for customers to access/reach the location? This is particularly important for service industries such as retail outlets, hotels, cinemas, etc.
Market potential	Revenue from sales might depend heavily on the location. For example restaurants, supermarkets and other tertiary sector businesses will often need to be close to their customers. Clearly, it is less important for secondary sector businesses to be located so close to their customers.
Government incentives	Both local and national governments will often provide financial and other incentives to encourage businesses to locate in a particular area. These incentives can significantly reduce set-up costs.

Table 18.1 Quantitative factors that influence business location decisions

**Qualitative factors**

In addition to the quantitative factors outlined above, businesses need to also consider qualitative factors in their decision-making process such as those outlined in Table 18.2.

Qualitative factor	Explanation
The size of the available site	Not only does the site need to be large enough for the current needs of the business, but it also might be important that it offers scope for expansion in the future.
Legal restrictions	In most countries it is not possible for a business to simply locate where it wants to. There may be planning restrictions or other legal restrictions that prevent location in certain areas or close to other community amenities. For example, it would be unlikely that a manufacturing business would be allowed to locate very close to an area for residential housing because of the effect noise and air pollution might have on residents.
Quality of local infrastructure	How good are transport links such as road, rail, air and sea? Does the location have good support services such as water, power and telecommunications?
Ethical issues and concerns	If a business is relocating from one part of the country to another, or from one country to another, how will this affect its existing workforce? The decision to relocate might lead to the redundancy of existing employees and could damage the reputation of the business among consumers – this could lead to reduced sales, revenue and profits.

Table 18.2 Qualitative factors that influence business location decisions

### EXPLORE!

Investigate businesses in your local area. Select three businesses, ideally one each from the primary, secondary and tertiary sectors. Try to choose one business which has recently opened.

Why do you think each of these businesses has located in your local area?



#### TOP TIP

When explaining why a factor is important, it is helpful if you can give reasons **why** you feel the factor is important. For example, don't just say that the location is cheaper; explain **how** it will save the business money.



**Product life cycle maturity stage:** see Chapter 12, page 168.

## Why businesses locate their operations to another country

As well as local location factors, some businesses may decide to locate their operations in another country. This decision is usually for one of the following reasons:

- **To achieve growth** – location overseas might be the best way of achieving growth for companies whose sales have reached their maximum level in the home market; the product in the maturity stage of its life cycle.
- **To reduce production costs** – for example, labour costs in countries such as India, China and Eastern Europe are much lower than in Western Europe, Japan and the USA.
- **To locate production closer to the market** – this reduces delivery time to customers and reduces transport costs.



Figure 18.2 There are several reasons for relocating a business overseas

International location decisions have their own benefits and limitations, which will influence the final decision.

The benefits include:

- **Lower labour costs** – businesses may decide to relocate from a high-labour-cost country to one where labour costs are much lower. For example, Dyson, a UK manufacturer of vacuum cleaners, relocated its production from the UK to Malaysia.
- **Access to global markets** – the development of the economies of many countries around the world has opened up markets to businesses whose sales in their home market have no further opportunity to grow because the product has reached the maturity stage of its life cycle. Although businesses could simply export their goods into these countries, it is often much easier and more successful to locate operations in the country. Several multinational companies have located factories close to their international markets; for example, Coca-Cola has manufacturing operations in many countries throughout the world including Pakistan, Argentina, Costa Rica, Nigeria and Jordan.

- **Avoidance of legal barriers and import tariffs** – although many countries have removed or reduced their barriers to free trade, they still exist. One way around this is to locate in the country. The business does not then have to pay import tariffs and will not be affected by legal restrictions on foreign companies.
- **Government incentives** – governments around the world can see the benefits of attracting overseas businesses to locate in their country. Such benefits include providing employment, improving workforce skills (including management skills), introducing new technologies, improving product quality and increasing consumer choice. These benefits lead to economic growth and the long-term improvements this brings to a country's citizens.



Inside a garment factory in Dhaka, Bangladesh

The benefits need to be balanced against the limitations of international location, such as:

- **Cultural differences** – these may affect the workplace and/or the marketplace. Products that are popular in one country may be less popular in some international markets due to different consumer tastes or religious beliefs. The workplace culture in one country may not be right for another.
- **Communication problems** – language differences may be a barrier to communication between employees, managers and suppliers. Communication problems may also arise as a result of the distance between head office and the operation unit based in another country.
- **Ethical concerns** – a decision to relocate to another country may affect the workforce in the home country. Although some managers may be prepared to relocate to another country, other employees may not be given the opportunity or wish to do so, resulting in high levels of redundancy. There have been several reported concerns about the exploitation of employees in low-cost economies, including issues of child labour. These issues could damage the reputation of a business and affect revenue and profits in all of its markets.
- **Quality issues** – it may be more difficult to control the quality of supplies and the quality of finished products in international markets.



**Multinational:** see Chapter 26, page 327.

**Global markets:** see Chapter 26, page 327.

**Import tariffs and free trade:** see Chapter 26, page 330.

**Economic growth:** see Chapter 24, page 300.

**Ethical issues:** see Chapter 25, page 313.



**Quality:** see Chapter 17, page 229.

**ACTIVITY 18.1**

Imagine that you have been employed as a consultant for a large international mobile phone manufacturer which is considering your country for the location of a new factory.

Write a report to the CEO of the company highlighting the benefits and drawbacks of the company locating its new factory in your country.

**The role of legal controls**

When considering its location, a business may also need to think about possible legal controls. For example, building new premises such as a factory or a supermarket may require planning permission from local government or other government agencies. Local and national governments want to attract businesses to locate in their country, or in particular areas of the country, as they provide employment for the population. However, they may also want to protect the environment so do not want businesses to locate in areas which may cause damage to wildlife, rivers, woodland or other open spaces that are enjoyed by the local community.

In many countries there are areas that have been set up for businesses to use. These areas are usually located away from local housing so that residents are not affected by any noise, air or traffic pollution from manufacturing activities.

Governments are now much more aware of the problems caused by pollution, especially from manufacturing. In some countries there are laws which require businesses to control the amount of pollution their activities cause. Any business found breaking these laws might be fined or closed down.

There are often legal controls concerning the employment of workers such as discrimination laws and minimum wage laws.

The legal controls placed on businesses will not be the same for every country. A business that is thinking of relocating to another country will have to investigate the laws of that country and make sure that these are considered along with other location factors.

**Choosing a location**

The task of owners or managers is to select the best location. This is never easy because every location will have factors which are a benefit and others which are a limitation. For example, the land on which to build a factory might be very cheap because it is located some distance from the nearest town. However, the business might find it difficult to recruit a workforce because of the distance employees would have to travel to get to work. Similarly, a business looking to relocate to a low-labour-cost country might need to balance the benefit of lower production costs with increased transportation costs for raw materials and finished goods.

Those faced with making the decision must balance location factors and choose the location where the benefits outweigh the limitations so that future profits are maximised.

 **Employment legal controls:**  
see Chapter 8, page 118.

**ACTIVITY 18.2**

Working in small groups, consider the following:

A fast-food takeaway business is considering locating near to your school. The owners of the business have asked your group to identify the benefits and drawbacks of this location for their business.

- 1 On a sheet of paper write the heading 'Benefits' and on another sheet of paper write the heading 'Drawbacks'.

- 2 Your group should discuss the benefits and drawbacks of locating such a business within 2km of your school. List each point you agree under the appropriate heading on your sheets of paper.
- 3 When all the groups have completed their discussion you should nominate two people from your group to report your findings to the rest of the class. Ask one person to report on the benefits and the other to report on the drawbacks.
- 4 Your teacher will make a list on the board of all of the benefits and drawbacks that all the groups have produced.

## Agrid South Africa

### Agrid chooses base in South Africa

Agrid South Africa, an offspring of Agrid International, was formed in July 1999. It manufactures diesel/petrol engines and agricultural implements for small-scale farmers.

Agrid has focused on exporting its products to Europe and other African countries, more specifically Kenya, Nigeria, Angola and Uganda. However, it recently found a gap in the local market for its products.

Agrid chose South Africa for its established and proven manufacturing base, skilled labour at reasonable rates and readily available management. Other attractions were the expansion of the local motor industry, excellent telecommunications and the accessibility of sub-Saharan Africa, South America and Australia.

A spokesman for the company said: 'I see South Africa as a low-cost manufacturing base for exporting products to the world.'

Source: Adapted from [www.southafrica.info/business/investing/globalcomps.htm#UsFsgEZFBMs](http://www.southafrica.info/business/investing/globalcomps.htm#UsFsgEZFBMs)

#### TASK

- a Identify **four** benefits to Agrid International of locating in South Africa.
- b Given the type of manufacturing activity of Agrid South Africa, what legal controls do you think might be placed on its business?
- c What other benefit has Agrid International obtained as a result of its decision to locate in South Africa?

#### TEST YOURSELF

- 1 State **three** factors that might influence location decisions.
- 2 Explain **two** reasons why a business may decide to relocate in another country.
- 3 Explain how legal factors can influence location decisions.
- 4 How can a relocation decision affect a business's existing workforce?
- 5 How might consumers influence a location decision?
- 6 Should cost be the major influence on location decisions?
- 7 How and why might a country's government encourage a business to locate in its country?

## Revision checklist

- There are several factors that owners or managers should consider when making a location or relocation decision.
- Location decisions require a business to balance the benefits against the limitations so that the best decision is made which will maximise long-term profits.
- In addition to quantitative and qualitative factors, businesses must also consider any legal controls affecting location decisions.

## Exam-style practice questions

- 1 Aisha is a qualified hairdresser. She has always dreamed of owning her own hairdressing salon. Her parents have offered to loan Aisha the money she needs. She is considering two possible locations for her business. Aisha will be a sole trader.
  - a Define 'sole trader'. [2]
  - b Identify **two** disadvantages to Aisha of being a sole trader. [2]
  - c Identify **four** reasons why Aisha might want to own her own business. [4]
  - d Explain **two** factors Aisha should consider when choosing the location for her hairdressing salon. [6]
  - e How important do you think the right location will be to the success of Aisha's business? Justify your answer. [6]
  
- 2 Triton Electrics (TE) is a public limited company. It manufactures electrical goods, such as microwave ovens, in two factories in Country X. TE employs 500 workers. The directors of TE are considering relocating the production of all their products to Country Y. The head office will remain in Country X.
  - a Define 'directors'. [2]
  - b Identify **two** features of a public limited company. [2]
  - c Outline **two** legal controls that might affect location decisions in Country Y. [4]
  - d Explain how any **two** of TE's stakeholders might be affected by the proposed relocation of TE. [6]
  - e Do you think TE should relocate its manufacturing to Country Y? Justify your answer. [6]

**Total available marks 40**

## Exam-style case study

### Sunshine Foods

Sunshine Foods (SF) manufactures a range of breakfast cereals. It purchases its ingredients from farms in Country Y. SF uses batch production for all of its products. However, the directors of SF have agreed to the introduction of flow production methods for its most popular products (see Appendix 1).

The company has achieved steady growth over the past five years and this has meant that it has been able to benefit from economies of scale.

The company has developed a new chocolate-flavoured cereal which it has called Choco-pops. The marketing manager has produced a break-even chart for Choco-pops, based on cost information supplied by the operations department and a proposed selling price of \$1.50.

The operations manager, who recently joined Sunshine Foods from one of its main competitors, wants to introduce a number of changes to SF's operations to improve productivity. He has suggested to the operations director a number of ways of achieving productivity improvements (see Appendix 2) and has also produced a report outlining the case for the introduction of just-in-time inventory management.

The marketing manager is concerned about a recent email received from one of SF's major customers (see Appendix 3).

#### Appendix 1

*Extract from the minutes of the most recent meeting of the Board of Directors*

Minute 3.1      The directors agreed to an investment of \$500 000 over the next two years to finance new flow production methods.

#### Appendix 2

**Extract from the report prepared by the operations manager**

*The company needs to improve productivity. This may be achieved through:*

- *increasing the frequency and quality of training for production workers*
- *improving employee motivation, perhaps through non-financial incentives*
- *investing in new technology.*

#### Appendix 3

**Email message from Core Supermarkets**

*We have recently received complaints from some of our customers about the quality of cereal products manufactured by your company. Some customers have returned boxes of cereal purchased from our supermarkets claiming that the product does not taste very nice, or contains material that does not look like cereal! If these complaints continue then we will have no option but to stop stocking your products and look for an alternative supplier.*

- 1 a** Explain **two** reasons why quality is important to Sunshine Foods.

Reason 1:

Explanation:

Reason 2:

Explanation:

[8]

- b** State the advantages and disadvantages of quality control and quality assurance.

Which method do you think would be most effective for Sunshine Foods to ensure that they produce quality products? Justify your answer.

Quality control:

Quality assurance:

Conclusion:

[12]

- 2 a** Explain **one** advantage and **one** disadvantage to employees at Sunshine Foods of the directors' decision to finance the investment for the introduction of flow production methods.

Advantage:

Explanation:

Disadvantage:

Explanation:

[8]

- b** The operations manager wants to introduce changes to improve productivity at Sunshine Foods.

Explain how each of the following might help the operations manager achieve this objective.

Which one is likely to be the most effective? Justify your answer.

Training:

Improving employee motivation:

Investing in new technology:

Recommendation:

[12]

- 3 a** Explain **two** examples of economies of scale which Sunshine Foods might have benefited from as a result of growth over the past five years.

Example 1:

Explanation:

Example 2:

Explanation:

[8]

- b** State the advantages and disadvantages of break-even charts to Sunshine Foods when launching a new product such as Choco-pops.

Do you think break-even charts are useful to Sunshine Foods when launching new products? Justify your answer.

Advantages:

Disadvantages:

Conclusion:

[12]

- 4 a** Explain **two** reasons why Sunshine Foods should manage the level of raw material inventories.

Reason 1:

Explanation:

Reason 2:

Explanation:

[8]

- b** Explain the advantages and disadvantages of just-in-time inventory management.

Do you think Sunshine Foods should introduce just-in-time inventory management? Justify your answer.

Advantages:

Disadvantages:

Recommendation:

[12]

**Total available marks 80**

## Section 5:

# Financial information and decisions

Just as you need money to finance your purchasing decisions, so too do businesses. Finance is needed for such things as start-up capital, to pay day-to-day expenses and to finance growth plans. In this section you will learn about the different sources of finance available to businesses and how they might choose the most appropriate source for a given situation. Profit is not the same as cash and this will be explained, as will how a business might use cash-flow forecasts to effectively manage its cash balances. All businesses will need to produce financial statements and you will learn about the main elements of income statements and statements of financial position and how different stakeholders might use the information contained in them. By the end of this section you will have learnt how to use ratio analysis to interpret a business's financial statements so that you are able to make reasoned judgement about its performance.

# 19

## Objectives

*In this chapter you will learn about:*

- why businesses need finance
- the difference between short-term and long-term finance
- the main sources of finance
- how businesses make financial choices.



### KEY TERMS

**Start-up capital:** the capital needed by an entrepreneur when first starting a business.

**Working capital:** the capital needed to finance the day-to-day running expenses and pay the short-term debts of a business.

**Non-current (fixed) assets:** resources owned by a business which will be used for a period longer than one year, for example buildings and machinery.

**Capital expenditure:** spending by a business on non-current assets such as machinery and buildings.

# Business finance: needs and sources

## Introduction

The main activity of business is the production of goods and services. This activity cannot take place without the resources of land, labour and capital. The purchase of these resources, and all business activity which follows, is not possible without finance to enable it to take place.

In this chapter you will learn about the different sources of finance available to businesses for funding a wide range of business activities. You will look at the factors that influence the choice of finance and how owners and managers may decide on the source of finance for their business needs.

## Why businesses need finance

Businesses need finance for many different activities including:

- To set up the business. This is known as **start-up capital**.
- To pay day-to-day expenses of the business such as wages, suppliers of raw materials and fuel expenses. This is known as **working capital**.
- To purchase buildings and other **non-current (fixed) assets** such as machines to replace ones that are no longer working efficiently or are obsolete.
- To invest in the latest technology. This is known as **capital expenditure**.
- To finance expansion of the business.
- To finance research into new products and/or new markets.

### CASE STUDY

## Start-up capital

Milena started her business – a juice shop – in her hometown of Palos Blancos, Bolivia. She obtained start-up capital. Through her hard work, dedication and business skills she was soon selling enough juice and milk to purchase two large refrigerators. The growth of her business continued, and Milena took out an additional loan to buy a refrigerated truck.

Today, Milena has plans to expand her business to the next town; she's proud of her ability to create jobs for others.

Source: Adapted from [www.grameenfoundation.org/impact/personal-stories/milena](http://www.grameenfoundation.org/impact/personal-stories/milena)



Selling juice from fresh fruits

**TASK**

- a Define 'start-up capital'.
- b Identify **two** day-to-day expenses of Milena's business.
- c Using an example from Milena's business, define 'capital expenditure'.
- d Why does Milena need more finance for her business?

**KEY TERMS**

**Long-term finance:** debt or equity used to finance the purchase of non-current assets or finance expansion plans. Long-term debt is borrowing a business does not expect to repay in less than five years.

**Short-term finance:** loans or debt that a business expects to pay back within one year.

**TOP TIP**

Most short-term finance is to help manage cash-flow problems. If capital is needed to finance the purchase of items such as non-current assets, for example machinery, then it is more likely to require long-term finance sources.

**Short-term and long-term finance**

Some business activities and decisions need large amounts of money and the business will invest this money over several years – **long-term finance**, for example building a new factory. Other activities need smaller amounts of money over a short period of time – **short-term finance**, for example the purchase of new computers.

**ACTIVITY 19.1**

Leroy is considering opening a tailoring shop in your town. He plans to make men's jackets, trousers, shirts and suits and sell these from the same premises. He would also like to offer a home delivery service.

- 1 Make a list of all the resources Leroy will need when setting up his business.
- 2 Identify the **five** most important items or resources that you think Leroy will have to finance when setting up his business.
- 3 Use the internet, local newspapers and any other resources you think useful to find out the cost of each of these five items.
- 4 Compare your list with the lists of other members of your class and agree on a list of items and their cost (take an average of everyone's costs for each item).
- 5 Total the costs for each of the items the class has identified. This will provide an approximation of the minimum start-up capital that Leroy needs when setting up his business.

**TEST YOURSELF**

- 1 State **three** reasons why businesses may need finance.
- 2 Outline the difference between short-term and long-term finance.

**Main sources of finance**

All of the sources of finance you will learn about in this chapter are appropriate for limited companies, but they may not be suitable for sole traders and partnerships. This is because these unincorporated businesses:

- cannot raise capital through the sale of shares
- usually only need to finance small capital expenditure projects
- are often considered by lenders to be too high-risk for large-scale borrowing.

Businesses can fund their activities using both internal and external sources of finance.



**Unincorporated:** see Chapter 4, page 48.

## Internal sources of finance

This is capital which can be raised from within the business itself. Sources include:

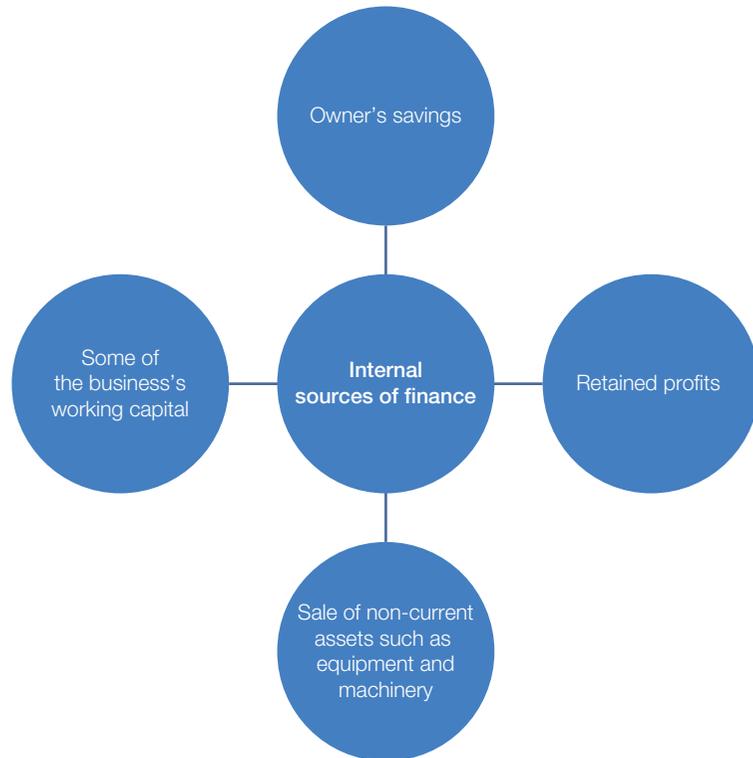


Figure 19.1 Internal sources of finance



### KEY TERM

**Retained profit:** profit remaining after all expenses, tax and dividends have been paid and which is ploughed back into the business.

### Retained profits

The owners of a profitable business may decide to reinvest some of their profits in the business instead of taking the profits themselves. This source of finance is known as **retained profits**. Once a business has paid all of its business expenses, including interest on borrowing and taxation, then the profit remaining belongs to the owners. Usually, owners receive part of the profits as dividends and the rest is reinvested back into the business.

The distribution of after-tax profit between dividends and retained profits is shown in the appropriation account of a company's income statement.

#### Extract from Company Y's Income Statement

##### Appropriation Account

	\$m
Profit after tax	13.6
Dividends	7.8
Retained profit	5.8

In the above example, Company Y had \$13.6m profit after paying tax. This amount belongs to the shareholders as they are the owners of Company Y. However, instead of distributing all of this profit to the shareholders as dividends, the company decided only to pay dividends of \$7.8m. The balance, \$5.8m, is kept as retained profit. This amount becomes a source of internal finance for the company which management can use to fund capital expenditure projects.



**Appropriation account:** see Chapter 21, page 273.

The amount available from retained profits is likely to be higher for a multinational company than it is for a sole trader. Nevertheless, it remains a very important source of finance for businesses of all sizes and types.

The main benefit of using retained profits is that there is no cost to the business. The profits have been earned through its trading activities. However, the main limitation of this source of finance is that it is only available when the business is profitable. If profits are low then there will not be enough retained profits to fund large investment projects. If the business makes a loss, then there will be no retained profit for reinvestment.

### Sale of non-current (fixed) assets

This is another possible source of internal finance. A business may be able to raise finance through the:

- sale of unwanted non-current assets
- sale and leaseback of non-current assets, for example selling land and buildings owned by the business and then renting them back from the new owner.

### ACTIVITY 19.2

Discuss with a classmate why:

- 1 The sale of an unused building is likely to raise more money than the sale of a piece of machinery.
- 2 The sale of a three-year-old motor vehicle is likely to raise more money than the sale of ten three-year-old computers.
- 3 The sale of a very large item of machinery which cost \$1m when bought new three years ago might only raise a much smaller sum of money if sold today.

The main benefit of this source of finance is that it has no direct cost to the business. However, it depends on whether the business has unwanted assets to sell and there is someone who wants to buy them.

Sometimes non-current assets, such as machinery, have a very specialised purpose. They have no commercial value except as scrap metal. If so, then the sale of such assets is unlikely to raise a lot of money. However, unwanted land or buildings are likely to be much more commercial. Buyers will be easier to find and a lot of capital can be raised.

Sometimes the business sells a non-current asset – usually land and buildings – and then leases the asset back from the new owner. This is known as sale and leaseback.

The benefits of raising finance through the sale and leaseback of non-current assets such as land and buildings include:

- there is no direct cost to the business
- it can often raise very large amounts of money.

The limitations of this method of raising finance include:

- future fixed costs of the business will increase as they now have to pay annual leasing charges to the new owner
- leasing charges are likely to increase each time the lease is renewed
- when the leasing agreement comes to an end the business may have to find new premises if the new owner decides that they want to use the land or buildings for other purposes.

## Cemex

### Cemex selling assets to raise cash

Cemex is the largest cement producer in the western hemisphere. The Mexican company also part owns subsidiaries in Trinidad and Jamaica.

According to a Bloomberg report in February, Cemex has not declared a profit in the past two years.

Cemex got into trouble because of an expensive purchase of the building products company Rinker Group in 2007. More than 80% of Rinker Group's revenue was from its sales in the USA. Just after Cemex purchased Rinker Group, the USA went into recession. The recession led to a sharp decrease in the sale of cement and other building products.

In his 2011 letter to Cemex shareholders, the company's CEO stated: 'In 2011, we sold assets valued at US\$225 million, and expect to sell an additional US\$500 million in assets by the end of 2012. All of these sales meet two important criteria: they improve our return on capital employed and reduce our long-term debt.'

Source: Adapted from [www.aggregateresearch.com/articles/24779/Cemex-selling-assets-to-raise-cash.aspx](http://www.aggregateresearch.com/articles/24779/Cemex-selling-assets-to-raise-cash.aspx)

#### TASK

- Explain **two** reasons why Cemex needed to raise finance from the sale of assets.
- Do you think selling assets was the best source of finance for Cemex to use to pay off its debts? Justify your answer.



**Working capital:** see Chapter 20, page 263.

#### Use of working capital

Businesses may be able to use some of their working capital to raise additional funds. Sources of finance may come from:

- cash balances
- reducing inventory levels
- reducing trade receivables (debtors).

#### Cash balances

Any cash a business has can be used to finance capital expenditure. However, businesses must make sure that they have enough cash to finance their day-to-day expenses, short-term debts and any unexpected expenditure. If too much cash is used to finance capital spending, they risk not being able to pay day-to-day expenses. This could threaten the survival of the business.

#### Reducing inventory levels

The business may decide to reduce the quantity of raw materials and components or finished goods it holds.

For example, if a business has inventories valued at \$60 000 and it is able to reduce this to \$50 000, then this will mean that \$10 000 less cash is tied up in inventories. This cash is now available for other, more profitable, uses.



**Inventories:** see Chapter 15, page 205.

**Reducing trade (or accounts) receivables**

Most businesses sell goods to customers on credit. These used to be referred to as debtors. This means that customers receive the goods but pay for them at an agreed date in the future, for example 30 days after delivery. A business can reduce the length of time it has to wait for payment by making sure that customers pay on time or offering discounts on early payment. By reducing the total of accounts receivable in this way the business's cash balances increase and this provides a possible source of internal funds for capital expenditure.

The amount of finance raised by reducing working capital depends on the size of the business as larger businesses are likely to have higher levels of inventory and credit sales than small businesses. But reducing the value of working capital is risky because it may reduce the business's liquidity and its ability to pay short-term debts.



**Liquidity:** see Chapter 23, page 288.

**ACTIVITY 19.3**

Invicta Engineering (IE) is a small private limited company that manufactures mechanical components. Its main customers are other businesses which manufacture domestic appliances such as washing machines, vacuum cleaners and refrigerators.

The owners of IE are considering how to finance the purchase of a new machine. The machine has a capital cost of \$14 000.

The directors of IE want to use internal sources of finance to fund the purchase of the machine. They have asked Kasinda, the company's finance manager, to provide them with relevant financial data. This is shown in the table below.

	\$000
Raw material inventories	18
Finished goods inventories	12
Trade receivables – over 60 days	4
Trade receivables – 30–60 days	8
Trade receivables – under 30 days	30
Bank balance	14

Table 19.1 Extract from IE's most recent quarterly financial statement

Notes:

IE holds enough raw material inventories for three weeks' production.

IE gives customers 30 days' credit.

The finance director has suggested reducing the raw material inventories so that IE only holds enough for one week's production. The operations director disagrees. He proposes reducing the level of finished goods inventories by 50%. The marketing director disagrees with this proposal.

- 1 Explain why the directors of IE decided against using any of the current cash balance to finance the purchase of the new machine.
- 2 Explain **one** limitation to IE of the finance director's proposal to reduce raw material inventories.
- 3 Explain why you think the marketing director disagrees with the operation director's proposal for finished goods inventories.
- 4 Discuss how the directors of IE might raise the \$14 000 from within its working capital.

**TOP TIP**

You must show that you understand the difference between an overdraft and a bank loan. A bank loan describes loans over 12 months, so generally anything described as a 'bank loan' without any time span cannot be accepted as a short-term measure.

## External sources of finance

This is capital which is raised from outside the business. External sources of finance are usually divided into short-term and long-term sources.

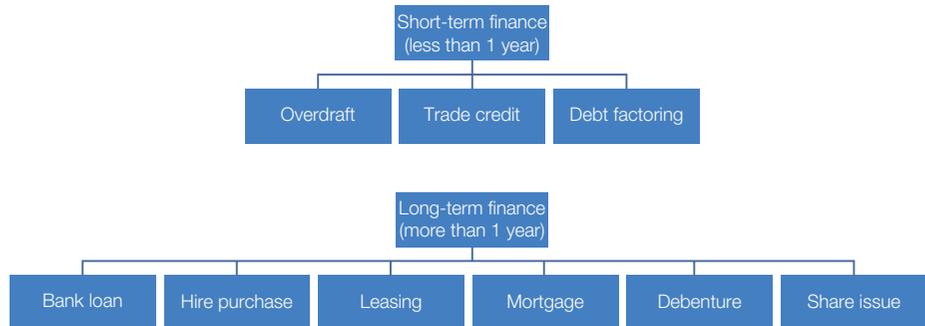


Figure 19.2 External sources of finance

### Short-term sources

Businesses sometimes need to borrow finance for a short period of time. If the finance is needed for less than one year it is classified as short term. The main sources of short-term finance are:

#### Overdrafts

Most businesses will have an **overdraft** agreement with their bank. This allows them to withdraw a sum of money from their account which is greater than the balance in their account. This is a very flexible source of finance because businesses are able to change the amount of borrowing at short notice depending on their needs. However, the cost of this type of borrowing is often higher than most other sources of borrowing. For this reason overdrafts are usually used only to meet short-term cash shortages.

#### Trade credit

Businesses usually buy most of their resources such as raw materials and components from their suppliers on credit. Trade credit is a source of finance as the supplier is really lending the money for the cost of the goods for the length of the agreed credit period.

If a business can negotiate longer credit terms with suppliers it will increase short-term finance. For example, if a business can buy \$5000 of raw materials from its supplier on credit terms of 40 days instead of 30 days, then this means that the business has \$5000 available for an extra ten days.

Another way of using trade credit to provide short-term finance is to delay the payment to the supplier. For example, instead of negotiating with the supplier to increase the credit period from 30 days to 40 days, the customer simply takes longer to pay. The limitations of this include:

- any discount offered by the supplier for prompt or early payment will be lost
- the supplier may refuse further deliveries to the business until the outstanding payment has been made
- if delayed payment occurs too often, then the supplier may demand payment before delivery.

**KEY TERM**

**Overdraft:** an agreement with the bank which allows a business to spend more money than it has in its account up to an agreed limit. The loan has to be repaid within 12 months.

**ACTIVITY 19.4**

Explain one consequence for a business of the three possible supplier actions outlined above.

**KEY TERMS**

**Trade receivables:** amount owed to a business by its customers who bought goods on credit.

**Debt factoring:** selling trade receivables to improve business liquidity.



**Trade receivables:** see Chapter 22, page 278.

**KEY TERM**

**Bank loan:** provision of finance by a bank which the business will repay with interest over an agreed period of time.

**KEY TERM**

**Leasing:** obtaining the use of a non-current asset by paying a fixed amount per time period for a fixed period of time. Ownership remains with the leasing company.

**Debt factoring**

Although most businesses in the retail sector insist on cash payment for any sales, most other businesses usually sell their goods to customers on credit terms. These customers become a debtor to the business and are shown in the statement of financial position as **trade receivables**. The longer the period of time a business gives its customers to pay, the greater the amount of finance it will need to find from other sources to be able to meet day-to-day expenses and other short-term debts.

One solution to this problem is to sell the debt to a **debt-factoring** company. The debt-factoring company buys the debt for a discounted amount. This provides the business with immediate cash. The debt-factoring company gains a profit as it will receive the full payment from the customer.

**Long-term sources**

Any source of finance which is required for more than one year is classified as long-term. Some long-term finance might be needed for buying non-current assets with a relatively low value, for example a motor vehicle. The amount needed will be quite small compared to the finance needed for non-current assets such as a new production line or factory extension. The main sources of long-term finance are:

**Bank loan**

A **bank loan** is the most common source of external business finance. The amount borrowed is offered with either a fixed or a variable rate of interest. If the rate of interest is fixed, then the business can be certain as to how much interest it will have to pay over the whole life of the loan. This reduces the risk to the business of increased costs if interests on borrowing rise in the future. A variable rate of interest can rise or fall depending on economic factors.

Small businesses often find it more difficult to obtain bank loans as they are seen as a greater risk by the banks. If they are able to obtain a loan then this is often at a higher rate of interest than might be charged to larger businesses which are seen to be at a much lower risk of not being able to repay the loan when due. Also, larger businesses will often have collateral which they can use as security against any money borrowed.

**Leasing**

**Leasing** is most often used as a source of finance for non-current assets, in particular motor vehicles and machinery. In return for having use of the asset, the business pays the leasing company a fixed amount over a set period of time. This payment is usually paid monthly or quarterly. The asset is not owned by the business and at the end of the lease term it can give the asset back to the leasing company. The leasing company is usually responsible for the maintenance and repair of the asset.



## KEY TERM

**Hire purchase:** the purchase of an asset by paying a fixed repayment amount per time period over an agreed period of time. The asset is owned by the purchasing company on completion of the final repayment.



## KEY TERM

**Mortgage:** a long-term loan used for the purchase of land or buildings.

### Hire purchase

Like leasing, **hire purchase** is most often used to finance non-current assets such as motor vehicles and machinery. However, the main difference is that the business will own the asset once all payments have been made and it is responsible for any maintenance or repairs to the asset.

Both leasing and hire purchase enable a business to have the use of an asset without the need for a large one-off cash investment. The cost is spread over time – usually one to five years – and this can be financed out of working capital. Both of these sources of finance include an interest charge as part of the payment.

The main limitation with both of these sources of finance is that they are expensive as the interest charges are much higher than other finance options.

### Mortgage

A **mortgage** is similar to a bank loan but is used specifically for the purchase of land or buildings. Interest is charged on the amount borrowed and this must be paid each year. By the end of the mortgage term the amount borrowed must be completely repaid.



Mortgages are used for the purchase of land or buildings



## KEY TERM

**Debenture:** a bond issued by a company to raise long-term finance usually at a fixed rate of interest.

### Debenture

A **debenture** is a type of bond that a business sells in order to raise very large sums of money. In return for buying the bond or debenture, the buyer receives a fixed rate of interest per year. At the end of the debenture term, the full purchase price of the debenture must be repaid to the debenture holder. It is usual for a business to provide security against the value of the debenture so that the debenture holder is guaranteed to get their money back even if the business is unable to repay it themselves. For example, a business may provide the debenture holder with the legal right to sell some of its land or buildings if it fails to repay the amount borrowed.



**KEY TERM**

**Share issue:** a source of permanent capital available to limited liability companies.



**KEY TERM**

**Equity finance:** permanent finance provided by the owners of a limited company.



**EXPLORE!**

Research the financial and other support the government provides for businesses in your country. Your research should consider the type and level of support available, the purpose of the grant/support, whether the grant has to be repaid and why the government is providing the grant/support.



**KEY TERM**

**Micro-finance:** small amounts of capital loaned to entrepreneurs in countries where business finance is often difficult to obtain. These loans are usually repaid after a relatively short period of time.



**KEY TERM**

**Crowd-funding:** financing a business idea by obtaining small amounts of capital from a large number of people, most often using the internet and social media networks.

**Share issue**

This source of finance is only available to limited companies as they are the only form of legal structure allowed to raise finance through a **share issue**. The company can offer to sell shares up to a maximum number. This is called authorised share capital. Private limited companies can only sell shares to existing shareholders or private investors. Public limited companies can offer their shares for sale to the general public. The amount of capital raised through a share issue becomes permanent capital and never has to be repaid unless the business ceases to trade.

**Debt or equity financing for long-term finance?**

	Benefits	Limitations
Debt financing	Does not change the ownership of the company. Lenders have no say in the running of the company.	Interest is charged on the amount borrowed and this increases business costs. Interest must be paid even if the business makes a loss. The amount borrowed must be repaid.
Equity financing	It never has to be repaid. There is no ongoing cost. If the business makes a loss it does not have to pay dividends to shareholders.	The increase in shareholders 'dilutes' the ownership of the company. Producing a prospectus to offer the shares for sale is expensive.

Table 19.2 Benefits and limitations of debt and equity financing

**Government grants**

The governments of many countries support businesses in their country by providing grants and other financial assistance to encourage new business start-ups, or to assist business growth and development.

**Alternative sources of capital**

**Micro-finance**

In some parts of the world it is difficult for people with a business idea to get access to any of the sources of finance outlined above. These entrepreneurs are often from poor backgrounds so do not have any savings or family or friends who are able to loan them the money to start their business. Banks and other lenders will not lend them the money as they are considered to be too high-risk.

In more recent times, mainly thanks to the vision of people like Professor Muhammad Yunus, founder and managing director of Grameen Bank, **micro-finance** is now available to people wishing to start a business, but who are unable to obtain finance from any other source. The loans are often for small amounts and are typically repaid within six months to a year. Once the loan has been repaid it then becomes available to other borrowers.

**Crowd-funding**

Entrepreneurs publish their idea for a project on the internet or through social media networks. They say how much finance they need, what they will do with the capital raised and how any investor might benefit in the future. They invite anyone who is interested to invest in their business idea. Often the finance is raised from a large number of people each investing a small amount of money.

## Marie-Claire Ayurwanda's story

After her second husband died, Marie-Claire decided to start a business. She took a \$40 loan from Village Phone micro-finance partner URWEGO to open the Isimbi Restaurant. The profits from the restaurant help support the four children in her household and pay school fees. If a customer wants to make a phone call, she proudly takes them to a separate, private room where she has set up her Village Phone.

Her Village Phone business was so profitable that she was able to pay off the loan for it in five months. She is now interested in adding a second phone that she can run in another small village. She also wants to buy a pickup truck to help others in IMPUHWE thrive economically. 'People in the association have their own gardens with Irish potatoes. With a pickup, I can take the potatoes to Kigali and sell them.'

*Source:* Adapted from <http://worldrelief.org/Page.aspx?pid=1674>. Visit this website for more information about micro-financing and read some of the success stories from around the world.

### TASK

- a Why might Marie-Claire be described as an entrepreneur?
- b Why might Marie-Claire have found it difficult to raise the finance she needed for her business from banks and other lenders?
- c Do you think Marie-Claire has a successful business? Justify your answer.

## Factors influencing the choice of finance

- **Size and legal form of business** – unincorporated businesses such as sole traders and partnerships are unable to raise finance by issuing shares. These smaller businesses will also find it more difficult to borrow from banks and other lenders because they are considered at greater risk of not being able to pay back the amount borrowed. Even when small businesses are able to borrow from banks, they are often charged a higher rate of interest. The business's legal status may therefore influence the sources of finance available to it.
- **Amount required** – if a large capital amount is required then share issues and debentures are more appropriate. A smaller amount might be financed through bank loans or leasing and hire purchase.
- **Length of time** – the business needs to plan carefully to decide how long it will need the finance for. If it is very long-term finance then it may want to consider debentures or share issues. In the short term, an overdraft may be the most flexible solution. The longer the period of time finance is borrowed over, the more costly it will be because of interest payments.
- **Existing borrowing** – if a business already has existing borrowing then it might find it more difficult to borrow further amounts from banks and other lenders. This is because it will be seen as a greater risk.



### TOP TIP

You must be able to describe the main sources of finance, but more importantly you must know which source would be suitable in a given situation.

## Choosing sources of finance

We have seen above the factors that may influence the choice of finance. Choosing the right source of finance will require consideration of these factors combined with other factors such as the profitability of the business, why the finance is needed and the extent to which the owners want to retain control over their business.

The more profitable a business is, the easier it will be for it to finance some of its plans through retained profit. However, for a limited company this might mean reducing the dividends paid to shareholders. Banks and other lenders are more likely to lend to businesses earning high profits because they are going to be able to make interest payments and repay the amount borrowed when it becomes due.

Some sources of finance are usually only available for very specific uses. For example, mortgages are only available for the purchase of land or buildings. Leasing is only available for financing physical assets such as cars, machinery and property; it could not, for example, be used to finance a major advertising campaign.

Finally, some sources of finance may affect the ownership of a business. For example, a sole trader might enter into partnership, or a private limited company might convert to a public limited company. In both of these cases the original owners of the business may lose some control over the business.

### TEST YOURSELF

- 1 Explain the difference between internal and external sources of finance.
- 2 Explain the main advantage of retained profit as a source of finance.
- 3 Identify **three** factors that influence the choice of finance.
- 4 Explain the advantages large businesses often have over small businesses when they borrow money from banks.

## Revision checklist

- Businesses need funds for a number of different reasons and these reasons will influence whether they use short-term or long-term sources of finance.
- When choosing between different sources of finance, a business will choose internal sources before external sources because they are less costly.
- In some countries micro-financing and crowd-funding have become popular ways for entrepreneurs to borrow small amounts of finance for business start-ups.
- When choosing which source of finance is the most appropriate to use, businesses will consider a number of factors such as cost, legal status, amount required and level of existing borrowing.

## Exam-style practice questions

- 1** George is a sole trader who owns a bicycle shop in a large town. The shop sells bicycles and cycling accessories. George wants to expand his business by offering a repair service to customers. George will need to rent a workshop and buy some equipment for the repair service. George estimates that he will need \$2000 to rent, fit and equip the workshop and a further \$1000 to buy inventories: a total of \$3000. George is considering asking his bank for a loan.

George's cousin, Winston, has offered to go into partnership with George. Winston would invest \$2000 in the business. Winston is a car mechanic.

- a** Define 'bank loan'. [2]
- b** Identify **two** disadvantages of external sources of finance. [2]
- c** Outline **two** pieces of financial information the bank manager might want to know when considering George's application for a bank loan. [4]
- d** Explain **two** external sources of finance, other than a bank loan, that George might consider for raising all or part of the \$3000 needed to finance the expansion of his business. [6]
- e** Do you think George should go into partnership with his cousin, Winston? Justify your answer. [6]
- 2** Bright Spark Electrical (BSE) is a private limited company. It manufactures large electrical appliances which are used in large commercial kitchens such as those found in hotels, schools and hospitals. The business has been very profitable over the past three years and this year is expecting profits to be \$100 000.
- One of BSE's most important machines for making appliances is nearly ten years old. Over recent months it has had to be repaired several times. The Board of Directors wants to replace the machine with a new one costing \$200 000. It is considering two finance options for this capital expenditure:
- leasing
  - debenture.
- a** Identify **two** features of a 'private limited company'. [2]
- b** Define 'capital expenditure'. [2]
- c** Outline **two** internal sources of finance available to businesses such as BSE. [4]
- d** Explain **two** factors that might influence BSE's choice of finance for the new machine. [6]
- e** The directors of BSE could choose to finance the purchase of new machinery through leasing or debenture. Which do you think is the best option for this business? Justify your answer. [6]

# 20

## Objectives

*In this chapter you will learn about:*

- the importance of cash to businesses
- cash-flow forecasting
- how businesses deal with short-term cash-flow problems
- the importance of working capital to businesses.

# Cash-flow forecasting and working capital

## Introduction

Business owners, especially those setting up a new business, need to understand the importance of cash. Making a profit is good but it is cash that will pay the bills!

Cash-flow management is essential to all businesses' survival. Surveys of failed businesses show that for more than half of these the main reason for failure was poor cash-flow management.

In this chapter you will study the importance of cash to a business, and how it can be effectively managed and what businesses might do if faced with the problem of temporary cash shortages.

## The importance of cash and cash-flow forecasting

### Why cash is important to businesses

There is a saying 'cash is king'. A business needs cash. Without it, the business will not be able to pay:

- its employees' wages
- its suppliers for goods and services
- rent, heating and lighting and other costs for its premises.

Without cash, a business will fail.

How does a business make sure it has enough cash to pay its bills? Most businesses operate cash-flow management, which means that they have the finance whenever they need it to pay their employees, or their suppliers, and so on. Managing a business's cash flow involves making sure that enough cash is coming in to the business to cover the cash that goes out of the business. For example, is there enough cash from the sale of goods to cover the amount needed to pay suppliers?

Here are some examples of businesses that failed because their owners did not manage the business's cash flow well.

Chinese home electronics company Dong Guan Yufeng Co. Ltd used its short-term cash flow to repay business debts. This left it without enough cash to pay bank loans and suppliers – the business failed.

African catering business Premier Catering Supplies Ltd used cash to buy shares in other companies. Eventually, it ran out of cash. Employees complained about not being paid, and the business failed.

**TOP TIP**

Cash is not the same as profit so make sure you understand the difference. A profitable firm can run out of cash. If it does, and cannot pay its debts, then even though it is profitable it might still not be able to survive. In the short run, cash is more important than profit.

Dozens of Swissair aircraft stood grounded at Zurich Unique Airport. Flights could not take off due to the simple lack of cash flow. So little was available that there wasn't enough money to pay for jet fuel.

**What is a cash-flow forecast?**

All business activity results in either a flow of cash into the business or a flow of cash out of the business. The survival of any business depends on the cash inflows being greater than the cash outflows.

**EXPLORE!**

Investigate new businesses that have set up in your area.  
 Why did they need cash in the first few months of trading?  
 Prepare a diagram showing the cash inflows and the cash outflows of the business.

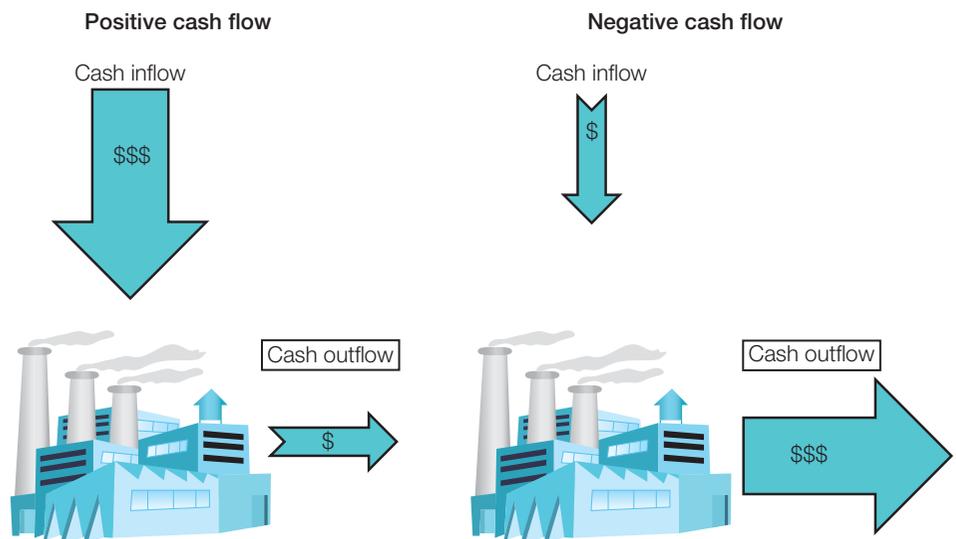


Figure 20.1 Positive and negative cash flow

It is better to have a positive cash flow as any temporary cash shortage may cause problems for the business and result in an increase in borrowing costs.

To prevent a negative net cash flow, businesses need an accurate forecast of the size and timing of cash inflows and cash outflows. This **cash-flow forecast** enables businesses to identify any future time periods when cash shortages may occur.

**Constructing a simple cash-flow forecast**

The cash-flow forecast in Figure 20.2 shows the amount of cash inflow and outflow each month. The difference between the monthly inflow and outflow is called the net cash flow. For example, in January the business expects to receive a \$10 000 cash inflow, but in the same month expects a \$7000 cash outflow. This means that in January there will be a **net cash flow** of \$3000 (\$10 000 – \$7000).

**KEY TERMS**

**Cash-flow forecast:** an estimate of the future cash inflows and outflows of a business.

**Net cash flow:** cash inflow minus cash outflow.

	Jan	Feb	Mar
Cash inflow			
Receipts	10	15	18
Total inflow	10	15	18
Cash outflows			
Payments	7	27	12
Total outflow	7	27	12
Net cash flow	3	(-12)	6
Opening balance	5	8	(-4)
Closing balance	8	(-4)	2

Figure 20.2 Sample cash-flow forecast

The closing balance in the cash-flow forecast shows how much cash the business expects to have at the end of each month. If the closing balance is forecast to be negative then this tells management that the business will have a cash shortage.

**ACTIVITY 20.1**

Look at the cash-flow forecast in Figure 20.2.

- 1 In which month is there going to be a negative closing balance?
- 2 What has caused the balance at the end of this month to become negative?

**TOP TIP**

You will not be expected to draw up a cash-flow forecast for IGCSE or O Level Business Studies, but you might be asked to fill in missing numbers.

If a business knows in advance that there is going to be a period of cash shortage, it can take action to try to prevent this from happening.

In the cash-flow forecast in Figure 20.2 the negative closing balance in February is caused by the outflows for the month being much higher than the inflows. If possible, managers need to increase the inflows or reduce the outflows.

Let's assume that the payments for February include the purchase of a new delivery van at a cost of \$16 000. If the decision to buy this vehicle is delayed by one month then the amended cash-flow forecast will look like the one in Figure 20.3.

	Jan	Feb	Mar
Cash inflow			
Receipts	10	15	18
Total inflow	10	15	18
Cash outflows			
Payments	7	11	28
Total outflow	7	11	28
Net cash flow	3	4	(-10)
Opening balance	5	8	12
Closing balance	8	12	2

Figure 20.3 Amended cash-flow forecast

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Cambridge University Press

Delaying the purchase of the delivery vehicle improves the cash flow by removing the negative cash balance in February. If the business cannot delay the purchase of the delivery van by one month it has two options:

- Use another source of finance for the purchase of the van, for example hire purchase, leasing or a bank loan.
- As the cash shortage is forecast to be very short term, then the business may arrange an overdraft with the bank to cover the shortfall.
- Both of these options are more costly than delaying the purchase of the vehicle until March.

## ACTIVITY 20.2

The following cash-flow forecast has been produced by the finance manager of Lucky Charm Jewellers (LCJ).

	Jan	Feb	Mar	Apr	May	Jun
Cash inflow						
Receipts	12	14	14	18	26	29
Total inflow	12	14	14	18	26	27
Cash outflows						
Payments	16	18	18	20	20	22
Total outflow	16	18	18	20	20	22
Net cash flow	(-4)	(-4)	(-4)	(-2)		
Opening balance	10	6	2	(-2)		
Closing balance	6	2	(-2)	(-4)		

- 1 Calculate the closing balance for both May and June.
- 2 Comment on the forecast cash flow for LCJ between January and June.
- 3 How could the finance manager use the cash-flow forecast to better manage LCJ's cash flow?



**Hire purchase, leasing, bank loan:** see Chapter 19, page 252.



**Overdraft:** see Chapter 19, page 251.

### Interpreting cash-flow statements

Remember, the most important line on any cash-flow statement is the one containing the 'closing balance'. If a business's cash position is forecast to become negative for a short period of time, management might decide to finance this with an overdraft. However, overdrafts can be a very expensive source of finance. Before deciding to use an overdraft, managers should consider ways of removing or reducing the cash shortage. Even if they only reduce the size of the forecast cash shortage, this will at least reduce the size and cost of any required overdraft.



**TOP TIP**

You will need to know the reasons for cash-flow problems and how a business might overcome them.

### Financing a short-term cash shortage

There are several ways a business can overcome a short-term cash-flow problem. It can:

- ask trade receivables to pay for goods more quickly by offering discounts to customers who have been sold goods on credit
- negotiate longer credit terms with suppliers
- delay the purchase of non-current assets until the cash flow improves
- find other sources of finance for the purchase of non-current assets.

### ACTIVITY 20.3

The following cash-flow forecast has been prepared for the next four months for AGO.

	Month 1	Month 2	Month 3	Month 4
	\$000	\$000	\$000	\$000
Cash inflow				
Receipts	35	42	36	47
Total inflow	35	42	36	43
Cash outflows				
Payments	33	46	53	35
Total outflow	33	46	53	35
Net cash flow	2	(-4)	(-17)	8
Opening balance	11	13	9	(-8)
Closing balance	13	9	(-8)	0

Having discussed the cash-flow forecast, the management of AGO plan to take the following actions:

- Offer an early payment discount to some of their most important customers. They expect that this will improve the inflow by \$1000 in months 1 and 2 and by \$2000 in months 3 and 4.
- In month 3 they were planning to replace one of their delivery vehicles with a newer model. They have decided to look at other ways of financing this purchase. They are considering leasing the vehicle instead of an outright cash purchase. This will reduce cash outflows in month 3 by \$8000, but increase the outflow in month 4 by \$2000, when the first quarter lease payment will be due.
  - 1 Use the information above to amend AGO's cash-flow forecast.
  - 2 Comment on your amended cash-flow forecast.
  - 3 Do you think the management of AGO were right to use a lease to finance the new delivery vehicle? Justify your answer.

### TEST YOURSELF

- 1 Explain why cash is important to a business.
- 2 Why is it important for a business to forecast its cash flow?
- 3 How might a business finance a short-term cash shortage?

## Metrorail

### Cash Flow Problems at Metrorail

East Rand-based Sinqobile Equestrian Security Services was forced to take Metrorail to court to try to recover money it was owed. It lost the case, but the company has since managed to recoup R1.5m and has been promised the balance 'soon'.

'We supply about 450 security guards to Metrorail, of which

about 80 are mounted. So far we have managed to feed the horses and pay the guards,' Sinqobile director Andries de Klerk told the paper.

Metrorail's financial manager is quoted as saying that 'supplier payments were being delayed due to Metrorail experiencing cash flow challenges in meeting its financial obligations'.

Source: Adapted from [www.railwaysafrica.com/blog/2010/02/cashflow-problems-at-metrorail](http://www.railwaysafrica.com/blog/2010/02/cashflow-problems-at-metrorail)

#### TASK

- Define 'cash flow'.
- How has the cash-flow problem at Metrorail affected Sinqobile?
- Why might the cash-flow problem be worse for Sinqobile than it is for Metrorail?
- How might Sinqobile overcome its cash-flow problem?



**Liquidity:** see Chapter 23, page 288.



#### KEY TERM

**Liquidity:** the ability of a business to pay its short-term debts.

## Working capital

All businesses must have enough finance to pay for their day-to-day expenses such as paying employees' wages and buying raw materials. Many businesses offer their customers credit terms, so they must also be able to finance the level of credit given to these customers.

Working capital measures the **liquidity** of a business. Liquidity is the ability of a business to pay its short-term debts. A business which does not have enough working capital will be illiquid. That means it cannot pay its short-term debts. If this happens the business may have to borrow the finance required. It will have to pay interest on the amount borrowed and this increases the business's costs. However, if the business is unable to borrow the finance required then it may fail.

The amount of working capital needed by a business depends on the time it takes from buying raw materials, making these into goods for sale, finding buyers for the finished goods and then receiving payment from customers. The relationship between these is known as the working capital cycle.

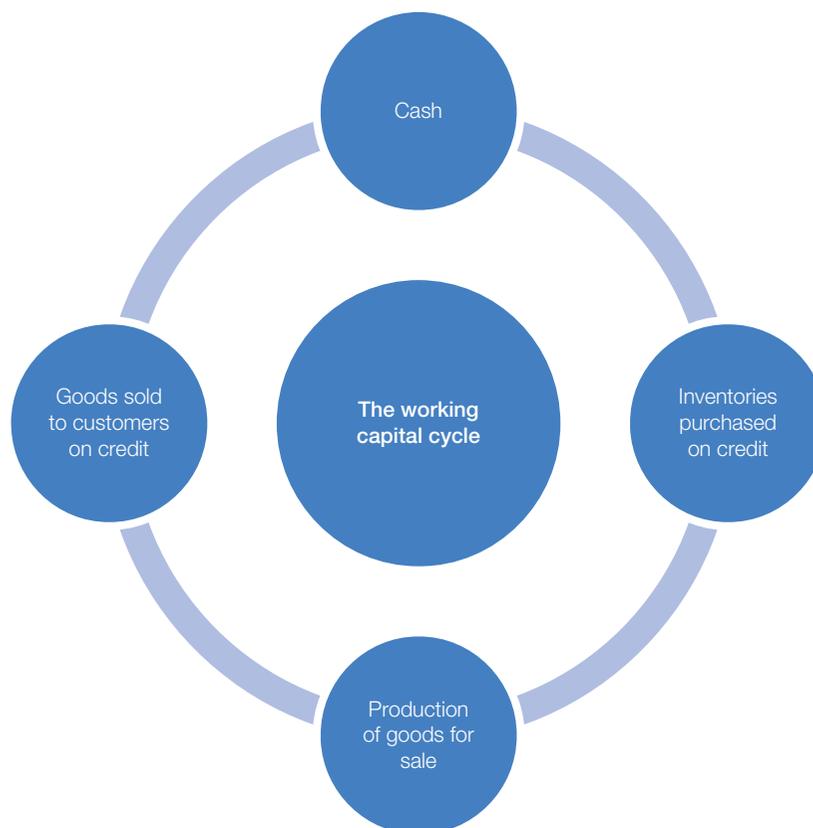


Figure 20.4 The working capital cycle

The length of the working capital cycle depends on:

- the level of inventories held by a business and how quickly suppliers are paid
- how long it takes to produce goods for sale
- how quickly the business finds buyers for its products
- the length of the credit period customers are given – **credit sales**.

A business can improve its working capital by:

- reducing inventory levels
- negotiating longer credit terms with its suppliers
- reducing the amount of time it takes to receive payments from customers who have been supplied goods on credit terms.

You will learn in Chapter 22 that working capital is the difference between current assets and current liabilities.



#### KEY TERM

**Credit sales:** goods sold to customers who will pay for these at an agreed date in the future.



**Current assets and current liabilities:** see Chapter 22, page 278.



**Improving working capital:** see Chapter 19, page 249.

#### TEST YOURSELF

- 1 Define 'working capital'.
- 2 How is working capital calculated?
- 3 Why is working capital important to a business?

## Shonaquip

Cape Town-based Shona McDonald is a highly successful woman who has clinched several prestigious awards for entrepreneurship in the past two years.

Shona founded Shonaquip, a manufacturer of wheelchair buggies and support devices for disabled children. In the early days Shona had two people working for her, and they operated out of her garage.

Today Shonaquip is a well-established and highly regarded business that builds more than 6000 wheelchairs a year, and generates more than US\$4m in revenue. The company employs more than 65 people who help to improve the lives of some of the many disabled people in this country.

Like all successful South African entrepreneurs, Shona had the ability to identify the bigger picture and take calculated risks.

*Source:* Adapted from [www.shonaquip.co.za](http://www.shonaquip.co.za)



A child using one of Shonaquip's wheelchairs

### TASK

- a Why is Shona McDonald a good example of an entrepreneur?
- b Identify **two** reasons why Shona needed cash for her business in the 'early days'.
- c Why is working capital important to Shonaquip?
- d What factors will determine the length of Shonaquip's working capital cycle?

## Revision checklist

- The management of cash is important to a business because it must have enough cash coming in to cover the cash leaving the business.
- Cash-flow forecasts can be used to show the timing of cash inflows and cash outflows and identify any periods of time when the business might have a cash shortage.
- There are a number of ways a business can solve or reduce cash-flow problems including measures to increase cash inflows or delay cash outflows.
- All businesses need sufficient working capital to be able to pay short-term debts and avoid liquidity problems.

## Exam-style practice questions

- 1 Charlotte and Amy are sisters and business partners. In September 2012 they opened a greetings card shop, Cards4U. Although the business has been profitable in its first four months, the business does not always have enough money to pay its suppliers. Their younger sister, Lydia, has a degree in business management. She has produced the cash-flow forecast, shown below, for the first four months of 2013. She has told her sisters that this will help them to manage their working capital more effectively. Charlotte does not see the need for cash management. 'After all,' she said, 'we are making profit!'

	Jan	Feb	Mar	Apr
Cash inflow	\$	\$	\$	\$
Cash sales	160	80	100	140
Credit sales	730	810	960	830
Total cash inflow	990	890	1060	970
Cash outflow				
Cash purchases	520	800	340	915
Credit purchases	60	50	70	55
Shop rent	150			150
Other expenses	30	30	30	30
Total outflow	760	880	640	1150
Net cash flow	30	10	A	(-180)
Opening balance	(-70)	(-40)	(-30)	390
Closing balance	(-40)	(-30)	390	B

Cash-flow forecast January–April 2013

- Define 'working capital'. [2]
- Calculate the missing figures shown as A and B in the cash-flow forecast. [2]
- Outline why the owners of Cards4U should be concerned about the results shown in this cash-flow forecast. [4]
- Explain **two** ways the owners of Cards4U could improve the cash flow of their business. [6]
- Do you agree with Charlotte's view that there is no need for cash management? Justify your answer. [6]

- 2 The following simplified cash-flow forecast has been produced by the finance manager of ABC for the next four months of trading. He has not completed the forecast for March and April.

	Jan	Feb	Mar	Apr
Cash inflows	\$000	\$000	\$000	\$000
Credit sales	230	250	200	180
Total cash inflows	230	250	200	180
Cash outflows				
Payments	160	350	230	160
Net cash flow	70	(100)		
Opening balance	20	90		
Closing balance	90	(10)		

- a Identify **two** reasons why businesses need cash. [2]
- b Define 'net cash flow'. [2]
- c Complete the cash-flow forecast for March and April. [4]
- d Explain **two** benefits to ABC of managing working capital. [6]
- e Recommend how ABC's finance manager might use his forecast to improve the company's cash flow over the coming months. Justify your answer. [6]

**Total available marks 40**

# 21

## Objectives

*In this chapter you will learn about:*

- the importance of profit
- how profit is calculated
- the difference between profit and cash
- income statements.

## Income statements

### Introduction

The main objective of all private sector businesses is to earn a profit.

In this chapter you will learn how profit is made and the important difference between profit and cash. You will look at the main features of an income statement and how the information it contains is used by the business's stakeholders.

### What is profit?

Profit is the difference between revenue and total costs.

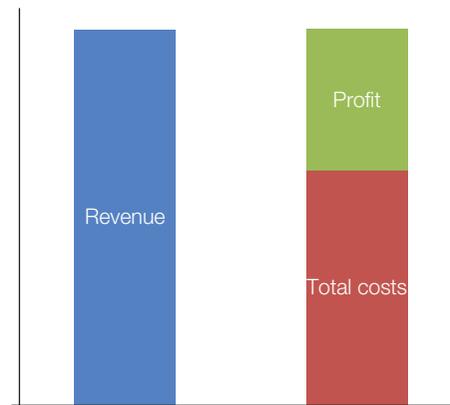


Figure 21.1 Profit = revenue – total costs

There are three types of profit:

- **Gross profit** – the difference between the revenue earned from selling products and the cost of making those products.
- **Profit** – the difference between the revenue from sales and total costs or the difference between gross profit and expenses. Profit used to be called 'net profit'.
- **Retained profit** – the owners of a profitable business may decide to reinvest some of the profits in the business.

### How a profit is made

A business earns a profit by selling its products to customers at a price which is higher than the **total cost** of making and supplying those products.

The profit formula is:

$$\text{profit} = \text{revenue} - \text{total costs}$$

The total amount of money a business earns from selling its products is called **revenue**.



#### KEY TERMS

**Gross profit:** the difference between revenue and cost of sales.

**Profit:** the difference between revenue and total costs.



**Retained profit:** see Chapter 19, page 247.



**Total cost:** see Chapter 16, page 215.



#### KEY TERMS

**Total cost:** costs of sales plus expenses.

**Revenue:** the amount earned from the sale of products.

**KEY TERM**

**Cost of sales:** the cost of purchasing the goods used to make the products sold.

The formula for calculating revenue is:

$$\text{revenue} = \text{selling price} \times \text{quantity sold}$$

The total cost to a business of supplying its goods and services can be divided into **cost of sales and expenses**.

**ACTIVITY 21.1**

Chata owns a small bakery. He only makes bread. Chata's main items of expenditure are listed below. Separate the list of items into costs of sales and expenses:

- flour
- electricity
- yeast
- rent
- advertising
- water
- machinery repairs
- salt.

**KEY TERM**

**Expenses:** day-to-day operating expenses of a business.

The formula for calculating gross profit is:

$$\text{gross profit} = \text{revenue} - \text{cost of sales}$$

Another formula for calculating profit is:

$$\text{profit} = \text{gross profit} - \text{expenses}$$

**EXAMPLE**

Chata sells the loaves of bread he makes in his bakery for \$0.30 each. In June, Chata sold 1500 loaves of bread. Chata has calculated his cost of sales for June to be \$150 and his expenses for the month to be \$100.

We can use this information to calculate Chata's gross profit and profit for June.

Chata's revenue will be:

$$\text{selling price} \times \text{quantity of loaves sold}$$

$$\$0.30 \times 1500 = \$450$$

Chata's gross profit will be:

$$\text{revenue} - \text{cost of sales}$$

$$\$450 - \$150 = \$300$$

Chata's profit will be:

$$\text{gross profit} - \text{expenses}$$

$$\$300 - \$100 = \$200$$

Note: if we only wanted to calculate Chata's profit, without calculating gross profit, then we could have used the first profit formula:

$$\text{profit} = \text{revenue} - \text{total costs}$$

$$\text{profit} = \$450 - (\$150 + \$100) = \$200$$

**ACTIVITY 21.2**

Table 21.1 shows Chata’s sales and costs for the first six months of 2013.

	January	February	March	April	May	June
Sales (loaves)	1600	1580	1550	1530	1520	1500
Cost of sales (\$)	160	158	155	153	152	150
Expenses (\$)	100	100	100	100	100	100

Table 21.1 Chata’s sales and costs, January–June 2013

- 1 Calculate Chata’s total revenue for the six-month period, January–June.
- 2 Calculate Chata’s gross profit and profit for the same six-month period.
- 3 Explain why Chata’s cost of sales changes each month, but the expenses remain the same.
- 4 Give **two** reasons which might explain why Chata’s sales of bread have fallen between January and June.



**TOP TIP**

Profit is vital for every business. You must understand why it is important.

**The importance of profit to private sector businesses**

Profit is a reward to business owners for the risk they take in investing their capital into the business. Profit is also used to:

- measure the success of a business
- measure the performance of managers
- decide whether or not to continue making or selling a product
- finance the purchase of non-current assets, expand the business, and so on
- attract investors who will provide the additional funds needed to finance business expansion.



**Private sector businesses:** see Chapter 2, page 25.

**ACTIVITY 21.3**

Consider the information contained in Table 21.2.

	Revenue	Profit	Dividend per share	Retained profit
Company A	\$340 000	\$95 000	\$2.00	\$15 000
Company B	\$260 000	\$101 000	\$1.60	\$27 000
Company C	\$570 000	\$130 000	\$1.30	\$76 000

Table 21.2 Information for Companies A, B and C

Work in small groups and consider the information in the table above and discuss the following:

- 1 Which of the three companies do you think has been the most successful and why?
- 2 Assume you are a shareholder in one of these companies. Giving reasons:
  - a Which company would you choose as a short-term investment?
  - b Would you choose a different company if you were looking for a long-term investment?

## The difference between profit and cash

In Chapter 19 we looked at the importance of cash to a business and in this chapter we have looked at the importance of profit. Many new businesses make a profit, but they do not survive very long because they do not manage their cash well. Businesses often fail because their owners do not understand the difference between cash and profit.

Some of these differences between cash and profit include:

- money invested in a business, or borrowed by a business, increases cash but does not increase profit
- capital expenditure, such as buying a new machine, decreases cash but does not decrease profit
- sales of goods on credit are recorded in the income statement as soon as the goods have been sold. This increases profit but cash does not increase until the buyer pays for the goods.

It is important for owners and managers to remember that cash pays the day-to-day expenses, not profit. Cash is important for the business at all times. Profit becomes more important for the long-term success of the business.

### Jimmy Lie



Bicycles in Indonesia

Jimmy Lie, a young Indonesian entrepreneur, opened a number of upmarket stores selling branded bicycles. He recognised a growing trend for such bicycles among young, affluent Indonesians.

He used his own savings and obtained investment from family members to purchase inventory, rent suitable premises and advertise his business. He paid premises rent in advance, even before he started to sell his bicycles. His shops have made good profits right from the start and he has been able to reward his investors with good dividends. Jimmy has also retained some of his profits.

Jimmy has taken advantage of the new expensive tastes of his consumers and is opening another branch in the city.

*Source:* Adapted from [www.bbc.co.uk/news/business-15809355](http://www.bbc.co.uk/news/business-15809355)

#### TASK

- a Define 'entrepreneur'.
- b How has Jimmy Lie made a profit?
- c Explain **two** reasons why profit has been important to Jimmy Lie's business.
- d Using the case study explain why profit is not the same as cash.

**TEST YOURSELF**

- 1 Explain 'gross profit'.
- 2 State **three** reasons why profit is important to businesses.
- 3 Explain why profit differs from cash.



**KEY TERM**

**Income statement:** a financial statement which records the revenue, costs and profits of a business for a given period of time.



**TOP TIP**

You will not be asked in IGCSE or O Level Business Studies to construct an income statement, but you must know how to interpret one.



**EXPLORE!**

Research the business sections of local and national newspapers and magazines, or use the internet to find examples of financial data about businesses in your country, for example the latest profit figures.

Explain how the data in these reports might be used by any five different stakeholder groups.



**Stakeholders:** see Chapter 5, page 62.

**Retained profit as a source of finance:** see Chapter 19, page 247.

## Income statements

An **income statement** is a financial record of business revenue, costs and profit. It must be produced at least once a year by all businesses. It may be produced more frequently for use by managers.

### Uses of income statements

An income statement contains financial data which business stakeholder groups may find useful. Both internal and external stakeholder groups use the information when analysing business performance against their own objectives. The most important figure on an income statement for stakeholder groups is profit. Why profit is important to different stakeholder groups is summarised in Table 21.3.

Stakeholder	Use
Owners/ shareholders	<ul style="list-style-type: none"> <li>■ Profit after tax belongs to the owners/shareholders. They can see how much they have earned for their investment in the business.</li> </ul>
Shareholders	<ul style="list-style-type: none"> <li>■ Usually the higher the profit, the higher the dividend payment.</li> <li>■ The market value of shares will often rise or fall depending on whether high or low profits earned.</li> </ul>
Employees	<ul style="list-style-type: none"> <li>■ High profit increases job security.</li> <li>■ Employees might expect to receive a good pay rise if a business is making good levels of profit.</li> <li>■ Some businesses have profit sharing schemes, so high profit means high share of profits for employees.</li> </ul>
Lenders	<ul style="list-style-type: none"> <li>■ They want to be sure that profit is enough to pay interest on loans.</li> <li>■ Is the business earning enough profit to be able to repay loans when due?</li> </ul>
Government	<ul style="list-style-type: none"> <li>■ The higher the profit, the more tax the government will receive.</li> </ul>
Suppliers	<ul style="list-style-type: none"> <li>■ A firm that is profitable will continue to purchase raw materials and other supplies. This helps suppliers to earn profits.</li> </ul>
Managers	<ul style="list-style-type: none"> <li>■ They can compare profit from one year to the next, or with competitors' profits, to measure the performance of the business.</li> <li>■ Retained profit is an important source of finance for businesses.</li> </ul>

Table 21.3 The usefulness of profit data to stakeholders

Activity 21.4 is about how different stakeholders might use financial information from the income statements of Muza Toys.

### ACTIVITY 21.4

Working in pairs or small groups, consider the information in the table below.

Change from last year	Cause of change
Revenue increased by 4%	Lower prices increased sale of toys
Cost of sales increased by 1%	More raw materials were purchased
Profit increased by 5%	Better control of expenses
Dividends fell by 3%	To increase retained profits
Retained profits increased	To finance expansion plans

Table 21.4 Comparison of Muza's income statements over the past two years

Each item of information in the table above has been commented on by various business stakeholders. The stakeholders and their comments are shown in the table below.

Stakeholder	Stakeholder comment
Government	This will increase our tax revenue.
Shareholders	The reward for our investment in the business is worse than last year.
Finance manager	This is going to increase our working capital.
Trade union	Our members at Muza should receive a good pay increase this year.
Potential investor	This company might be worth investing in.
Supplier	Our sales and profits have increased because of Muza's increased sales.
Employees	This information is good for our job security.
Lender	The risk of Muza not being able to pay interest on borrowing is less than last year.
Customers	This company is giving us better value for money than other companies.
Senior managers	This will be a good source of finance for our expansion plans.
Competitors	We will have to think about how we price and market our products.

Table 21.5 Stakeholders and their comments about information contained in Table 21.4

In your pairs/groups, discuss why you think stakeholders made the comments shown in the above table about the financial data in Muza's income statement.

## Uchumi

**Uchumi's pre-tax profit drops**

Uchumi is Kenya's second largest retail chain with stores in neighbouring Uganda and Tanzania. Its pre-tax profit fell 35.4% in the half-year ending December 2012 due to lower revenue and higher operating costs.

In October 2012, the company announced it was opening at least eight new branches in the east Africa region by 2014.



An Uchumi store in Kenya

Source: Adapted from <http://kenya.uchumicorporate.co.ke>

**TASK**

- a Define 'profit'.
- b Identify **two** reasons for the fall in Uchumi's half-yearly profits.
- c Explain **three** reasons why profit is important to Uchumi.

**TEST YOURSELF**

- 1 Explain the difference between gross profit and profit.
- 2 Define 'dividends'.

## Revision checklist

- Profit is the difference between the revenue earned from sales and all the costs of producing and distributing the goods and services sold.
- Profit is the return to owners/shareholders as a reward for risking their investment in the business. Some of the profit will be paid to owners and some will be retained in the business to finance future operations and plans.
- The income statement shows how the gross profit and the profit of a business have been calculated. This information is useful to several different stakeholder groups.

## Exam-style practice questions

- 1 Consider the information below for Company A and Company B. Both companies are located in Country Y. Company A is a manufacturer of components used in the car industry. Company B is a manufacturer of leather goods such as belts and watch straps. Sabrina is looking to invest \$10 000 in one of these companies.

### Trading Account

	Company A	Company B
	\$	\$
Revenue	72 000	83 000
Cost of sales	32 000	41 000
Expenses	22 000	30 000
Profit	18 000	12 000
Retained profit	15 000	3 000

- a Define 'revenue'. [2]
- b Identify **two** examples of an overhead cost. [2]
- c Outline **two** reasons why profit is important to businesses such as Companies A and B. [4]
- d Explain **two** uses of Company A's income statement to any **two** stakeholder groups. [6]
- e In which company do you think Sabrina should invest her \$10 000? Justify your answer. [6]
- 2 Victory Machines (VM) is a manufacturer of motorcycles. The data below shows the market data for motorcycles and VM's revenue and profit data for the motorcycles it produces.

	VM's financial data for motorcycles in 2012	Market data for motorcycles in 2012
Revenue	5% share of the market	\$8 500 000
Profit	\$84 000	\$3 400 000
Dividends paid	\$70 000	–
Retained profit	\$14 000	–

In 2011 VM's profit was \$91 000. It paid \$58 000 in dividends.

- a** Identify **two** internal stakeholders who might be interested in the financial performance of VM. [2]
- b** Calculate VM's revenue for 2012. [2]
- c** Outline the possible benefit to VM of retained profits. [4]
- d** Explain **two** possible causes for the fall in VM's profits between 2011 and 2012. [6]
- e** Do you think VM's shareholders will be satisfied with their investment in VM? Justify your answer. [6]

**Total available marks 40**

# 22

## Objectives

*In this chapter you will learn about:*

- the main parts of a statement of financial position
- assets and liabilities
- how to interpret a simple statement of financial position.



### KEY TERMS

#### Statement of financial position:

an accounting statement that records the assets, liabilities and owners' equity of a business at a particular date.

**Assets:** resources that are owned by a business.

**Liabilities:** debts of the business that will have to be paid sometime in the future.



**Stakeholders:** see Chapter 5, page 62.

# Statement of financial position

## Introduction

As the name suggests, a statement of financial position is a snapshot of a business's current financial position. In this chapter you will study the main parts of a statement of financial position and understand what stakeholders can learn about the business from the information contained in the statement.

## The main parts of a statement of financial position

A **statement of financial position** shows the financial position of a business at a certain point in time. It is a statement about the business on the date the statement of financial position was prepared. It is a record of a business's **assets** and **liabilities**. The statement also shows how a business finances its operations.

Limited companies must, by law, produce a statement of financial position at the end of every financial year. Other types of business often choose to produce a statement at the end of their financial year as it provides useful information about the business for both internal and external stakeholders.

The layout and main parts of a limited company's statement of financial position are shown below:

Statement of financial position for Tang Toys as at 31 December 2012

Non-current (fixed) assets		100
Current assets	50	
Less:		
Current liabilities	30	
Net current assets		20
<b>Net assets</b>		<b>120</b>
Financed by:		
Owner's capital (equity)		90
Non-current (long-term) liabilities		30
<b>Capital employed</b>		<b>120</b>

### ACTIVITY 22.1

Using the statement of financial position above:

- 1 Can you see why a statement of financial position is sometimes called a 'balance sheet'?
- 2 Net current assets is the difference between current assets and current liabilities. Can you think of another financial term which is also the difference between current assets and current liabilities?

**KEY TERM****Non-current (fixed) assets:**

resources that a business owns and expects to use for more than one year.

**Trade receivable:**

see Chapter 19, page 250.

**Debentures:** see Chapter 19, page 253.



**Liquidity:** see Chapter 23, page 288.

**KEY TERMS**

**Current assets:** resources that the business owns and expects to convert into cash before the date of the next statement of financial position.

**Trade receivables:** the amount of money owed to the business by customers who have been sold goods on credit.

**Current liabilities:** debts of the business which it expects to pay before the date of the next statement of financial position.

**Trade payables:** the amount a business owes to its suppliers for goods bought on credit.

**Non-current liabilities:** debts of the business which will be payable after more than one year.

**Owner's equity:** the amount owed by the business to its owners; includes capital and retained profits.

**Shareholders' equity (funds):** alternative term for owner's equity, but can only be used by limited liability companies.

**Assets**

Assets are any resource which a business owns. They can be divided into non-current assets and current assets.

**Non-current (fixed) assets**

**Non-current (fixed) assets** are resources that the business owns and expects to use for a period of more than one year. Examples are land, buildings, machinery, computers and motor vehicles.

**Current assets**

**Current assets** are cash or any other resource owned by the business which it expects to convert into cash within the next 12 months. The most common examples of current assets are inventories (inventory), **trade receivables** (debtors) and cash. Current assets are very important to business because they are an important source of liquidity.

**Liabilities**

Liabilities are the amounts owed by the business to stakeholders such as suppliers and lenders. The liabilities of a business can be divided into:

- **Current liabilities** are the short-term debts of a business which it expects to pay within the next year. Examples include **trade payables** (these used to be called creditors), bank overdraft, taxation and dividends.
- **Non-current (long-term) liabilities** are the long-term debts of a business which it does not expect to repay within the next year. Examples include long-term bank loans, mortgages and debentures.
- **Owner's equity** is the amount of money that has been invested in the business by the owners. This includes money brought into the business by the owners plus any retained profit. For a limited company these amounts are also known as **shareholders' equity** or shareholders' funds.



**TOP TIP**

Learn the definitions of key terms for both the statement of financial position and the income statement. Using an example for each will help you to explain your understanding.

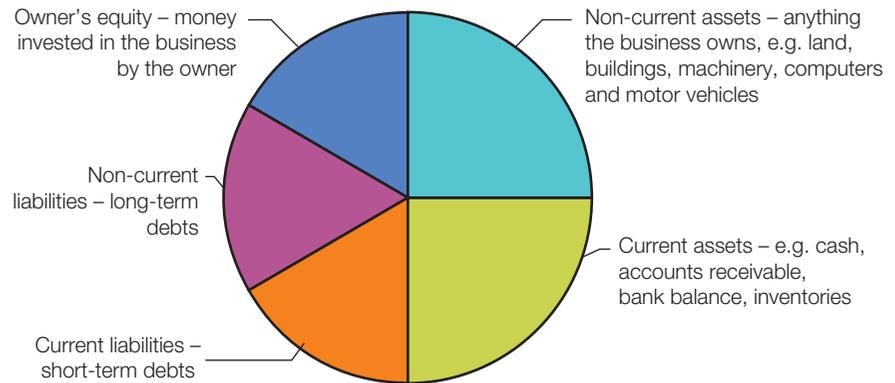


Figure 22.1 Assets and liabilities

**ACTIVITY 22.2**

Copy out the table below.

Statement item	Non-current asset	Current asset	Current liability	Non-current liability	Owner's equity
Inventories		√			
Bank loan					
Share capital					
Machinery					
Overdraft					
Trade receivables					
Retained profit					
Premises					
Trade payables					
Debenture					

Place a tick in the correct column for each statement of financial position item shown in the table. The first has been done for you.

**TEST YOURSELF**

- 1 Define 'non-current asset' using an example.
- 2 Define 'non-current liability' using an example.
- 3 Other than bank/cash balances, state **two** other current assets.
- 4 State **two** current liabilities.
- 5 Explain why a business wants its current assets to be greater than its current liabilities.

**TOP TIP**

If a question simply refers to the 'financial statements', you could look at income statements, statements of financial position or cash-flow forecasts.

## How to interpret a statement of financial position

The statement of financial position gives different stakeholders useful information about a business. It shows:

- the assets the business owns
- what the business is owed
- what the business owes
- how the business finances its activities.

Remember that a statement of financial position is only a snapshot of a business's financial position at a particular point in time – the date of the statement. The individual figures can change a lot in a short space of time. Also, as you learnt earlier, the non-current asset valuations on the statement of financial position may be different from the market value of these assets. For these reasons the statement is not a reliable measure of how much a business is worth.

### ACTIVITY 22.3

Consider the statement of financial position below for JB Plastics Ltd.

	\$000s	\$000s	\$000s	\$000s
<b>Non-current assets</b>				
Land and buildings			30	
Machinery			60	
Motor vehicles			10	
				100
<b>Current assets</b>				
Inventories		15		
Trade (accounts) receivables			30	
Cash and bank balance		<u>5</u>		
			50	
Less:				
<b>Current liabilities</b>				
Trade (accounts) payables			16	
Taxation		9		
Dividends		<u>5</u>		
			<u>30</u>	
Net current assets				<u>20</u>
<b>Net assets</b>				<b>120</b>
Financed by:				
<b>Shareholders' equity</b>				
Share capital				40
Retained profits				<u>50</u>
				90
<b>Non-current liabilities</b>				
Bank loan				30
<b>Capital employed</b>				<b>120</b>

- 1 What is the statement value of the amount owed to JB Plastics?
- 2 What is the statement total of the amount JB Plastics owes to its suppliers?
- 3 Why do you think JB Plastics has non-current liabilities of \$50 000?
- 4 What is another name for 'net current assets'?
- 5 What is the statement value of all of the assets that are owned by JB Plastics which it expects to use for more than one year?
- 6 Why might the statement value of non-current assets not be the same as their market value?
- 7 Define 'equity capital'.
- 8 Why do businesses such as JB Plastics retain some of their profit?
- 9 What is the name of the tax paid by businesses such as JB Plastics Ltd?
- 10 Who does the business owe 'dividends' to?

### TEST YOURSELF

- 1 How does the statement of financial position provide users with information about how a business is being financed?
- 2 Explain why a statement of financial position prepared six months ago may not show the business's current financial position.
- 3 Explain why the retained profit figure shown on a business's most recent statement of financial position may be lower than on the previous year's statement.

### CASE STUDY

## Maldives Hotels Company

The following financial data has been extracted from the statements of financial position of the Maldives Hotels Company (MHC) for 2011 and 2012.

	\$m	\$m	\$m	\$m
		2012		2011
Non-current assets		3622		3026
Current assets	1836		1822	
Current liabilities	2006		1344	
Net current assets		(-170)		478
Total assets		3452		3504
Shareholders' equity (funds)				
Share capital		200		200
Retained profit		3090		2966
Non-current liabilities		162		338
Capital employed		3452		3504

### TASK

- a Define 'non-current liabilities'.
- b Calculate the percentage increase in MHC's retained profit between 2011 and 2012.
- c Explain the reasons for any **three** changes that have taken place on MHC's statement of financial position between 2011 and 2012.
- d Why is retained profit important to MHC?

## Revision checklist

- The statement of financial position records all of the assets (what a business owns) and liabilities (what a business owes) on a particular date.
- Assets can be divided into non-current assets and current assets. Liabilities can also be divided into those that are non-current and those that are current.
- The statement of financial position shows the amount of capital invested in the business by the owners and how much the business owes to the owners.
- Internal and external stakeholder groups will find information contained in the statement of financial position useful when considering the extent to which a business helps to satisfy its personal objectives.

## Exam-style practice questions

- 1 The data below has been extracted from the statement of financial position of a limited liability company, Safiya Soft Furnishings (SSF).

	30 June 2012	30 June 2013
	\$000s	\$000s
Non-current assets	2500	2900
Net current assets	230	150
Non-current liabilities	130	420
Shareholders' equity	2600	2630

- a Define 'limited liability'. [2]
- b Define 'shareholders' equity'. [2]
- c Outline why SSF needs non-current assets. [4]
- d Explain how **two** stakeholder groups of SSF might use the statement data. [6]
- e Do you think the management of SSF should be concerned about the change in net current assets between 2012 and 2013? Justify your answer. [6]
- 2 Below are extracts from the statements of financial position of BJ for 2012 and 2013.

	2012	2013
	\$m	\$m
Non-current assets	2.7	2.9
Current assets	0.5	0.8
Current liabilities	0.3	1.0
Non-current liabilities	1.0	1.1
Owner's equity	1.9	2.2

- a Identify **two** non-current assets that BJ might have. [2]
- b Define 'non-current liabilities'. [2]
- c Outline **two** elements of BJ's current assets. [4]
- d Explain **two** differences between BJ's statement data between 2012 and 2013. [6]
- e Do you agree that the information from BJ's statements of financial position is more useful to internal stakeholders than external stakeholders? Justify your answer. [6]

**Total available marks 40**

# 23

## Objectives

*In this chapter you will learn about:*

- profitability ratios and liquidity ratios
- the importance of liquidity
- why and how accounts are used.

## Analysis of accounts

### Introduction

In previous chapters you learnt how information contained in income statements and statements of financial position can be used by business stakeholders. It's essential to take care when interpreting financial data. A simple comparison of the change in revenue, costs, profits, assets or liabilities of a business, from one year to the next, can provide stakeholders with misleading information.

Consider the following accounting data for two companies which are competitors in the clothing industry.

	Company X	Company Y
	\$000	\$000
Revenue	200	500
Profit	140	200
Total equity	50	300

Table 23.1 Financial data for Companies X and Y

A simple comparison of these results might conclude that Company Y has performed better than Company X. This is because both the revenue and the profits for Company Y are higher than they are for Company X.

Shareholders in Company Y may expect to receive a higher dividend than shareholders in Company X. This is based on the fact that Company Y has the higher profit. However, its owner's equity is six times higher. This may mean that the profit of Company Y has to be divided between more shareholders. Therefore, shareholders in Company Y may receive a higher dividend than the shareholders in Company X, even though its profits are lower.

Clearly, the simple interpretation of accounting data you learnt in previous chapters needs to be used with some caution. This does not mean that this analysis is not useful, but it does mean that you must interpret the results with care.

In this chapter you will find out how to analyse business accounting information with the aid of ratios. You will learn how to calculate and interpret ratios that measure business profitability performance and business liquidity.

### How to interpret financial statements

A business must check its performance regularly as this can help to:

- identify its strengths and weaknesses so that it can decide which, if any, of its policies or strategies need to be changed
- show whether the business is meeting its objectives
- improve future business performance.

**ACTIVITY 23.1**

Use the internet, newspapers or local knowledge to identify businesses which are performing better or worse this year than last year, or who are performing better or worse than competitors.

- 1 Identify the factors that have affected the performance of your chosen businesses.
- 2 Make a presentation to the rest of your class about the performance of any **two** of your chosen businesses.



**Stakeholder groups:** see Chapter 5, page 62.

The performance of a business will be of interest to its internal and external stakeholders. They may want to know such things as:

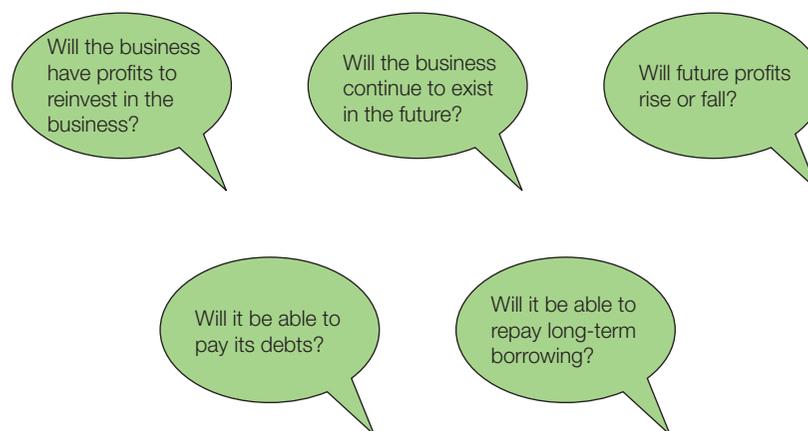


Figure 23.1 What stakeholders may want to know

**ACTIVITY 23.2**

Explain why each of the statements in Figure 23.1 might be important to one or more business stakeholders.



**Difference between profit and cash:** see Chapter 21, page 271.

**The importance of profit:** see Chapter 21, page 270.

**Measuring business performance**

Since the main objective of all businesses in the private sector is to make a profit, profitability is an important indicator of how well a business is performing. As you learnt earlier, a business cannot depend on profit to survive. It must also have enough cash to pay its short-term liabilities. The business also needs some cash in reserve so that it can pay any unexpected expenses. When looking at a business's performance you also need to consider how well it manages its liquidity.

The information on income statements and statements of financial position can be analysed using profitability and liquidity ratios. These provide stakeholders with important information to help them assess both the profitability and the liquidity of a business and help to improve their decision-making.

**Profitability**

You have already learnt about the importance of profit to business growth and survival. You are now going to learn how to calculate and use the following ratios to analyse a business's profitability:

- gross profit margin
- profit margin
- return on capital employed.

**TOP TIP**

You must learn the formula for all five ratios in this chapter and remember to include the % sign where appropriate.

To help with your understanding of these ratios we are going to use an extract from the accounting statements of Tang Toys Ltd (TT) which we used in previous chapters.

	2012	2013
	\$000	\$000
Revenue	420	500
Gross profit	189	240
Profit before interest and tax	63	70
Capital employed	120	120

Table 23.2 Extract from the financial statements of TT

**KEY TERM**

**Gross profit margin %:** ratio between gross profit and revenue.

**Gross profit margin**

The **gross profit margin** ratio shows gross profit as a percentage of revenue. This ratio tells us how much gross profit is earned per \$1 of revenue.

$$\text{gross profit margin \%} = \frac{\text{gross profit}}{\text{revenue}} \times 100$$

**EXAMPLE**

Using the data from Table 23.2, the 2012 gross profit margin for TT is:

$$\begin{aligned} \text{gross profit margin \% (2012)} &= \frac{189}{420} \times 100 \\ &= 45.5\% \end{aligned}$$

This result tells us that every \$1 of revenue earned \$0.45 gross profit.



**Gross profit:** see Chapter 21, page 268.

Since gross profit is the difference between revenue and cost of sales, you can see that the gross profit margin is influenced by both revenue and cost of sales. This means that if a business wants to improve its gross profit margin it can do this by:

- **Increasing revenue without a similar increase in cost of sales** – this may be achieved through an increase in price.
- **Reducing cost of sales without a similar decrease in revenue** – this can be achieved by buying cheaper supplies.

**KEY TERM**

**Profit margin %:** ratio between profit before tax and revenue.

**Profit margin**

The **profit margin** shows profit as a percentage of revenue. This ratio tells us how much profit is earned per \$1 of revenue.

$$\text{profit margin \%} = \frac{\text{profit}}{\text{revenue}} \times 100$$



**Profit:** see Chapter 21, page 268.

**EXAMPLE**

Using the data from Table 23.2, the 2012 the profit margin for TT is:

$$\begin{aligned} \text{profit margin \% (2012)} &= \frac{63}{420} \times 100 \\ &= 15\% \end{aligned}$$

This result tells us that every \$1 of revenue earned \$0.15 of profit.



**TOP TIP**

Do **not** confuse gross profit margin and profit margin.



**KEY TERM**

**Adding value:** selling a product for more than it cost to produce it.



**Adding value:** see Chapter 1, page 16.

This ratio measures the performance of the business in converting revenue into profit. Since profit is the difference between revenue and total costs, it is:

$$\text{profit} = \text{revenue} - (\text{costs of sales} + \text{expenses})$$

To improve profit margin a business can:

- improve gross profit margin (as discussed above)
- reduce expenses.

Both the gross profit margin and the profit margin can be used to measure how well the business **adds value** and controls costs.

The gross profit margin is also a good measure of added value. Any improvement in the gross profit margin from one year to the next indicates improved added value. Also, if a business has a higher gross profit margin than a competitor, the business has achieved a higher added value for its products than its competitors.

Since profit before tax will always be lower than gross profit, this means that the percentage profit margin will always be lower than the percentage gross profit margin. The difference between these two ratios is the effect that expenses have on the profits of a business. Therefore, the profit margin is also a good measure of how well the business has controlled its expenses.

**ACTIVITY 23.3**

The table below shows the gross profit margin and the profit margin for two companies in the same industry over the three years 2010–2012.

	Company A			Company B		
	2010	2011	2012	2010	2011	2012
Gross profit margin (%)	23	24	25	30	28	26
Profit margin (%)	8	8.5	8	10	9.5	9

Table 23.3 Information for Companies A and B

- 1 Comment on the change in Company A's gross profit margin between 2010 and 2012.
- 2 Compare the change in gross profit margin of Company A and Company B between 2011 and 2012.
- 3 Explain why you think the profit margin for Company A has decreased in 2012 despite an increase in the gross profit margin.
- 4 Which company do you think has performed best over the period 2010–2012? Justify your answer.



## KEY TERM

**Return on capital employed (ROCE):** ratio between profit before tax and capital employed.

### Return on capital employed

The **return on capital employed (ROCE)** ratio shows profit before tax as a percentage of capital employed. It tells us how much profit is earned for every \$1 invested in the business. This ratio is the most used measure of efficiency and is often considered to be the most important way of analysing a business's profitability.

Capital employed is the amount invested in the business by the owners, for example sole trader, partners or shareholders. Any long-term borrowing, such as debentures, should also be included as capital employed. The money is usually borrowed to purchase profit earning assets such as buildings and machinery.

$$\text{return on capital employed} = \frac{\text{profit}}{\text{capital employed}} \times 100$$

### EXAMPLE

Using the data from Table 23.2, the 2012 return on capital employed for TT is:

$$\begin{aligned} \text{return on capital employed (2012)} &= \frac{63}{120} \times 100 \\ &= 52.5\% \end{aligned}$$

This measure tells us that every \$1 of capital invested in TT earned a return to the shareholders of \$0.525.

### ACTIVITY 23.4

Copy out the table below.

Profitability ratio	2012	2013
Gross profit margin	45%	
Profit margin	15%	
Capital employed	52.5%	

- Use the data in Table 23.2 to calculate the profitability ratios for 2013.
- Using your results, comment on the financial performance of TT in 2013 compared to 2012.
- Explain how the following stakeholders of TT might view these results:
  - shareholders
  - employees
  - suppliers
  - government
- Based on the information, do you think a bank would lend money to TT to finance expansion plans? Justify your answer.

As with the other ratios you have studied so far, the return on capital employed ratio is of little use unless it is compared with the business's ROCE results from previous years, or with the ROCE results of similar businesses in the industry. As a general rule, if the ROCE increases from one year to the next, or the business has a higher ROCE than competitors, the business's profitability has improved or is better than similar firms in the industry.

**KEY TERM**

**Liquidity:** the ability of a business to pay its short-term debts.



**Assets and liabilities:** see Chapter 22, page 278.

## Liquidity

If a business does not have enough cash to pay for its immediate expenses or short-term liabilities (business debts), and has no access to cash from internal or external sources, it will not be able to continue trading. A business's **liquidity** is its access to cash.

Current assets are important to a business because they indicate how much cash a business has access to in order to meet its short-term liabilities.

Liquidity is so important to a business's survival that it must be carefully managed at all times. One way of monitoring a business's liquidity is through the use of the following liquidity ratios:

- current ratio
- acid test ratio.

To help with our calculation and understanding of these ratios we are going to use a further extract from the accounting statements of Tang Toys Ltd.

	2012	2013
	\$000	\$000
Current assets	60	50
Current assets – inventories	20	30
Current liabilities	40	30

Table 23.4 Extract from the statements of financial position of TT

### Current ratio

The **current ratio** shows the ratio between current assets and current liabilities.

$$\text{current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

Current assets represent things owned by the business which are already in the form of cash, or are easy to convert into cash. Current liabilities are the short-term debts of a business, which are expected to be paid in the near future. Therefore, it is important that the level of current assets is greater than the level of current liabilities. If this is not the case, then the business risks liquidity problems. There is not enough cash coming into the business to pay its short-term liabilities and have spare cash for unexpected expenses.

### EXAMPLE

Using the data from Table 23.4, the 2012 current ratio for TT is:

$$\begin{aligned} \text{current ratio (2012)} &= \frac{60}{40} \\ &= 1.5:1 \end{aligned}$$

(Note that the result is always shown as a ratio.)

For every \$1 of current liabilities TT has \$1.5 of current assets – that is, it has access to more cash than it needs to meet its short-term liabilities and has spare cash to pay for any unexpected expenses.

**KEY TERM**

**Current ratio:** ratio between current assets and current liabilities.

As a general rule, the current ratio must be no less than 1.5:1 – otherwise there is a risk of running out of cash. It should be no greater than 2:1 – since this suggests that the business has too much cash tied up in unprofitable assets. However, there are other factors that can influence a business's ability to access cash quickly such as overdraft facilities and the sale of unwanted assets.

### Acid test ratio

The main problem with the current ratio as a measure of liquidity is that some current assets are more difficult to turn into cash than others. Inventories are the least liquid of the current assets because:

- the finished goods inventories have to be sold
- when they are sold on credit, the business has to wait for customers to pay.

The **acid test ratio** excludes inventories from current assets. It shows the most liquid current assets as a ratio of current liabilities. For this reason the acid test ratio is often considered to be a better measure of a business's liquidity.

$$\text{acid test ratio} = \frac{(\text{current assets} - \text{inventories})}{\text{current liabilities}}$$



#### KEY TERM

**Acid test ratio:** ratio between liquid assets and current liabilities.

### EXAMPLE

Using the data from Table 23.4, the 2012 acid test ratio for TT is:

$$\begin{aligned} \text{acid test ratio (2012)} &= \frac{(60 - 20)}{40} \\ &= 1:1 \end{aligned}$$

An acid test ratio of 1:1 is generally satisfactory. If it is lower than this there is a risk of the business not having enough cash to pay its short-term liabilities. If it is too high then cash is being tied up in unprofitable assets.

### ACTIVITY 23.5

Copy out the table below.

	2012	2013
Current ratio	1.5:1	
Acid test ratio	1:1	

- 1 Using the data in Table 23.4, calculate the liquidity ratios for 2013.
- 2 Using your results, comment on the liquidity position of TT in 2013 compared to 2012.
- 3 Explain **two** ways of improving TT's liquidity.

### Profitability versus liquidity

Profitability and liquidity are essential for the long-term survival of any business, large or small. A business needs sufficient liquidity to be able to pay its debts. However, it must not keep large amounts of cash which could have been used more profitably. For example, the cash could be used to invest in non-current assets or developing new products, both of which should increase the future profitability of the business.

From this we can see that those assets which increase a business’s profitability – non-current assets – do not improve liquidity. Whereas current assets, which increase a business’s liquidity, do not improve profitability. Therefore it is important for a business to maintain a balance between the need for profitability and the need for liquidity if it is to ensure its long-term survival.

### Benefits and limitations of ratio analysis

Ratio analysis is not perfect so care must be taken not to rely too heavily on the results.

Table 23.5 summarises the main benefits and limitations for users of financial statements and profitability and liquidity ratios.

Benefits	Limitations
Users can compare ratios over time and identify trends.	Ratios compare past data. Users of accounts – stakeholders – are much more interested in what the future holds for the business.
Users can compare results with similar businesses to see how well a business is doing against competitors.	Financial statements do not include all the strengths and weaknesses of a business, for example the quality and skills of employees. These factors are also likely to affect business performance, especially profitability.
Users can easily identify important information, such as profitability and liquidity, without having to look at all of the financial statements.	Income statements and statements of financial position are not always prepared in the same way by different businesses. Therefore, the ratios do not compare like with like.
	Businesses are affected by external factors – such as legislation, exchange rates and economic factors – but these will not be shown in the financial statements.

Table 23.5 Benefits and limitations of financial statements and profitability and liquidity ratios

#### ACTIVITY 23.6

Southern Gas Company (SGC) is a distributor of natural gas. The following information has been extracted from the company’s accounts for 2011 and 2012.

	2011	2012
	\$	\$
Capital employed	533 670	590 000
Revenue	1 162 340	1 328 300
Gross profit	114 217	117 998
Profit	56 002	41 458
Current assets	805 394	1 087 365
Current liabilities	784 856	1 066 017

- 1 Calculate the gross profit margin and the profit margin for both years.
- 2 Calculate the return on capital employed for both years.
- 3 Using your results to Questions 1 and 2, comment on the company's performance in 2012 compared to 2011.
- 4 Calculate the current ratio for both years.
- 5 Using your results to Question 4, comment on the company's liquidity in both years.

### TEST YOURSELF

- 1 State the formula used for calculating gross profit margin.
- 2 State the formula used for calculating profit margin.
- 3 State the formula used for calculating return on capital employed.
- 4 State the formula used for calculating the current ratio.
- 5 State the formula used for calculating the acid test ratio.
- 6 Is profitability more important than liquidity? If not, why not?
- 7 Explain **two** limitations of profitability and liquidity ratios.

## Why and how accounts are used

Both internal and external stakeholders are interested in the financial statements of a business, although they may not need to calculate any of the performance or liquidity ratios. The main uses of financial statements by business stakeholder groups are summarised below:

- **Owners/shareholders** – they will want to know how well the business is performing and whether they are getting a good return on their investment. They will compare the profits of the business with previous years and with similar businesses. Shareholders will compare the dividends they receive with previous years and with the returns they could get if their money was invested elsewhere.
- **Potential investors** – before investing in a business they will also be interested in the profits of the business and the return that they might expect to receive from their investment.
- **Managers** – they are responsible for the efficient running of the business. They will want to know if financial objectives have been achieved, for example: Has the company met its revenue targets? How well have costs been controlled? Are profits rising? The level of retained profits is an important source of finance for businesses and managers will want to know how much has been retained in the business and is available to finance business activities such as the purchase of new technology.
- **Employees** – they will be interested in the profitability of the business. A business which continues to make good levels of profit offers greater job security. Also, the employees or their trade union might use profit figures to support their claim for higher wages.



**TOP TIP**

Each stakeholder group will want to know different information. You will need to be able to explain how each group would use the accounts. Remember too that not all the information the stakeholders want will be in the accounts.

- **Trade payables** – many goods and services supplied to a business are on a credit basis. The supplier will want to know that the business has sufficient cash to pay its debts when they become due. They will be interested in the liquidity of the business. Suppliers will also be interested in the profitability of a business. A business which is making good profits and expanding will continue to need raw materials and other supplies. This will help suppliers to increase their own revenue and profits.
- **Lenders** – banks and other lenders will want to know that they will receive the interest on any money they have loaned the business and that the business will be able to repay its borrowing when it becomes due. For these reasons they will be interested in the profits and liquidity of the business.
- **Government** – companies have to pay tax on their profits. The higher the profits, the higher the tax revenue received by the government. Also, a business which is performing well and earning profits to expand will provide employment. This will reduce government spending on support for the unemployed.
- **Customers** – they want to know that a business will continue to supply them with goods and services which meet their needs and wants. Businesses may use some of their profit to invest in new technology which improves the quality of products and might even lower prices.

**ACTIVITY 23.7**

Copy out the table below.

Stakeholder	Stakeholder objective	Interested in:	Reason
1 Shareholders	1 Dividends	Profit	The level of dividends paid to shareholders is usually linked to the level of profit, for example high profits = high dividends.
	2 Increase market value of shareholding	Profit	High profits will usually increase the market value of shares. Shareholders might then sell their shares at a higher price than they paid for them.
2 Employees			
3 Lenders			
4			
5			
6			

- 1 Complete the table for employees and lenders. (Identify **two** objectives for each stakeholder.)
- 2 Add **three** more stakeholders and complete the table for each.

You might find it useful to review the topic of stakeholder objectives in Chapter 5 before attempting this question.

**ACTIVITY 23.8**

Using the financial data provided in the Southern Gas Company activity on page 290, and the results of your ratio analysis:

- 1 Explain how any **five** of the company's stakeholder groups might use this information.
- 2 Do you think potential investors would consider the Southern Gas Company a good investment? Justify your answer.

**TEST YOURSELF**

Explain **two** uses to stakeholders of profitability and liquidity ratios.

## Revision checklist

- The calculation of profitability and liquidity ratios helps stakeholders groups to interpret financial statements and assess the importance of these results in meeting their own objectives.
- Although profit is the primary objective of all private sector businesses, they must not ignore the importance of liquidity to business survival.

## Exam-style practice questions

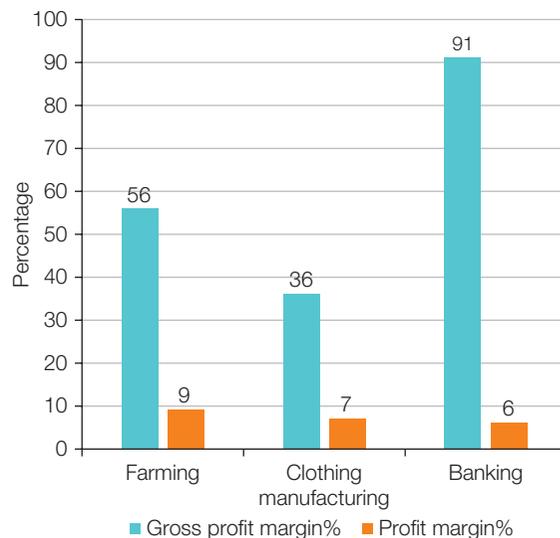
- 1 Two years ago Josep was made redundant from his job. He decided to invest his \$35 000 redundancy payment and \$15 000 life savings into his own catering business. He used the \$50 000 to buy machinery and equipment, rent suitable premises and buy the inventories needed to set up the business.

The table below shows an extract from Josep’s financial statements for the first two years of trading.

	Year 1	Year 2
	\$	\$
Revenue	36 000	42 000
Profit	10 000	12 000
Return on capital employed	?	24%

- Define ‘redundancy’. [2]
- Calculate the return on capital employed for Year 1. [2]
- Outline **two** factors that might influence Josep’s revenue. [4]
- Explain the usefulness of Josep’s financial data to any **two** of his businesses stakeholders. [6]
- Do you think Josep should be pleased with the performance of his business during the first two years? Justify your answer. [6]

- 2 Figure 23.2 shows the gross profit margin and the profit margin for three industries in Country Y.



- a Define 'profit margin'. [2]
- b Identify the **two** sectors of business activity which the farming and banking industries belong to. [2]
- c Outline **one** benefit and **one** limitation of financial ratios to shareholders. [4]
- d Explain **two** reasons why the difference between gross profit margin and profit margin is greater for banking than for either of the other two industries shown. [6]
- e Do you think that all clothing manufacturers in Country Y will have a profit margin of 7%? Justify your answer. [6]

**Total available marks 40**

## Exam-style case study

### The Paradise Group

The Paradise Group is a public limited company in Country Z. The company owns a chain of six hotels. Although company profits have grown rapidly over the past two years, the finance director, Winston Stanley, is concerned about the performance of one of the hotels, The Hideaway, which has performed less well than the others in the group. He has produced the data shown in Appendix 1 for The Hideaway and other Paradise Group hotels.

The company's accountant, Eve Wan, has raised concerns about the group's cash position. The overdraft shown on the statement of financial position increased from \$0.1m in 2012 to \$0.5m in 2013. Although Winston understands Eve's concerns, he stated in a meeting with her that, 'Profit is what our business is all about and this has been increasing year on year for the past five years, so there is nothing to worry about.' Eve is still worried and has prepared a cash-flow forecast for the next six months.

The Board of Directors has been approached by the CEO of the privately owned City Budget Hotels. The owners of City Budget Hotels are looking to sell the two hotels they own in Country Z. The hotels are located in regions of Country Z where the Paradise Group does not currently have any properties. The asking price for the two hotels is \$2.4 million. Paradise Group directors are keen to proceed with the purchase of these two hotels, but are undecided about how best to finance this investment. Winston has sent the memorandum shown in Appendix 3 to all other directors of the Paradise Group. However, other directors are not convinced about the advantages of a share issue and support the CEO's view that a long-term bank loan is the better option.

#### Appendix 1

*Financial data for The Hideaway Hotel and the other hotels in the Paradise Group for 2012/13*

	Hideaway Hotel	Other Paradise Group hotels
Revenue	\$1 m	\$8 m
Gross profit	\$0.5 m	\$4 m
Profit	\$0.1	\$2 m
Capital employed	\$0.5 m	\$5.7 m

#### Appendix 2

*Extract from the financial statements of the Paradise Group of Hotels*

	2013	2012
	\$m	\$m
Profit after tax	2.5	2.1
Dividends paid	1.8	1.5
Non-current assets	5.9	5.5
Current assets	2.1	1.1
Current liabilities	1.8	1.4
<b>Net assets</b>	<b>6.2</b>	<b>5.2</b>
Share capital	1.0	1.0
Retained profits	2.8	2.1
Non-current liabilities	2.4	2.1
<b>Capital employed</b>	<b>6.2</b>	<b>5.2</b>

#### Appendix 3

*Memorandum*

From: Winston Stanley

To: All directors

As we have not issued all of the company's share capital, I think this will be the best way to raise the capital needed to finance the purchase of City Budget Hotels.

- 1 a** Explain how any **two** external stakeholders of the Paradise Group might use the financial data provided in the text and Appendix 2.

Stakeholder 1:

Explanation:

Stakeholder 2:

Explanation:

[8]

- b** Do you think The Hideaway hotel is as successful as other businesses in the Paradise Group chain? Justify your answer using at least **two** profitability ratios.

Ratio 1:

Calculation:

Ratio 2:

Calculation:

Justification:

[12]

- 2 a** Using examples, explain the difference between non-current assets and current assets that might be held by the Paradise Group.

Non-current asset example:

Explanation:

Current asset example:

Explanation:

[8]

- b** Consider the advantages and disadvantages of the following methods that could be used to finance the purchase of City Budget Hotels.

Recommend to the Board of Directors which source it should use. Justify your answer.

Share issue:

Long-term bank loan:

Recommendation:

[12]

- 3 a** Explain **two** ways the company's accountant, Eve Wan, might use the cash-flow forecast she has prepared to better manage the Paradise Group's cash position.

Use 1:

Explanation:

Use 2:

Explanation:

[8]

- b** 'Profit is what our business is all about and this has been increasing year on year for the past five years, so there is nothing to worry about'. Explain why each of the following is important to the Paradise Group.

Which do you think is the most important? Justify your answer.

Cash:

Profit:

Conclusion:

[12]

- 4 a** Explain **two** ways the Paradise Group could increase its profits.

Way 1:

Explanation:

Way 2:

Explanation:

[8]

- b** Explain how the following **two** financial documents might be useful to Paradise Group's directors when choosing a source of finance.

Which statements do you think is the most useful to Paradise Group's directors? Justify your answer.

Income statement:

Statement of financial position:

Conclusion:

[12]



## Section 6:

# External influences on business activity

This section analyses how governmental, environmental and international factors influence and shape business decision-making.

The government of a country has the job of organising funds for the common needs of the people in areas such as education and health. Every government sets out certain economic objectives and aims to achieve them by setting relevant economic policies. The taxation and interest rate policies of the government help meet a country's economic aims but also have a major impact on businesses. The trade cycle also affects businesses.

The positive and negative impact of businesses on the physical environment and society around them greatly

influences business operations and success. The role of pressure groups and government initiatives aimed at controlling business externalities has become significant in recent years. When making decisions, businesses need to bear in mind their environmental, ethical and corporate responsibilities.

The global recognition of brands is a sign of the growth in international trade and the growth of globalisation. Although the advantages of globalisation are many, some argue that it is done at the cost of environmental degradation and that one country's gain is another country's loss. The international business environment and its considerations also influence business activity.

# 24

## Objectives

*In this chapter you will learn about:*

- the economic objectives of any government
- the main stages of the business cycle
- how changes in taxes, government spending and interest rates affect business activity
- how businesses respond to these changes.

## Economic issues

### Introduction

All governments have economic objectives. They try to achieve their objectives by introducing or changing policies. These policies affect government spending and interest rates, as well as taxation in the country, which in turn affects businesses.

In this chapter you will look at how government control over the economy affects business activities. Businesses are affected differently depending on the product or service they are selling, the industry they are in, and the size of the business. They are also affected by the economic environment of the country.

### How government control over the economy affects business activity

#### Government economic objectives

Every government has economic objectives. There are four main ones:

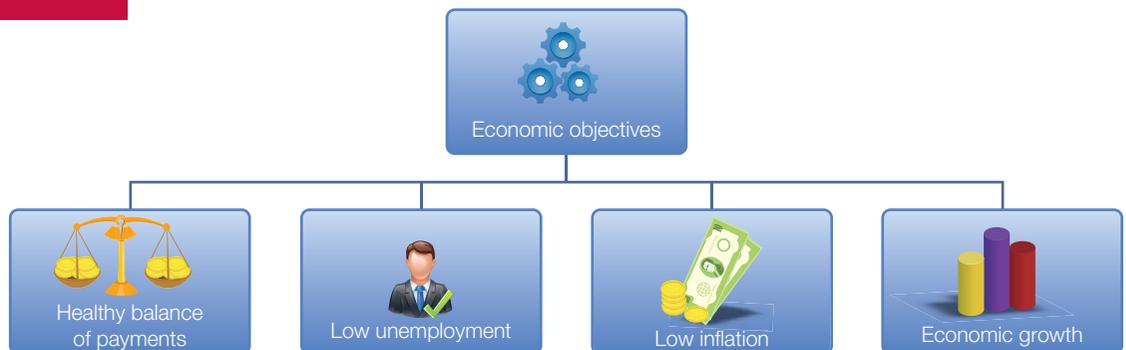


Figure 24.1 Economic objectives of a government



#### KEY TERM

**Balance of payments:** the difference between the values of export and import goods and services of a country over a year.



**Exchange rates:** see Chapter 26, page 335.

#### A positive balance of payments

The **balance of payments** of a country is positive when the value of exports is greater than the value of imports – this is called a balance of payments surplus. The goods and services sold by one country to other countries in return for foreign currency are exports. The goods and services bought by a country from other countries are imports. Exports involve money coming into the country and imports involve money flowing out of the country.

If there are more imports than exports, then there is more foreign currency flowing out than coming into a country. This is known as a balance of payments deficit, which can cause a shortage of foreign exchange. This means that the government of the country may have to borrow foreign currency from other countries at expensive rates of interest, which could also affect the exchange rate of the country. To avoid expensive borrowing costs and varying foreign exchange rates, it is better for a country to have a positive balance of payments.

## KEY TERM

**Inflation:** the price increase of goods and services over time.

## KEY TERM

**Level of unemployment:** the proportion/percentage of the population that are capable of working but are unable to find a job.

## KEY TERM

**Gross domestic product (GDP):** the value of all goods and services produced by a country in a year.

### Low inflation

When **inflation** is low, people enjoy a better standard of living as they can afford to pay for goods and services. They can also afford to pay for non-essential (luxury) items. It becomes easier for companies to set up new ventures and expand, which means that all the sectors of the economy benefit. If inflation increases, however, people may not be able to afford to buy local goods and instead may buy foreign goods (which may be cheaper). This can affect local businesses in the country as they receive fewer sales.

### Low unemployment

All governments want their country to have a low **level of unemployment**.

A government wants as many people to have jobs as possible so that:

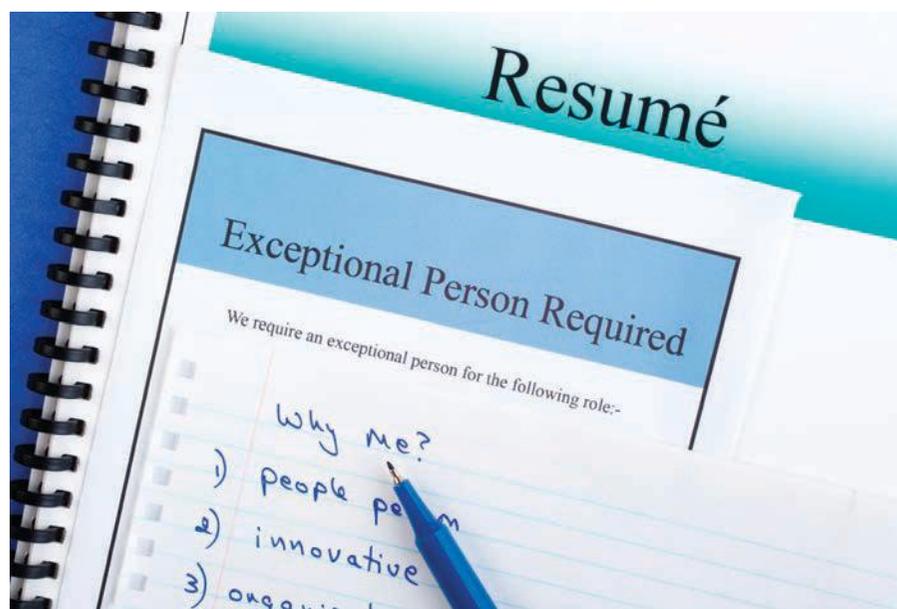
- they contribute to the total output of the country and improve economic growth (see gross domestic product below)
- the people of the country can earn money and have a better standard of living
- the government does not have to spend money on unemployment benefits so can spend that money on improving the country's infrastructure
- the higher the level of employment, the more income tax a government receives.

### Economic growth

The **gross domestic product (GDP)** shows whether a country's economy is growing or not. If GDP increases it means more goods and services have been produced in the country compared to the previous year. If GDP increases, this is good for people as their standard of living should improve. A growing economy should mean more business opportunities.

However, if GDP falls, this is bad for the economy and the businesses and people in it. For example, it could lead to lower output so fewer employees are needed, and generally people experience a lower standard of living as they cannot afford to buy as many goods and services.

GDP is a good measure of economic activity. It allows us to analyse the economic growth of a country from one year to the next between years and to compare its performance with other countries' economies.



A government wants as many people as possible to have a job  
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**ACTIVITY 24.1**

Below is a newspaper article published in a national newspaper of Country X.

### Country X's economy remains in recession

Country X's economy has been in recession since late 2008 and is unlikely to return to growth before 2014. The unemployment rate has hit an all-time high of 27%.

Although inflation has remained steady, GDP growth rate has massively declined.

The government has tried to encourage growth and investment by keeping interest rates at 0.5%. It has put together a committee of economic and financial experts to recommend further measures to improve economic growth.

- 1 Make a list of the economic indicators that reflect the state of the economy of Country X.
- 2 What measures has the government of Country X taken to help the economy?
- 3 What is the main economic objective of Country X?
- 4 What problems might businesses in Country X face in a recession?

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## The business cycle

The economy of a country is unlikely to grow by the same amount over a period of time. The change in the economic activity as the economy grows and shrinks over a number of years is known as the business cycle. It plays a vital role in shaping the economic policies of the government.

The business cycle has four main stages. Each stage may last for months or even years. The stages, as shown in Figure 24.2, are:

- growth
- boom
- recession
- slump.

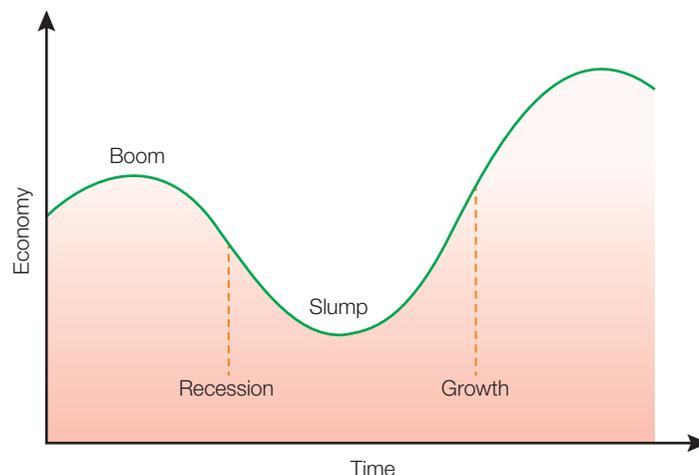


Figure 24.2 The business cycle

**TOP TIP**

Don't confuse the business cycle with the product cycle of a particular business. A business cycle shows the ups and downs in the growth of an economy over time – this affects all businesses. The product cycle only refers to a product of an individual business.

**Growth**

This stage is when the economy recovers or grows. It has the following key characteristics:

- a positive outlook for new businesses
- existing businesses grow and make profits
- growth in economic activity is measured by a rise in GDP until it reaches a maximum (boom)
- falling unemployment as there are more jobs due to businesses doing well
- raised standards of living as more people are employed.

**Boom**

This stage is the peak of the business cycle. Its key characteristics are:

- business investments and profits are at their highest levels
- most sectors of the economy are performing at their best
- high levels of demand for goods and services causing prices to rise (inflation)
- very low unemployment rates and people have better jobs to choose from; this leads to increased wage costs for businesses as well as a shortage of skilled people.

Too much spending and high borrowing costs during this stage may be risky for businesses. If the economic outlook looks poor, the economy may go into a decline.

**Recession**

This is when the economy shrinks in size. Its key characteristics are:

- business confidence falls leading to less investment in new and existing businesses
- decline in economic activity until it reaches a minimum (slump)
- falling demand by consumers leads to falling profits
- unemployment rises as businesses are not doing well and have to cut costs; employees are made redundant and some businesses even close down.

**TOP TIP**

You must be able to define the terms of the business cycle and explain how each stage of the business cycle could affect a company's sales and profit.

## Unemployment rates in Egypt

Combined with the effects of the global recession in 2008–2009, the Egyptian revolution that started in January 2011 has led to many economic challenges. Since then, Egypt's economy has seen a declining GDP, rise in unemployment rate and a widening gap in the balance of payments. The economy is said to be in recession.

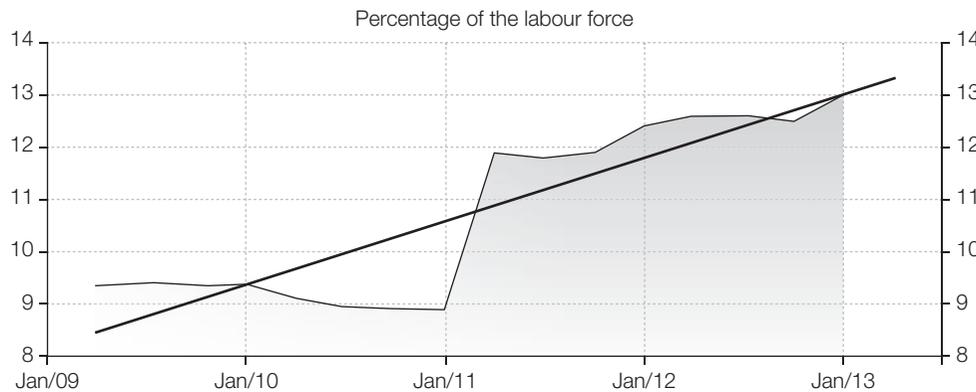


Figure 24.3 Egypt's unemployment rate

Source: www.tradingeconomics.com, Central Agency for Public Mobilization & Statistics

### TASK

- What percentage of Egypt's labour force was unemployed in January 2010?
- What percentage of Egypt's labour force was unemployed in January 2013?
- What has been the percentage increase in the unemployment rate since January 2010?
- What are the other characteristics of an economy that is in recession?
- How do you think the political instability caused by the Egyptian revolution in January 2011 affected the economy and the businesses in Egypt?



### EXPLORE!

What stage of the business cycle is the economy of your country in?

Research the factors that have led to this stage. (Hint: Use the internet or ask your teacher to provide you with business newspapers or journals to do your research.)

### Slump

This is when the recession stage of the economy is at its worst. Its key characteristics are:

- very low business confidence with very little investment in new and existing businesses
- low production of goods and services – many businesses close down
- low demand for goods and services
- high unemployment due to low business activity.



### KEY TERMS

**Interest rate:** the cost to a person or business of borrowing money from a lender such as a bank.

**Tax:** a charge/fee paid to the government on income, goods and services.

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### How changes in taxes and government spending affect business activity

In order to achieve their economic objectives, governments affect the economic activities of a country by controlling **interest rates** (monetary policy), **tax** rates and **government spending** (fiscal policies). We will look at monetary policy later in the chapter.

Governments mainly get their income from taxes. A steady growth in the economic activity of a country is what most governments aim for. If the growth is too fast, it can persist for a long time as the infrastructure to support this growth

may not exist. A slow growth rate will increase unemployment levels as there will be fewer jobs. In this situation, governments may change their economic (fiscal) policies to encourage growth.

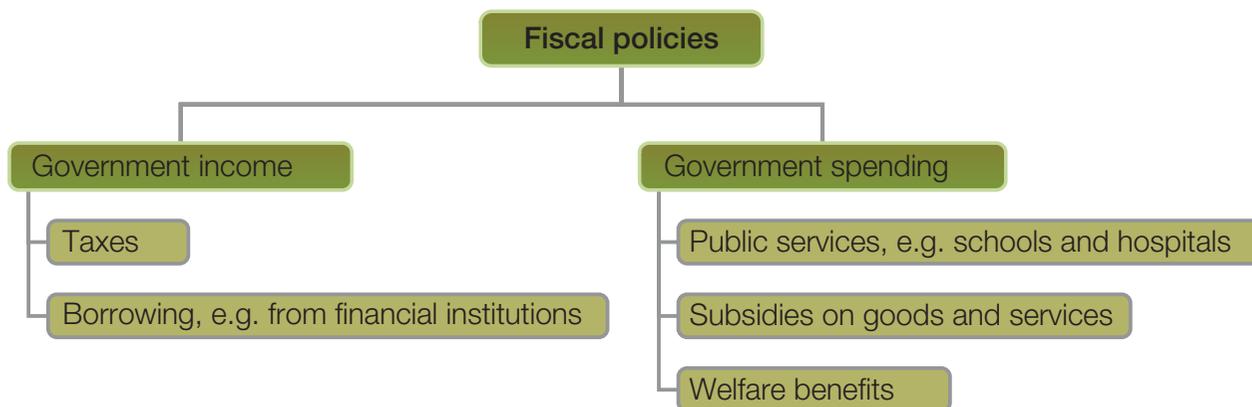


Figure 24.4 Economic (fiscal) policies



**KEY TERMS**

**Direct tax:** the tax charged on personal income or tax on the profit made by a business.

**Indirect tax:** the tax charged on the price of goods and services, which is added to the price of goods and services before they are bought.

**Disposable income:** the amount of income left for individuals after taxes have been paid.

Taxes are used by governments to pay for investments they make in public services such as education, health and transportation. Taxes may be **direct** and **indirect**.

**Direct taxes**

There are two main types of direct taxes that can be paid by an individual or a business.

- income tax
- corporation tax.

**Income tax**

The amount of income tax charged depends on the amount of income. The higher the income tax rate, the smaller the **disposable income** of individuals.

If the economy is in recession, the government may decide to invest in certain sectors in order to encourage growth. This investment may be partly funded by higher tax rates.

**ACTIVITY 24.2**

Hasan Ahmed is a computer software engineer for a technology company in Country Z. He has a salary of \$5000 a month. His income level is taxed at the rate of 20%.

- 1 How much disposable income would Hasan have after paying tax on his income?
- 2 The government of country Z has raised the tax rate to 25%. What would be the impact on Hasan’s disposable income and his spending habits?

Figure 24.5 explains the effects of an increase in income tax rates on consumers and businesses and how businesses may respond to this.

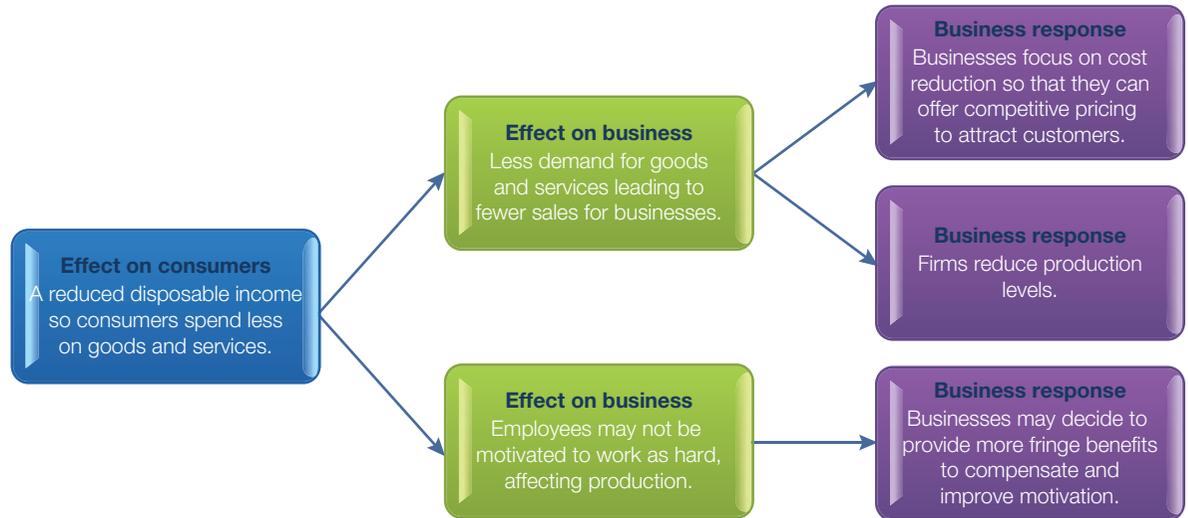


Figure 24.5 The effects of an increase in income tax rates

### Corporation tax

This is the tax paid by businesses on the profits they make. The higher the corporation tax rate, the smaller the profit after tax available to businesses.

If a country is in recession and the government's objective is to encourage economic growth, it can lower the corporation tax rate.

### ACTIVITY 24.3

Company XY wants to expand its operations in a foreign country. It looks at the corporation tax rates in Countries A, B and C to see which country offers the best business environment for them.

Country	Corporation tax rate (on income less than \$1 000 000)	Tax paid (\$)
A	28%	
B	26%	
C	32%	

- Assuming a profit of \$600 000, copy and complete the table to show the tax that Company XY may have to pay in each of these countries.
- Which country should XY expand its operations in based on the corporation tax rate?
- What is the corporation tax rate in your country? Do you think it is competitive with neighbouring countries in order to attract foreign investment? (Hint: Use the internet or ask your teacher to provide you with business newspapers or journals to do your research.)

**ACTIVITY 24.4**

In a group, investigate what the corporation tax rate of your country is. Analyse how a decrease in the corporation tax rate can affect the businesses in a particular industry that is dominant in your country.

An increase in corporation tax rate will lead to a smaller profit after tax for businesses. Figure 24.6 looks at the impact of this on shareholders and businesses and how businesses may respond to this.

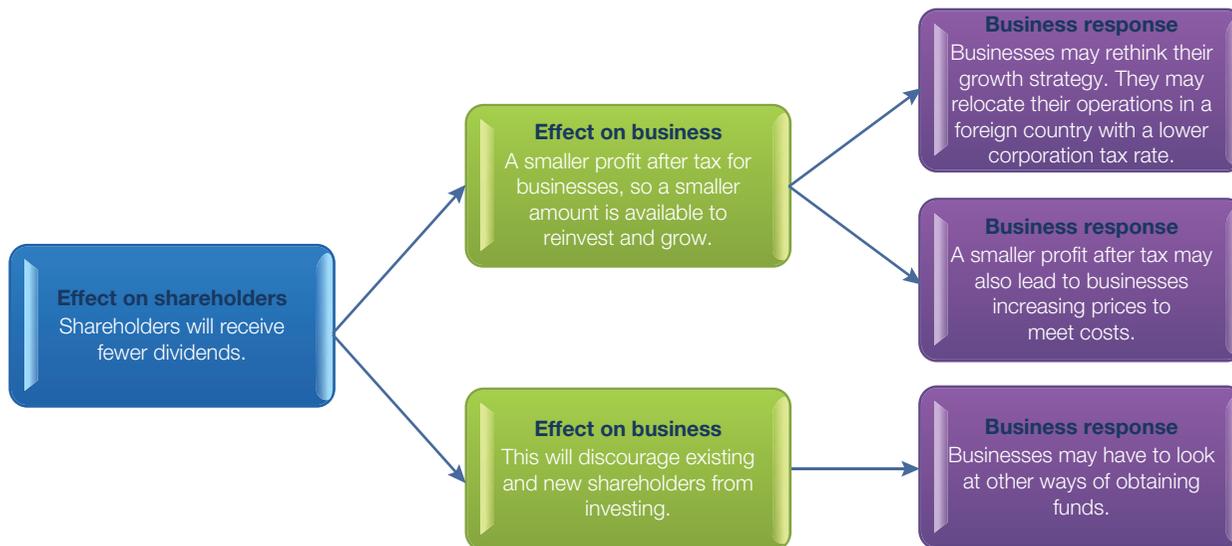


Figure 24.6 The effects of an increase in corporation tax rates

**Indirect taxes**

Around the world, countries have specific names for the indirect taxes listed below. They all have the same purpose.

- value added tax (VAT)
- import tariffs/customs duty
- sales tax
- excise duty.

**Value added tax (VAT)**

Value added tax (VAT) is added to the prices of some goods and services we buy. This makes those goods and services expensive and harder for us to buy, so the government does not put VAT on essential items.

Table 24.1 explains the effects of an increase in the VAT rate on consumers and businesses and how businesses may respond to this.

Policy change	Effect on consumers	Effect on businesses	Business response
Increase in VAT/sales tax.	<ul style="list-style-type: none"> <li>■ Goods and services become more expensive.</li> <li>■ Demand for related goods and services falls.</li> </ul>	<ul style="list-style-type: none"> <li>■ Businesses make fewer sales.</li> </ul>	<ul style="list-style-type: none"> <li>■ Less production due to decreased demand.</li> <li>■ Businesses will have to become more competitive in price.</li> </ul>

Table 24.1 The effects of an increase in VAT/sales tax



**EXPLORE!**

Make a list of the goods and services that VAT is applied to in your country.

Is VAT applied only on non-essential items? What is the VAT rate?

### Import tariffs/customs duty

Governments can also raise money by charging import tariffs or customs duty on goods that are imported from other countries. This helps the government control the number of imports, so that local businesses do not incur loss of sales. Import tariffs may increase the costs of local businesses that rely on imported raw materials for making their goods. The duty is calculated as a percentage of the value of goods being imported.

Table 24.2 explains the effects of an increase in import tariff/customs duty on consumers and businesses and how businesses may respond to this.

Policy change	Effect on consumers	Effect on businesses	Business response
Increase in import tariffs/customs duty.	<ul style="list-style-type: none"> <li>Imported goods or goods using imported raw materials become more expensive.</li> </ul>	<ul style="list-style-type: none"> <li>Lower sales for businesses selling imported goods.</li> <li>Increased cost of imported raw material may lead to higher cost of production.</li> <li>Local firms may benefit as demand for their products will increase.</li> </ul>	<ul style="list-style-type: none"> <li>Businesses may decide to use local raw materials which may be cheaper, but quality may suffer as a result.</li> <li>Local firms may set up more branches and expand.</li> </ul>

Table 24.2 The effects of an increase in import tariffs/customs duty

### Sales tax

This is the tax paid by consumers on the purchase of some items. There will be different rates of sales tax depending on the type of item. Sales tax may be known by a different name in some countries; in Brazil it is known as IPI.

### Excise duty

This is the tax paid by a manufacturer on the production of specific goods within the country. In India, the government has different tariffs for different classes of goods.

### Government borrowing

Tax rates can only be altered to a certain extent. Governments also borrow money from the public in order to fund their spending. This money can be borrowed locally by issuing treasury bills and bonds, which people and organisations of the country invest in. Governments may also borrow from other countries, but this can be expensive.

### How businesses respond to changes in government spending

The money raised through taxes is used by the government to improve the infrastructure of its country.

The government can affect economic growth by controlling its own spending. If growth is slow, the government can increase its spending in areas such as schools, hospitals and transportation. This will create more jobs in these and other dependent sectors. For example, if the government spends more on roads, then construction firms that build and repair the road network will benefit. This will encourage businesses to think about growth. Alternatively, the government can affect the level of business activity by reducing its spending, or discouraging businesses from expansion.

### How changes in interest rates affect business activity and how businesses respond

Monetary policy is how a country’s government or central bank controls how much money there is in circulation. The government or central bank uses interest rates to maintain economic growth and keep inflation low.

Interest rates determine:

- the money that an individual or a financial organisation can gain when they deposit money with a bank
- the cost of borrowing money from a bank.

Some Islamic countries follow Sharia law, which does not permit financial gain on loan of money. These countries combine standard and Islamic banking principles (which are based on profit sharing and non-interest-based lending and borrowing).

CASE STUDY

### Interest rates in Indonesia

The Central Bank of the Republic of Indonesia controls the interest rates in that country. In the global recession of 2007, the Central Bank cut interest rates to encourage borrowing for spending and new investments, which led to economic growth. Figures 24.7 and 24.8 show the interest rates and the GDP in Indonesia from 2006 to 2012.

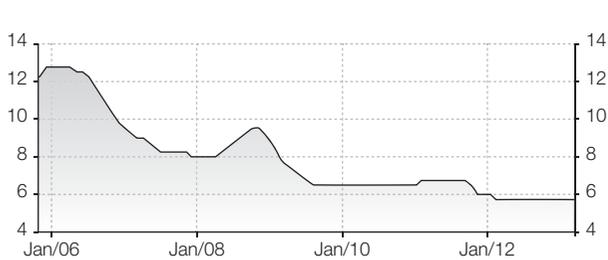


Figure 24.7 Interest rate in Indonesia  
Source: www.tradingeconomics.com and Bank of Indonesia

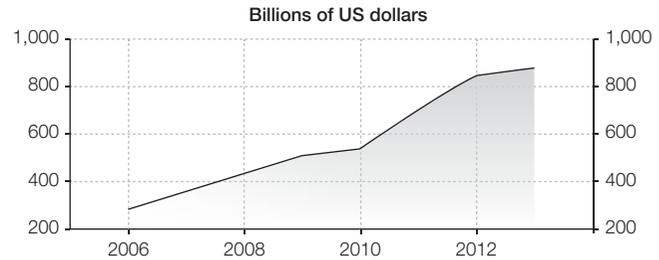


Figure 24.8 GDP in Indonesia  
Source: www.tradingeconomics.com and Bank of Indonesia

#### TASK

- a What has been the change in interest rates from 2006 to 2012?
- b How has the change in interest rates from 2006 to 2012 affected the GDP of Indonesia?
- c Analyse how the change in interest rates may have helped economic growth and businesses in Indonesia.
- d Analyse the changes in interest rates in your country, over the past five years.
- e Which is the main authority controlling the interest rates in your country?
- f Evaluate and discuss whether these changes have proved to be beneficial for economic growth and businesses in your country.

Table 24.3 explains the effects of increase in interest rates on consumers and businesses and how businesses respond to this.

Policy change	Effect on consumers	Effect on businesses	Business response
Increase in interest rates.	<ul style="list-style-type: none"> <li>Cost of borrowing increases thus people will borrow less.</li> <li>More incentive to save thus they will spend less.</li> </ul>	<ul style="list-style-type: none"> <li>Credit/cost of borrowing is more expensive; interest costs rise.</li> <li>With people spending less, business sales will drop.</li> </ul>	<ul style="list-style-type: none"> <li>Firms may delay or cancel their plans to expand as the cost of borrowing money is high.</li> </ul>

Table 24.3 The effects of an increase in interest rates



**Exchange rate appreciation:**  
see Chapter 26, page 337.

**TOP TIP**

Make sure you understand what happens when interest or tax rates change. If rates rise, what does this mean for businesses and consumers? Can you explain it?

In the long term, an increase in interest rates may lead to the following effects on the economy:

- Reduced business activity leading to slow economic growth.
- High rate of return from savings will encourage individuals and financial institutions from other countries to invest their money with the banks in that country. This strengthens the national currency and leads to exchange rate appreciation. This will make imports cheaper.

Changes in taxation and interest rates affect businesses differently. Generally, businesses that produce non-essential/luxury goods and services (such as electronic gadgets and the tourism industry) are affected the most by changes in taxation policies. Businesses that produce essential goods and services, such as food and health-related products, are less affected by such changes. People cannot do without essential goods and have to buy them no matter how expensive they are.



Shoppers at a store in Hong Kong

**ACTIVITY 24.5**

The interest rate changes made by the Bank of Botswana from 2008 to 2012 are shown Figure 24.9.

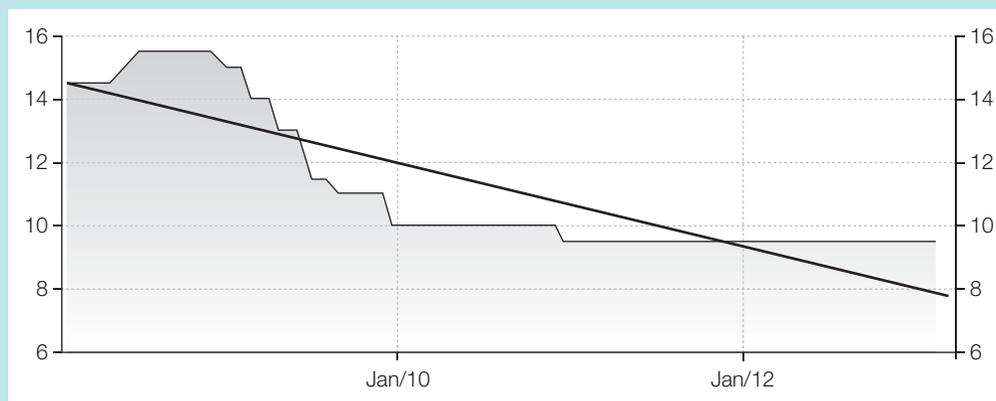


Figure 24.9 Interest rates in Botswana, 2008–2012

Source: [www.tradingeconomics.com](http://www.tradingeconomics.com), the Bank of Botswana

Gregor Naledi is thinking about buying a house. He met with the bank manager to apply for a housing loan/mortgage. The bank manager explained how changes in interest rates could affect how much he has to spend each month. He did this by analysing the changes in interest rates and their impact over the last few years on a borrowed amount of 650 000 pula.

Year	Interest rate	Monthly payment (pula)
2008	14.5%	7854
2009	15.5%	
2010	10%	
2011	9.5%	
2012	9.5%	

- 1 Copy and complete the table above.
- 2 Do you think the changing interest rates are likely to be helpful to Gregor?



#### TOP TIP

Always answer the longer questions in context. For example, when explaining the impact of tax and interest rates on businesses, make sure you relate it to the business or country mentioned in the question.

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#### TEST YOURSELF

- 1 List the main economic objectives of a country.
- 2 Explain how governments control the economic activity in their country.
- 3 What are the main stages of a business cycle? Identify at least **two** characteristics of each stage.
- 4 Make a list of some of the different types of taxes that affect businesses and consumers.
- 5 Discuss the effect of an increase in income tax rate on consumers.
- 6 Explain how businesses are affected by a decrease in interest rates.
- 7 How might businesses respond to an increase in interest rates?

## Revision checklist

- Economic growth, healthy balance of payment, low inflation and low unemployment are the key economic objectives of any government.
- Governments aim to achieve these economic objectives by changes to tax and interest rates and also by controlling how much they spend on public services.
- There are four stages in the business cycle: growth, boom, recession and slump. These can affect the economic objectives and policies of a government.

## Exam-style practice questions

- 1 The unemployment rate in Country A has risen from 4.5% to 7.2% in the past year, the inflation is said to have gone up and the GDP is decreasing. The economy of Country A is said to be in recession. Country A is a very small country and relies heavily on imports from other countries.
  - a Define 'recession'. [2]
  - b Identify **two** features of a decreasing GDP. [2]
  - c Outline **two** types of taxes that retail businesses in Country A may have to pay. [4]
  - d Explain **two** effects that the economic recession may have on a manufacturing company in Country A. [6]
  - e Explain **two** ways that the government of Country A can help stimulate growth in the economy. Justify which way should be chosen. [6]
  
- 2 Country Z is a growing economy with an increasing GDP and a healthy balance of payments. The country's success depends on exports of sugar, textiles and tourism. However, due to lack of natural resources, Country Z is heavily dependent upon imports of fuels for its energy needs. The government of Country Z wants to accelerate economic growth further to be able to meet all its economic objectives. The government is also considering ways to attract more investment from both local and foreign companies.
  - a Define 'balance of payments'. [2]
  - b List **two** economic objectives that the government of Country Z may have. [2]
  - c Outline **two** features of Country Z's economy, which is in a growth stage. [4]

- d** Explain the effect of a decrease in both corporation tax and interest rates in attracting new companies to invest in Country Z. [6]
- e** Do you think an increase in import tariffs in Country Z will be helpful to businesses? Justify your answer. [6]

**Total available marks 40**

# 25

## Objectives

*In this chapter you will learn about:*

- the impact of business activity on the environment
- the external costs and benefits of business decisions
- sustainable development
- environmental pressures and opportunities
- ethical issues faced by businesses.

# Environmental and ethical issues

## Introduction

Business activity has an impact on the physical, social and economic environment in which it operates. This chapter looks at the positive and negative impact businesses have on the environment and society around them. It also looks at the role of pressure groups and government controls on business activity. Many ethical issues have to be considered in business decision-making. In dealing with environmental and ethical concerns, businesses face many threats as well as opportunities.

## Environmental concerns and ethical issues

Many businesses are increasingly aware of the need to deal with the environmental impact and ethical issues related to their activities. Failure to recognise this may lead to bad publicity and loss of sales for a business. Equally, a business that is environmentally friendly and ethical can lead to a positive image and an opportunity to increase sales. Businesses try to work in such a way that their environmental impact is minimal and their operations are ethical.

### How business activity can impact on the environment

Every business activity, whether it is from the primary, secondary or tertiary sector, has an impact on the environment. The impact can be positive or negative. For example, a mining company (primary) may use up the natural resources of a country, create pollution and damage the environment of an area. Table 25.1 analyses how the tourism industry (tertiary) can have an impact on the environment.



**Primary, secondary, tertiary industry:** see Chapter 2, page 20.

Negative impact	Positive impact
Overuse of a country's natural resources such as water (used in swimming pools, hotels and golf courses).	Spreads awareness and helps in the conservation of wildlife and natural resources.
Increased pollution through littering, noise and air pollution.	Employment generated through tourism may help in reducing other activities such as overfishing that are bad for the environment.
Construction of buildings can lead to soil erosion and loss of habitat for animals.	Additional work for local construction businesses.

Table 25.1 Impact of the tourism industry on the environment

Business activity can affect us and our environment through:

- pollution
- waste

- emission of greenhouse gases
- use of energy
- use of natural resources.

**Pollution**



Business activity can result in pollution

Business activity is responsible for a range of pollutions, as shown in Table 25.2.

Air pollution	Caused by fumes from manufacturing units and exhaust fumes created by vehicles. Can lead to respiratory disorders in humans, and affects plants and animals. Corrosive chemicals in the air can damage buildings.
Land pollution	Waste that cannot be recycled finds its way into landfill. Harmful and possibly nuclear waste from factories can end up in landfill too. Some of this does not decompose and is toxic and unpleasant to see.
Thermal pollution	Exhaust fumes in the air that trap heat lead to an increase in air temperatures. Water is used as a coolant in factories and then returned to the environment at a higher temperature, damaging the plants and animals in the area.
Light pollution	Electronic billboards used by businesses for advertising and over-illumination can interfere with ecosystems and astronomical observations.
Water pollution	Caused by improper waste disposal and contamination by toxic, chemical waste from factories. This can seriously damage the plant and animal life in the water and can be life-threatening if consumed by humans.
Visual pollution	Unattractive views such as power lines (needed by a manufacturing plant) and overcrowding can be unpleasant and prevent people from enjoying the natural environment.
Noise pollution	Caused by manufacturing plants and cars and aeroplanes. Can be an irritant and affect people’s quality of life.

Table 25.2 Types of pollution

**TOP TIP**

Don't worry about learning specific laws – you only need to understand why protection is important. Also, think about how laws affect businesses. Do they have to change what they do? Is it expensive? What could happen if they do nothing?

In order to reduce the amount of pollution, governments of most countries put controls on pollution. For example, they may do this by charging a levy on the release of pollutants or introducing laws to ban the release of dangerous chemicals. In some countries, however, laws are not as strict. Controlling pollution has to be a combined effort of governments, scientists, businesses and individuals.

**Waste**

A landfill site

The types of waste produced by businesses are shown in Figure 25.1. Factories, offices and farming and mining activities, in particular, produce large amounts of waste.

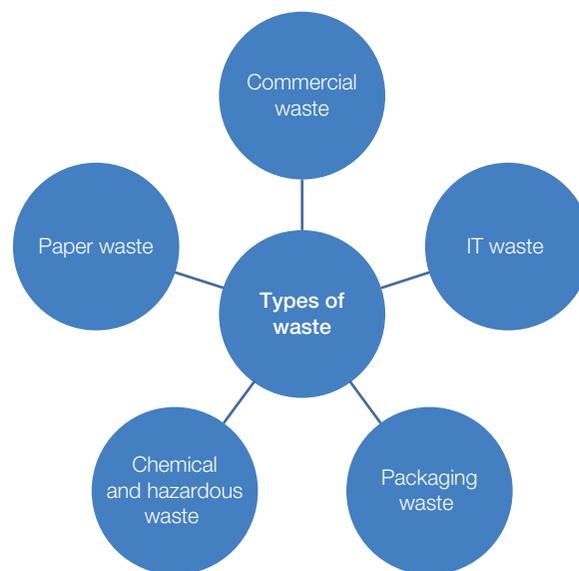


Figure 25.1 Types of waste produced by business activities

**TOP TIP**

Remember, externalities can be positive and negative.



**Packaging:** see Chapter 12, page 167.

Globally, many governments are trying to deal with the issue of waste by introducing initiatives based on the 3Rs – reduce, reuse and recycle. Businesses are also trying to be more environmentally friendly by reducing the amount of natural resources they use and recycling their waste.

Not all types of waste can be recycled. For example, electrical waste such as computers and packaging waste often ends up in landfill where toxic chemicals and harmful gases then flow into the ground and air.

Waste is not just a problem caused by primary and secondary sector businesses. A good example is packaging and plastic bags. Although packaging is a very important part of the marketing mix, packaging waste can have a serious impact on the environment. Many businesses are trying to reduce the quantity of packaging materials that they use. For example, the sports and lifestyle company Puma has changed the packaging design for its shoes. Unlike a traditional shoebox, the new design uses less cardboard and the container can be reused afterwards as a shopping bag, which can be recycled.



### Emission of greenhouse gases

Greenhouse gases such as carbon dioxide and methane are naturally found in the environment. When manufacturing businesses and others burn fossil fuels such as coal and oil, the amounts of greenhouse gases in the atmosphere greatly increase. Heating and air conditioning systems release greenhouse gases from offices and factories into the atmosphere, which leads to global warming.

### Use of energy

Office equipment, lighting, heating and air conditioning,

and machinery use large amounts of a country's energy sources such as coal, gas, oil and electricity. Coal, gas and oil are natural resources that cannot be replaced once they have been used. By turning off lights and equipment when not working, businesses reduce the amount of energy they use. Many countries are developing renewable sources of energy such as wind and solar power. These do not produce greenhouse gases and can easily be replaced.

### Use of natural resources

Many manufacturing businesses use non-renewable raw materials which may lead to scarcity. Overfishing and deforestation (cutting down large numbers of trees) can affect the plants and animals in those areas, destroying their natural food source or habitat. Deforestation contributes to global warming.

When factories burn fossil fuels, they increase the amount of greenhouse gases in the atmosphere

**EXPLORE!**

Which type of pollution affects your country the most? Is it caused by any particular industries? What steps has the government taken to control it?



**External stakeholders:** see Chapter 5, page 63.



#### KEY TERMS

**Externality:** the effect of business activities on unrelated parties.

**Social cost:** the negative impact of a business decision on society.

**Social benefit:** the positive impact of a business decision on society.

## Externalities

Some business activities are more environmentally friendly than others. How a business uses energy, disposes of waste or creates pollution may have far-reaching effects on the local community and other businesses in the area and beyond. People and organisations not directly involved in a business's decision-making but who will be affected by its operations are external stakeholders.

A business's activities can have a negative or positive impact on the community and the environment – these are known as **externalities**.

- Negative externalities make up the **social cost** of a project. For example, the setting up of a new hospital in a residential area will cause traffic congestion and increased noise levels for the residents.
- Positive externalities contribute to the **social benefits** of a project. For example, the construction of a new hospital in a residential area will create more jobs and the local community will have easier access to health care.

### ACTIVITY 25.1

Loreli Handa wants to set up a detergent manufacturing factory very close to a nature reserve (protected area). The nature reserve is also a popular tourist spot. She likes the site because it is cheap and close to a good supply of water. The nearest city also has a high unemployment rate.

Before putting her proposal to the government, she analyses the potential externalities of this project (Table 25.3). Loreli hopes her proposal will be approved as she has invested a lot in research and development and is willing to work with the government to help improve the infrastructure of the area (to benefit her and the community as well).

Positive externalities	Negative externalities
New production techniques can lead to a better product at reduced costs. This knowledge can be shared with other businesses.	Air pollution caused by fumes created by manufacturing plants, contributing to climate change as a result of greenhouse gas emissions. Other forms of pollution may also be created.
The business may improve the infrastructure in the area by having a reliable power supply, better transportation network, schools and hospitals. It may provide these facilities to keep employees motivated. This can be beneficial to the employees as well as the community in that area.	Having a factory close to the nature reserve will spoil the beauty of the place and also discourage tourists from coming.
Due to research and development, consumers can have access to improved products at possibly reduced costs.	Road congestion caused by delivery lorries will also affect the tourism in the area.
The business will provide employment for the local people.	Destruction of ecology in the area due to sound, light and air pollution from the factory.

Table 25.3 Positive and negative externalities of Loreli Handa's proposal

- 1 Analyse and discuss whether the impact of the positive externalities is greater than that of the negative externalities.
- 2 Should the government approve the proposal?

**KEY TERM**

**Cost-benefit analysis:** analysis of the costs and benefits of a project, the focus being on the social costs and benefits.

### External costs and external benefits of business decisions

Businesses need to work out if the externalities created by their decisions are justified. They use **cost-benefit analysis** to do this. The social benefits must outweigh the social costs, and the interests of the various stakeholders need to be taken into account. This is not an easy task as it is hard to put a value on some costs, for example the cost of overfishing.

Also, there can be conflicting interests. For example, a business may decide to use expensive technology in order to reduce its pollution levels (meeting the interests of the community) but this will increase costs and reduce overall profits (affecting shareholders and owners).

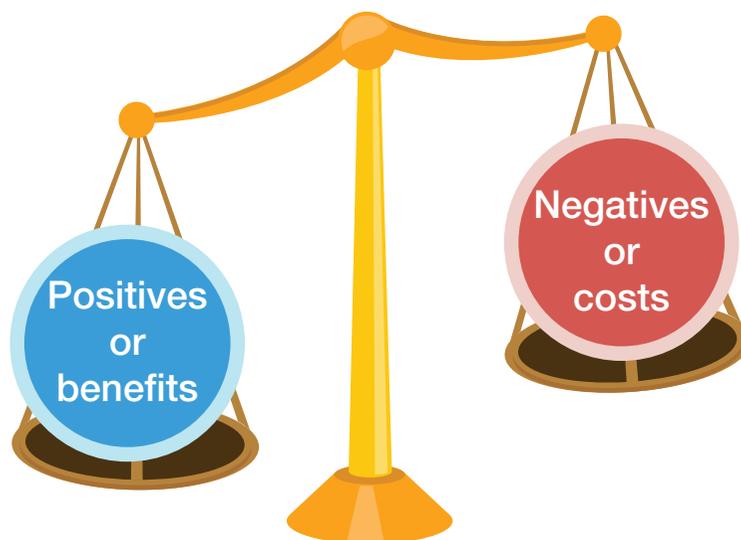


Figure 25.2 Cost-benefit analysis

Corporate social responsibility is at the heart of business decisions, which makes a business think of the overall impact on the public.



**Corporate social responsibility:** see Chapter 5, page 59.

### ACTIVITY 25.2

Country X has one international airport in its capital city. The existing airport is unable to handle the increased air traffic. The government is planning to open a second airport. The proposed location is near a residential area. There has been a lot of opposition from environmentalists and the community in the area of the proposed location. The government, however, thinks this will be good for the economy (which is in recession) and wants to go ahead with the decision.

- 1 Identify the stakeholders involved in this business decision.
- 2 As a spokesperson for the community, identify and analyse the social costs that the community would have to experience because of a new airport near them.
- 3 Imagine you are a government official placed in a decision-making committee of this project. Explain the economic benefits of this decision and how they will help the economy grow.
- 4 From the point of view of an environmentalist, discuss the impact (social costs) that this business decision would have on the environment.
- 5 Present the above arguments of at least **three** of the stakeholders (identified in Question 1) in a table. Conduct a cost-benefit analysis and evaluate whether this project is worth considering. Do the economic and social benefits exceed the social costs?

## Sustainable development

A business is said to be sustainable if it contributes towards the economic growth of the country and makes profits while obeying the law and being ethical and environmentally friendly. For example, a business can take the following steps to be sustainable:

- use renewable sources of energy
- avoid unnecessary travel by promoting a work from home policy (telecommuting)
- avoid or reduce the use of chemicals that produce toxic waste
- use packaging that is made of recycled material
- use packaging that can be recycled or reused
- use energy-efficient processes and equipment to minimise the use of energy
- reduce waste or find a market where it can be used as a raw material
- work with employees, customers and suppliers fairly.



### KEY TERM

**Sustainable development:** a business activity is said to be sustainable if it has a positive overall impact on the environment and its stakeholders, ensuring its survival in the future.

To achieve **sustainable development**, a business needs to weigh up the environmental, social and economic impacts of its activities. If these meet the indicators shown in Table 25.4, the business is said to promote sustainable development.

Environmental	Social	Economic
<ul style="list-style-type: none"> <li>■ Conservation of natural resources.</li> <li>■ Conservation of forest and habitats for endangered animals and plants.</li> <li>■ Use of renewable sources of energy for business activity such as solar and wind power.</li> <li>■ Reduction of greenhouse gas emissions by using greener sources of energy.</li> <li>■ Proper waste management from business activity so that pollution levels can be controlled, for example recycling.</li> </ul>	<ul style="list-style-type: none"> <li>■ High life expectancy by generating less pollution.</li> <li>■ Gender equality by having relevant human resource policies in place.</li> <li>■ Ethical business decisions by conducting a social cost–benefit analysis of a project.</li> <li>■ Fair compensation to employees.</li> </ul>	<ul style="list-style-type: none"> <li>■ Low unemployment by providing work to people.</li> <li>■ High literacy rates by setting up training and knowledge-sharing programmes for employees.</li> <li>■ Growing GDP by generating products and services.</li> <li>■ Improved standards of living by paying employees fairly and improving working conditions.</li> </ul>

Table 25.4 Indicators of sustainable development

Despite the possible costs of sustainable development, some businesses try to do what is right for the environment and the community in which they operate. This might be in terms of production processes used, charitable actions or what they produce. For example, Samsung, one of the world's leading home electronics manufacturers, has led the way in sustainable development in the technology industry. It has introduced a number of environmentally friendly products such as solar-powered computer notebooks and energy-efficient microwave ovens.

## Environmental pressures and opportunities

Businesses have to respond to the threat they face from environmental pressures. Environmental pressures can also be positive and offer opportunities for established and new firms.

### Pressure groups

A pressure group is a group of people who join together for a common cause (ethical or environmental). It aims to change the way businesses function. It often does this by trying to influence government policy. For example, the pressure group Greenpeace campaigns on environmental issues. Another example is the Environmental Justice Foundation (EJF), a non-profit organisation working globally to protect the environment and human rights. It campaigns against the negative effects of shrimp farming in Brazil, which is destroying the lives of coastal communities and damaging the environment.

Pressure groups use the following methods to make their point:

- **Demonstrations** – this involves a group of people protesting about a business's actions or policy, either at a rally or outside the company's offices.
- **Boycotting** – refusing to buy a business's products or services and trying to influence other consumers to do the same.
- **Petitioning** – making an oral or written official complaint to the government or concerned authority on an issue.
- **Lobbying** – attempting to influence the policy-making of the government.
- **Increasing awareness of the issue** – this is done through the pressure group's website and possibly causing negative publicity with the help of the media.



A pressure group demonstration



#### TOP TIP

Remember, pressure groups do not have the power to make laws. They only try to influence consumers, businesses or the government.

### How businesses respond to environmental pressures

Businesses respond to environmental pressures by:

- using green manufacturing methods, which produce less waste and pollution
- reducing their use of energy
- obeying government regulations and standards
- following sustainable business practices

- taking legal action against pressure groups
- defending business decisions in order to improve their image, which may have been damaged by pressure groups.

### Why businesses respond to environmental pressures

If a business fails to respond to environmental pressures, then it may face the following threats:

- The business's reputation may be damaged. It may lose customers, employees and investors.
- The business may be closed down if government regulations to use greener methods of production are not followed.
- Inability to meet government regulations may create legal problems for businesses.
- Pressure groups may oppose the business, produce negative publicity and prevent a company's growth.

Pressure groups may also have a positive influence. They may approve businesses that have environmentally friendly practices, which gives businesses good publicity.

### Opportunities presented by environmental pressures

Businesses respond to environmental pressures because environmentally friendly practices may have benefits.

- Recycling and using energy-efficient machines may lead to cost savings.
- Governments may provide financial incentives to encourage firms to use environmentally friendly methods of production.
- Publicity gained from greener methods can attract new customers, employees and investors and keep existing ones.
- Telecommuting (working from home) benefits the environment and is a great motivator for employees.
- The green revolution has led to the growth of new businesses dealing with environmental management.
- Following government regulations and standards can give a firm a competitive advantage over other businesses.

#### EXAMPLE

Futuris is a company that has developed and benefited from the environmental pressures faced by businesses. The Costa Rican environmental management company provides environmental advice to companies worldwide.

### The role of legal controls

Governments use legal controls to limit the negative effects of business activity on the environment. Some examples are listed below.

- Governments may impose penalties, in the form of fines, closure of facilities and imprisonment, on businesses that ignore pollution targets or waste disposal regulations.
- They may charge a levy or tax on the commercial use of energy. It is hoped that this will encourage businesses to be more energy efficient.

- They may set standards that businesses have to meet when using natural resources; for example, a certain percentage of this must come from renewable sources.
- Businesses may not be permitted to set up in some areas.

Governments also help businesses to be environmentally friendly by:

- Making environmental information more accessible. This can be done by setting up organisations to provide environmental management advice.
- Enabling recycling by providing waste collection vehicles, containers and coordinating collection of waste for businesses.

### Incentives

Government incentives encourage businesses to be environmentally friendly. The following incentives are common in a lot of countries:

- The government can reward the greenest companies with tax credits. This encourages businesses to go green as this will help improve their profits.
- The government can make policies that allow tax exemptions for companies using renewable sources of energy and being energy efficient.

For example, the Energy and Environment Park (enpark) has been set up by the government of the UAE, to encourage businesses to be more environmentally friendly. It offers a tax-free business environment for energy and environment management companies, located in Dubai. It provides support for sustainable business operations through the integration of environmentally friendly policies, knowledge and technologies, combining environmental, social and economic elements to encourage sustainable development.

### ACTIVITY 25.3

ABC Tyres, a tyre manufacturing company, wants to open a new plant. Although the site is located on the outskirts of a big city, it is close to a residential area. The government is considering the environmental impact of this plant before allowing the company to go ahead.

The government's analysis shows that manufacturing of tyres involves the use of toxic chemicals and generates large amounts of waste. The plant will also require huge amounts of water and power. The government does recognise that the plant will generate employment in the local area. To benefit from this, the government is also looking at ways in which the environmental impact can be reduced or controlled.

- 1 Analyse the impact this new plant may have on the environment.
- 2 How will it affect the residents living in the area?
- 3 How can the government control the environmental impact of the plant?

### Ethical issues faced by businesses

Businesses must make sure that they satisfy the interests of all stakeholders, whether they are individuals, organisations or the community. We usually expect businesses to behave responsibly when carrying out their activities. This is known as business ethics. Although not always enforced by law, business ethics have a vital role to play in decision-making.

Some businesses, however, do not behave in an ethical way. Some examples of unethical business practices are shown in Table 25.5.

Sector	Examples of unethical practice
Finance	<ul style="list-style-type: none"> <li>■ Failing to tell customers about extra/add-on costs.</li> <li>■ Insider trading (trading of a company's stocks by individuals who have knowledge of non-public information).</li> </ul>
Marketing	<ul style="list-style-type: none"> <li>■ False advertising of products and services.</li> <li>■ Providing products and services that are unsafe for use.</li> <li>■ Non-disclosure of risks associated with products or services.</li> </ul>
Human resources	<ul style="list-style-type: none"> <li>■ Unfair payment to employees, for example unequal pay for the same work done by different groups of people.</li> <li>■ Use of child labour.</li> <li>■ Production in sweatshops, where the working environment and hours do not meet health and safety standards.</li> <li>■ Discrimination against employees based on gender, ethnic group, religion or age.</li> </ul>
Operations	<ul style="list-style-type: none"> <li>■ Dumping: selling products at very low cost internationally so as to drive out competition.</li> <li>■ Improper waste disposal.</li> <li>■ Exceeding pollution limits set by the government.</li> </ul>

Table 25.5 Unethical business practices

### EXAMPLE

A pesticide factory in Bhopal, India, owned and operated by Union Carbide India Limited, leaked large and fatal amounts of a highly poisonous gas in December 1984. This was responsible for the death of around 8000 people. Afterwards, many children were born with birth defects.

Poor maintenance, lack of quality control and safety regulations not being followed led to the disaster. Chemicals abandoned at the plant continue to leak and pollute the groundwater. India's government had to settle for \$470 million in compensation from Union Carbide, although the damage to the region has been estimated to cost \$3.3 billion. No amount of money, however, can compensate for the disaster caused by the company's unethical business practices.

### EXPLORE!

Amnesty International is a worldwide campaign to end abuse of human rights and unethical practices. Find out about other pressure groups that have an international presence. Are there any pressure groups that are currently active in your country?

Not all businesses are unethical. For example, many businesses set ethical objectives. Most businesses choose to treat their suppliers and employees fairly by paying reasonable prices and wages and providing good terms and conditions. These businesses also make an effort to avoid the use of child labour, use recycled materials and try to consider the environmental impact of their operations. Fair Trade is one such initiative. Fair Trade is a global campaign about trying to ensure better prices for producers and fairer working conditions, as well as promoting sustainability for producers in developing countries. Other organisations such as Starbucks have set up their own charitable foundations to help the communities which supply them with products.

Some businesses will always aim to provide goods that are safe to use and not try to mislead customers. Legislation exists as a form of protection against those businesses that try to exploit other stakeholders.

Businesses also need to make sure that ethical practices are followed by all parts of their supply chain, from suppliers and distributors to the sales agents who sell their products.

**Conflicts between profits and ethics**

Businesses may find that achieving ethical objectives increases their costs. Greater costs mean lower profits, so businesses often face a conflict between profits and ethics. For example, an increase in production levels may lead to economies of scale and possibly more sales, but it also causes an increase in pollution. Paying employees higher salaries rather than earning higher profits is another example of an ethical decision.

It is important that the right balance is found, as earning profit by unethical means is not good for the long-term survival of a business.

The outsourcing industry is a good example of the conflict between profits and ethics. Outsourcing is the relocation of business functions (such as finance or manufacturing operations) to other countries. This means that jobs may be lost in one country, and gained in another.

**ACTIVITY 25.4**

Many businesses worldwide have outsourced some of their business functions to countries such as India, the Philippines, China, Brazil and Costa Rica. This is usually done in order to reduce costs (because of a cheaper workforce) and increase profitability. The businesses also benefit from favourable exchange rates with these countries. This loss of local jobs to people in other countries has contributed to increasing unemployment in the home country.

- 1 Businesses argue that during a global recession they need to cut costs in order to survive and make profits. Discuss in a group the ethical decision between loss of local jobs and growth in profits.
- 2 Some reports say that foreign employees are often paid wages lower than the local minimum wage of the business's own country. Do you think this is ethical?

**How businesses respond to ethical issues**

When faced with an ethical issue, a business has to consider the interests of the various stakeholders. When stakeholders have conflicting interests, decision-making may not be easy. Both the advantages and the disadvantages of ethical behaviour need to be considered. These are shown in Table 25.6.

**TOP TIP**  
 Questions on social or environmental issues will usually require you to give an opinion on a given statement. Try to look for both the positive and the negative points and make a decision. Make sure the points are relevant to the type of business identified (this is what is meant by the word 'context').

Advantages	Disadvantages
<ul style="list-style-type: none"> <li>■ Improved image and reputation, which helps in attracting new investors, which can help a business grow.</li> <li>■ Can be a motivating factor for existing staff, which will help with retaining them.</li> <li>■ Customers these days demand eco-friendly products that have been made fairly. Businesses can use this to improve their brand awareness and recognition.</li> </ul>	<ul style="list-style-type: none"> <li>■ High costs may be involved when choosing raw materials ethically (such as using recycled materials) as opposed to choosing those with the lowest price, leading to lower profits.</li> <li>■ Costs may be increased by improving working conditions and pay for employees, and not using cheap child labour. All this leads to lower profits.</li> </ul>

Table 25.6 Advantages and disadvantages of ethical behaviour

Overall, it is in the long-term interests of a business to act ethically, for its survival. Although there is a cost involved initially, it pays off over time and society as a whole is likely to benefit. For some businesses, their failure to follow ethical policies may bring unwelcome publicity, which can damage their reputation.

## Garment industry in Bangladesh

### Ethical issues in Bangladesh

Bangladesh has one of the largest garment industries in the world that provides cheap clothing for major Western retailers. This is mainly due to its widespread low-cost labour.

In April 2013, a significant number of people died when a building collapsed outside the capital, Dhaka, where employees made Western clothing. Police said the owners of factories in the building had ignored warnings about cracks appearing in the building.

The whole garment industry in Bangladesh has been criticised for its low pay, limited rights given to employees and often dangerous working conditions in garment factories. Some of the factories are also guilty of using child labour. The tough economic conditions mean that child labour is widely accepted and very common in Bangladesh. Many families rely on the money earned by their children for survival. Also, employers often prefer to employ children because they are cheaper and considered to be more obedient than adults.

Sources: Adapted from [www.bbc.co.uk/news/world-asia-22476774](http://www.bbc.co.uk/news/world-asia-22476774) and [www.unicef.org/bangladesh/Child\\_labour.pdf](http://www.unicef.org/bangladesh/Child_labour.pdf)

#### TASK

- a Identify the unethical business practices mentioned in the extract above.
- b Discuss whether the Western retailers are being ethical in buying from the garment factories in Bangladesh.
- c How can Western retailers ensure that their suppliers are following ethical business practices?
- d Explain why child labour is unethical.
- e What steps can the government take to stop child labour?

#### TEST YOURSELF

- 1 Explain how business activity can impact the environment.
- 2 Define 'an externality'.
- 3 Why is it important to conduct cost-benefit analysis?
- 4 Define 'sustainable development'.
- 5 Why are ethics important in business decision-making?
- 6 What is a pressure group?
- 7 Discuss some legal controls that governments may use to control the impact of business activity.

## Revision checklist

- Businesses have a huge impact on the environment and the community.
- The effect that a business has on unrelated parties is called an externality.
- Depending on the nature of the externality, it may generate a social cost or a social benefit for the environment and the community.
- A social cost–benefit analysis and assessment of stakeholders' interests need to be done when considering a business decision.
- Businesses should have environmentally friendly and ethical business practices in order to avoid opposition by pressure groups.
- Governments place legal controls to minimise the impact of business activity on the environment.

## Exam-style practice questions

- 1** Juan Cruz runs a small shrimp farm in the Philippines. The seafood industry has come under a lot of international pressure from environmentalists about the effect of this industry on environmental degradation and destruction of marine biodiversity. It has also been linked to human rights abuses, such as child labour and unfair payments and working conditions. The government has been trying to prevent overfishing and promote sustainable development.
- a** Define 'sustainable development'. [2]
  - b** Define an 'externality'. [2]
  - c** Outline **one** positive and **one** negative externality caused by this business. [4]
  - d** Explain **two** effects that Juan Cruz's business may have on its environment. [6]
  - e** Explain **two** ways the government can control the effect of a business activity on the environment. Justify which of these two ways is likely to be the most effective. [6]
- 2** Khan Garments is a retail company that sells luxury cotton garments. It buys its inventory from suppliers based in different countries. The economies of these countries are in a growth stage and there is plenty of labour. This means labour costs are very low and working conditions are often poor.
- The cheap production costs enable Khan Garments to have a high profit margin. Although Khan Garments pays competitive wage rates to its own employees, the owner is aware that his suppliers may not be following ethical business practices. With increasing awareness of ethical issues and the presence of pressure groups, the owner is thinking about changing his suppliers.
- a** Define a 'pressure group'. [2]
  - b** Identify **two** unethical business practices that may be followed by the suppliers of Khan Garments. [2]
  - c** Outline **two** advantages to the owner of Khan Garments of running his business ethically. [4]
  - d** Explain **two** problems pressure groups could cause for Khan Garments. [6]
  - e** The owner of Khan Garments is aware of the unethical business practices followed by his suppliers, but if he sources his products from different suppliers then his costs may go up. Should he change his supplier? Justify your answer. [6]

# 26

## Objectives

*In this chapter you will learn about:*

- globalisation
- multinational companies
- exchange rate changes.

# Business and the international economy

## Introduction

Countries that trade with each other contribute to the process of globalisation. Due to technology, the world has become smaller, making international expansion much easier for companies. For many businesses, expansion into international markets is an important growth strategy.

The global recognition of brands is a sign of the growth of businesses internationally. The international business environment and such things as tariffs and exchange rate fluctuations greatly influence business activity.

## The importance of globalisation

In the past, goods and services were often produced in one country and sold locally. Nowadays, goods and services may be produced by a business in one country and then exported to countries all over the world. Yet another type of business is the **multinational company**, where a company has its headquarters in one country and branches and factories in other countries around the world. The result has been a huge increase in international trade which has led to **globalisation**.

## Reasons for globalisation

The use of information and communication technology has helped to make international expansion easier for many companies. More efficient methods of communication and international transportation have helped to break down geographical and language barriers. For example, perishable food items such as fruits and vegetables can be shipped anywhere in the world. Free trade agreements also assist business operations by improving economic and technical cooperation.

Many governments have realised the importance of international trade to their economies, and have changed their economic policies to allow foreign companies to set up operations in their countries. This has helped some large companies to grow into multinationals. Many governments have also reduced or removed trade barriers, so that it is easier for goods and services to move from one country to another.

## Characteristics of globalisation

With greater cultural, technological, social and political interaction between countries (globalisation) and fewer barriers and regulations, there is greater trade (exchange of goods and services between countries.) This makes the world a single market with the economies of

### KEY TERMS

**Multinational company:** an organisation that has operations in more than one country.

**Globalisation:** the process by which countries are connected with each other because of the trade of goods and services.



Goods being moved from one country to another

different countries being dependent upon each other. Brands become recognised globally and products and services are easily accessible anywhere in the world.



Figure 26.1 Characteristics of globalisation

**E-commerce:** see Chapter 13, page 186.

**Growth of globalisation**

Factors that have increased the pace of globalisation are migration (movement of people from one place to another) and the improvement of technology (leading to faster and more effective telecommunication and transportation).

The development of countries being held together by free trade agreements has also contributed to the growth of globalisation.

Free trade agreements are considered to be an important way of opening up foreign markets. Most free trade agreements aim to reduce trade barriers between member countries by creating favourable trade and investment policies. Free trade agreements also help business operations by improving economic and technical cooperation. Countries wanting to trade with each other form a **trade bloc** and reach a common agreement to lower trade barriers within the member countries. For example, the Asia-Pacific Economic Cooperation (APEC) is an association of 21 countries that aims to promote free trade and economic cooperation throughout the Asia-Pacific region.



APEC aims to promote free trade in the Asia-Pacific region

**KEY TERM**  
**Trade bloc:** a group of countries that trade with each other and are usually part of a free trade agreement.

**EXPLORE!**

Is your country part of a trade agreement? If not, research a free trade agreement of your choice. (Hint: Use the internet or ask your teacher to provide you with business newspapers or journals to do your research.)

Has this helped reduce barriers to trade between member countries? Has this helped the economies of the member countries?

**ACTIVITY 26.1**

Carlos owns a manufacturing business. He buys the raw material locally but he is concerned that it has become expensive and the quality is not as good as before. He sells his products to the local market. His country's government is planning to join a free trade agreement with the neighbouring countries. The government says this would encourage more trade between the countries.

- 1 How might joining the free trade agreement help Carlos with the problem he is facing with the raw materials?
- 2 How would joining the free trade agreement encourage more trade between the countries?
- 3 Do you think there are any disadvantages of the free trade agreement for Carlos and other businesses in his country?

**KEY TERMS**

**Home country:** the domestic country where a multinational starts/first establishes its operations.

**Host country:** the foreign country where a multinational sets up its operations.

**Opportunities and threats of globalisation**

Globalisation affects people and businesses in the **home country** and in the **host country** in many ways. The home country is where a multinational first sets up its operations. The host country is the foreign country where a multinational sets up its operations.

Globalisation has a great impact on the people and the countries involved. People benefit from a wider variety of products available to them at a lower cost. Also, multiculturalism promotes peace and understanding between people. Globalisation is good for countries as it leads to increased cooperation between them. Reduction in prices contributes to greater exports and incoming foreign currency. Attracting more businesses to invest in their country can help governments achieve their economic objectives, such as lower employment, and increase economic growth.

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Opportunities	Threats
<ul style="list-style-type: none"> <li>Businesses can access more markets, which may lead to an increase in sales.</li> <li>Labour may be cheaper in host nations and so businesses can gain from lower costs.</li> <li>Due to increased competition, businesses operate more efficiently and reduce costs due to cost-effective innovations and economies of scale. Reduction in costs will lead to greater profits. They can also offer their products at reduced prices, encouraging sales.</li> </ul>	<ul style="list-style-type: none"> <li>Local businesses in the host country may suffer as foreign companies start to sell their products at a cheaper price.</li> <li>Exchange rate fluctuations may cause lowering of profits.</li> <li>Competition will increase for both local and international businesses.</li> <li>The marketing and distribution costs for the international business will increase.</li> </ul>

Table 26.1 Opportunities and threats of globalisation



**Economic growth:** see Chapter 24, page 300.

**TOP TIP**

Globalisation is a growth strategy and it poses both opportunities and threats for businesses.

There are risks and costs associated with globalisation. For example, people in the home country may lose their jobs if a company decides to move its operations to a country with a cheaper labour force. This will increase unemployment rates in the home country.

Opponents of globalisation claim that increased globalisation has led to increased demand for goods and services at the cost of environmental damage. Globalisation forces companies to conform to a standard culture and this may lead to a loss of individual cultures in the host countries.

Despite the limitations mentioned in Table 26.1, entry to international markets for some businesses is an important objective, as it will enable the business to grow. Starbucks, Nike and Samsung are examples of companies that have grown because of their expansion into other countries.

## Globalisation – the growth of Starbucks

Starbucks, a global retailer of speciality coffee, first opened in 1971 with a single store in Seattle, USA. In 2013, the company had about 18 000 stores spread across 62 countries around the globe. Its growth strategy in 2013 aimed at opening about 1300 stores worldwide, with about half of them planned to be opened in China.

In a survey done by American Express/SAP in 2013, Starbucks was ranked 49th among the top 100 global retailers.

Source: [www.starbucks.com](http://www.starbucks.com); [www.forbes.com/sites/walterloeb/2013/01/31/starbucks-global-coffee-giant-has-new-growth-plans](http://www.forbes.com/sites/walterloeb/2013/01/31/starbucks-global-coffee-giant-has-new-growth-plans)

### TASK

- How has Starbucks benefited by opening stores in other countries?
- What sort of problems might Starbucks have faced while expanding internationally?
- Why do you think China seems to be an attractive market for Starbucks (it is planning for China to be its second largest market)?
- How might the opening of a new Starbucks store affect the local coffee shops in a host country?



### TOP TIP

Free trade agreements can help improve trade between countries. Tariffs and quotas, on the other hand, help control the trade in a country.

### Why governments introduce import tariffs and import quotas

Globalisation offers consumers a wider choice of products and services, but this may cause problems for businesses in the host country. Multinational companies can often supply products and services at cheaper prices than local businesses. Smaller businesses sometimes cannot compete and may have to close down, with the loss of jobs. If multinationals start to take over the trade in the host country, this can have a damaging effect on the local economy. As local businesses and shops close, there will be less choice for consumers and unemployment may rise. For these reasons, governments often try to control the amount of international trade. Two of the main ways they use are tariffs and quotas.

### Tariffs

A **tariff** is a type of tax that is paid on goods that are imported and exported.

A government may place a tariff on imports so as to reduce imports into the country. The tariff increases the cost of the imported goods, and businesses then have to sell the goods at a higher price. This reduces local demand for the goods and benefits local businesses as they have less competition.

Governments may also put tariffs on the export of essential items such as foodstuffs to ensure that the country has enough of them. In the past, China has placed export tariffs on many major grain products.

Restriction on imports and exports is important because every country's economic objective is to have a positive balance of payments. The import tariff also earns revenue for the government.

### Quotas

A **quota** is a physical limit on the quantity of goods that can be imported and exported. Quotas on imports benefit local producers as there are fewer foreign goods in the market and they face less competition. However, customers might be disappointed as there are limited supplies of popular products.



### KEY TERM

**Tariff:** a tax applied to the value of imported and exported goods.



**Balance of payments:** see Chapter 24, page 299.



### KEY TERM

**Quota:** a physical limit on the quantity of goods that can be imported and exported.

Quotas are set on the import of certain commodities, either from specific countries or globally. They may be set with or without consultation with the exporting countries. Exporting countries may suffer as they will only be able to sell a limited amount of goods to the country that has a quota.

### ACTIVITY 26.2

Country B imports its clothing from three main countries, X, Y and Z. In 2012, Country B imposed a quota on imports of selected clothing lines from Country X. Country B wanted to promote its own declining local clothing industry and improve its competitiveness in the global market. People opposed to the policy argue that the quota has not worked.

Country importing from	Imports in 2011 (\$ millions)	Imports in 2012 (\$ millions)	% share in 2011	% share 2012
X	30	16	60	32
Y	12	20		
Z	8	14		
<b>Total imports</b>	<b>50</b>	<b>50</b>		

- 1 Copy and complete the table above to show the % share of imports from Countries Y and Z in 2011 and 2012.
- 2 Do you think that this quota on imports from Country X has helped reduce the competition for the domestic clothing companies? Use data from the table to support your answer.

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### TEST YOURSELF

- 1 Identify the key characteristics of globalisation and explain the impact of globalisation on businesses.
- 2 Discuss the role of quotas and tariffs in international trade.
- 3 Explain how being part of a trade bloc can improve trade between the member countries.



#### TOP TIP

Remember, for a business to be called a multinational it must produce goods and services in more than one country. It does **not** apply to a business that only sells its products in other countries.



**Joint ventures:** see Chapter 14, page 197.

**Objectives:** see Chapter 5, page 57.

## Importance and growth of multinational companies

A company that wants to enter international markets usually starts by exporting its locally produced products to foreign markets. Later it may set up operations in the host country by opening branches on its own or by having joint ventures with foreign companies. Once a company has operations overseas, it is known as a multinational company (MNC). Whether a business decides to expand internationally or become a MNC will depend on what its objectives are. If successful, it may be able to produce enough goods in the host country to export them back to its home or other countries.

For a MNC to be successful, the host country needs to provide a positive environment in which the business can establish and grow. Four main factors are required, which are shown in Table 26.2, page 332.

Economic factors	<ul style="list-style-type: none"> <li>■ There should be little or no restrictions on foreign investments, so that the foreign company that is going to start operations will have fewer regulations to deal with and will be able to establish itself easily.</li> <li>■ Tax incentives and stable currencies of the host country will aid the MNC financially and help increase overall profits.</li> </ul>
Social and political factors	<ul style="list-style-type: none"> <li>■ Security and safety in the host country must be considered so that the physical assets of the MNC as well as its employees are safe.</li> <li>■ Productivity of the workforce is very important if the MNC wants to deliver goods on time and be profitable.</li> <li>■ Skilled employees need to be available and lower paid than in other locations to help the firm perform efficiently, as well as keep its labour costs low.</li> <li>■ Political stability and legal controls are required. A change in government may change the legal framework or change policies that may affect the business (for example, the corporation tax rate or the minimum wage rate may be changed).</li> </ul>
Infrastructure	<ul style="list-style-type: none"> <li>■ Good infrastructure, such as roads, transportation, and communication, can help the firm operate more efficiently.</li> <li>■ Reliable power supply, with as little downtime as possible, is a key resource needed for the business to operate.</li> </ul>
Operational factors	<ul style="list-style-type: none"> <li>■ It must be close to the source of material, resources and sales outlets. This will reduce the firm's transportation costs.</li> <li>■ Cost of factory lease, space and land use must be considered. The lower the cost, the more profit the MNC will make.</li> <li>■ A reliable supply of raw material at a reasonable price is important. This will ensure timely production of goods at reasonable prices.</li> </ul>

Table 26.2 Factors required for a positive environment in a host country

**ACTIVITY 26.3**

Asale Banda is a director of a large public limited company and is responsible for its international operations. The company wants to expand and start its operations in other countries. Asale thinks that it should set up operations in emerging countries like Turkey and Mexico, as it would face less competition there. However, she also recognises that there is opposition to globalisation in some emerging nations.

- 1 What economic factors should Asale consider before selecting the country in which to set up operations?
- 2 Why is it important to consider the infrastructure of a country before setting up operations there?
- 3 What other factors should be considered?
- 4 Why might some emerging nations oppose globalisation?

**Corporation tax:** see Chapter 24, page 305.

**Minimum wage:** see Chapter 8, page 120.

**TOP TIP**

The coming of an MNC has both positive and negative effects on a country.

**Benefits to a business of becoming a multinational**

Most businesses benefit from expanding their operations in foreign countries. The benefits include:

- **Easier access to raw materials** – by setting up operations where the raw materials are easily found, businesses can reduce transportation time and costs and may even be able to avoid any trade barriers. These advantages will help the businesses lower production costs and improve reliability of supply.
- **Lower cost of labour** – if there is a plentiful supply of labour in the host country then it is likely to be available cheaply.
- **Economies of scale** – by selling in many countries, businesses can benefit from economies of large-scale production. This makes them very competitive.



**Growth and economies of scale:** see Chapter 3, page 36.

- **Access to bigger markets** – mergers and joint ventures with companies in the host country can lead to increases in revenue.
- **Lower production costs** – energy costs and the purchase or rental of business sites may be cheaper in host countries. If there is a local market then companies can save on transportation costs.
- **Spreading of risk** – MNCs are not dependent upon one market. Their business may not be badly affected even if one of their markets is in decline or politically unstable or has a natural disaster.
- **Premium pricing** – MNCs may be able to charge higher prices for globally recognised brands.

#### ACTIVITY 26.4

Look again at Table 5.1 in Chapter 5 on page 65 to remind yourself of the different business stakeholders and their objectives. Copy and complete the table below to identify the positive and negative impact on different stakeholders (you should add two of your own choosing) of a firm's decision to become a multinational.

Stakeholder	Positive impact	Negative impact
Shareholders		
Managers		
Customers		

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Sometimes the environment in the host country can pose a threat to the success of an MNC. The main threats include:

- **Shortage of labour** – the MNC may have to bring in specialist employees and managers from other countries, which will be more expensive.
- **Lack of information about the local market** – this may lead to fewer sales as the products being sold by the MNC may not meet the market's demand.
- **Language barrier** – this may make it hard to communicate with the local workforce in the host country, which might lead to mistakes, which reduce efficiency.
- **Cultural differences** – to be accepted, the MNC needs to be sensitive to the culture of the host country.
- **Strict regulations** – for example different quality standards. This will make it harder for the MNC to operate in the host country.
- **Hostile business environment** – for example, there might be a high level of brand loyalty to existing competitors, or competitors might retaliate through marketing tactics to defend their market position.
- **Expensive labour costs** – this will raise the overall costs of the business.
- **Local opposition or threat from pressure groups** – this can lead to bad publicity for the MNC.
- **Little brand awareness** – the MNC may have to spend a lot of money on advertising.
- **Currency fluctuations** – can affect the profits of the MNC.
- **Political instability in the host country** – can make government decision-making slower and cause delays for the MNC.



**Opportunities and problems of entering new foreign markets:** see Chapter 14, page 193.

Solutions to some of the above problems may be found through local joint ventures, strategic alliances or use of local agents. For example, if an MNC forms a joint venture with a local company in the host nation then the problems of language barriers, cultural differences and lack of knowledge of the local market may be solved easily.

### Benefits of a multinational to the host country

The host country benefits from multinational companies that set up operations in its country. The advantages include:

- **Increases the choice and quality of goods and services** – the local market has access to a greater variety of goods as there is more competition. Due to competition and better production methods, the quality of goods may be higher too.
- **Improves the country's reputation** – the fact that a foreign company has decided to invest in the host country shows that it has a positive regulatory and economic environment. This may encourage other MNCs to set up there.
- **Increases employment opportunities** – the local workforce will be employed to work in the MNC. Governments of host countries provide incentives to MNCs to set up in areas with high unemployment and a plentiful supply of labour.
- **Generates income in the form of tax** – the income generated by the MNC will be taxable in the host country, leading to income for the government to spend on important services such as health care and education.
- **Improves infrastructure** – the MNC may have to invest in transportation and communication networks. This may benefit everyone in the host country.
- **Knowledge-sharing** – new technology and techniques that are being used by the MNC will be shared with local employees. Local companies could learn from them and improve.
- **Improves the balance of payments** – imports may reduce as the MNC may be able to provide the products that were previously imported. Exports will increase as the MNC has global presence and will export its goods.

### Drawbacks of a multinational to the host country

Multinationals also pose many drawbacks to the host country.

- **Undue influence on the government** – the investment made by MNCs can be huge, greatly affecting the economic conditions of the host country. In exchange for this, MNCs may try to influence government policies that affect them. This may not be good for the host country in the long term.
- **Increased competition** – since multinationals are large and are experts in their area of operation, they are cost-efficient and can provide better-quality goods at lower prices. Local companies that provide the same goods may suffer in such a case.
- **Environmental damage** – MNCs aim to produce goods as quickly and as cheaply as possible, and in doing so may ignore their impact on the environment.
- **Exploitation of labour** – if the host country has high unemployment, then MNCs may pay low-skilled employees low wages and hire experts from abroad for high-skilled jobs.
- **Repatriation of profit** – many MNCs repatriate (send back) the profits that they earn to their home country, leaving the host country with very little financial benefit.
- **Exploitation of natural resources** – sometimes MNCs set up their operations in host countries so that they can have easier and cheaper access to their natural resources. In the long term this may lead to scarcity of that natural resource in the host country.



#### EXPLORE!

Make a list of multinational companies that have started operations in your country. What products or services do they provide? How do you think that local customers have benefited by their presence? What have been the drawbacks or advantages for your country?

## Mexico's manufacturing boom

Mexico is increasingly becoming a popular destination for investment by multinationals.

In 2013 General Motors, the largest car manufacturer in the US, announced it would invest millions of dollars to expand its plant in Toluca, Mexico.

Mexico offers a large workforce of generally educated and trainable people. The World Trade Organization ranks Mexican employees among the hardest-working in the world. Mexico also benefits because of its geographical location, being close to North America. The North American Free Trade Agreement (NAFTA), signed in 1994, helped Mexico integrate with the world economy and is a key factor in attracting foreign investment.

With higher fuel prices, manufacturers are aiming to reduce shipping costs by producing goods close to their market. Thus many multinational corporations are building factories in Mexico to supply to the North American market.

*Source:* [www.cnn.com/id/48986442;www.reuters.com/article/2013/06/26/us-mexico-general-motors-idUSBRE95P1FZ20130626](http://www.cnn.com/id/48986442;www.reuters.com/article/2013/06/26/us-mexico-general-motors-idUSBRE95P1FZ20130626); <http://internationalinvest.about.com/od/globalmarkets101/a/A-Guide-To-Investing-In-Mexico.htm>



Mexico has become a popular choice for MNCs

### TASK

- Explain what factors make Mexico an attractive destination for investment by foreign companies.
- How could General Motors benefit by investing in its Mexico plant?
- Explain **three** ways in which the host nation, Mexico, may benefit from the investments by MNCs?
- Do you think the increased presence of MNCs in Mexico would have a negative impact on local businesses?

### TEST YOURSELF

- Explain the benefits to a business of becoming an MNC.
- Discuss the positive impact of MNCs on the host country.
- Discuss the negative impact of MNCs on the host country.



### KEY TERM

**Exchange rate:** the rate at which one country's currency can be exchanged for that of another.

## The impact of exchange rate changes

The success of international trade depends a lot on the **exchange rate** between currencies.

The main factors affecting exchange rates are demand and supply. If demand for a currency is high, the exchange rate will rise. For example, if investors from Argentina want to invest in Singapore or buy Singapore's exports then the demand for the Singapore dollar will rise. This also affects the value of the Argentine currency as it will have to change its Argentine peso to Singapore dollars. This will increase the supply of the Argentine peso in the foreign currency market. This increase in supply may lead to a drop in the value of the Argentine peso.



**EXPLORE!**

Find out the exchange rate of your country's currency with respect to the United States dollar. Analyse the fluctuations in the exchange rate between the two currencies for the last three to five years. What do you think has contributed to the changes?



**TOP TIP**

You must learn how movements in the exchange rate affect companies. You will be expected to know how, for example, an appreciation of the currency will affect the prices paid by importers and exporters. How will this affect their sales and profit? Note that the impact of price changes is different depending upon whether the business is an importer or an exporter. Acronyms are a useful way to help you remember ideas. For example: for this you could think of 'MADE' – iMporters benefit from Appreciation, while a Depreciation benefits Exporters in terms of lower prices.

**ACTIVITY 26.5**

Georg Godby, the owner of a growing retail company in Germany, is travelling to Sri Lanka on a business trip. When travelling, he carries different currencies with him and then exchanges some of them for the local currency of the country he is going to. The local currency in Sri Lanka is the Sri Lankan rupee (LKR).

Currency	Exchange rate	Amount of LKR obtained for 250 units of currency being exchanged
USD	1 USD = 127 LKR	31 750
GBP	1 GBP = 197 LKR	
Euro	1 euro = 166 LKR	

- 1 Copy and complete the table above.
- 2 Which currency should Georg change to local currency? Which currency has a favourable exchange rate and gives him the most Sri Lankan rupee?



**KEY TERM**

**Depreciation:** a currency is said to depreciate if the value of the currency goes down with respect to another.

**Depreciation and appreciation of an exchange rate**

Exchange rate changes can have a significant effect on a business in terms of sales, costs and profits. Changes in exchange rate affect the levels of exports and imports. This in turn can have an effect on the whole economy. Let's examine the impact of appreciation and depreciation of the exchange rate.

**Effect of depreciation of currency on exporters**

A currency is said to **depreciate** if the value of the currency goes down in relation to another currency. When this happens, the exchange rate of that currency falls. Figure 26.2 explains how a fall in exchange rate affects businesses and the country as a whole.

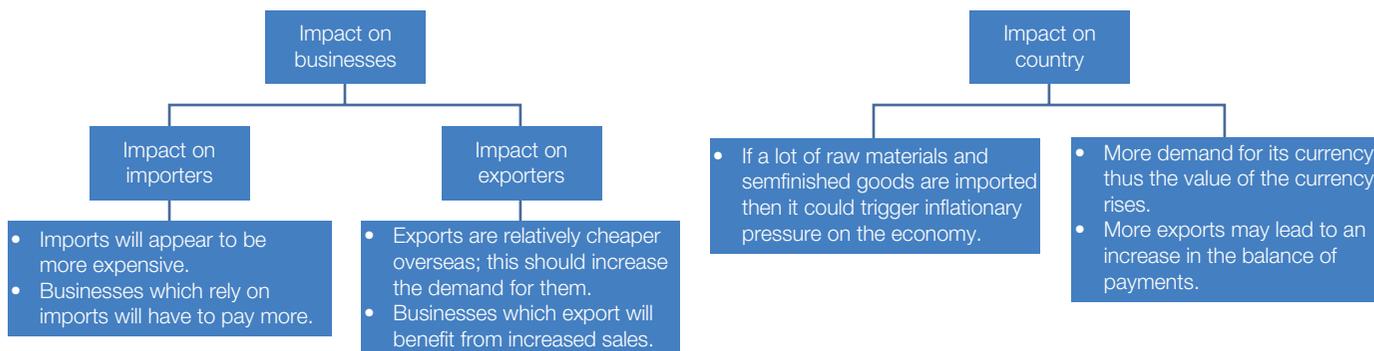


Figure 26.2 Effects of exchange rate depreciation

**EXAMPLE**

Jing Chen is in the garment business in Singapore. He exports garments from Singapore to the USA. If the exchange rate between the Singapore dollar (SGD) and the US dollar is 1 SGD = 0.78 USD, an export of garments from Singapore worth SGD 1000 will cost 780 USD (to an importer in the USA).

If the SGD depreciates and the exchange rate falls to 1 SGD = 0.71 USD then an export of 1000 SGD costs 710 USD (to an importer in the USA). So the depreciation in the exchange rate leads to a decrease in export prices in other currencies. Since exports are relatively cheaper overseas, this should increase the demand for them by importers.

**KEY TERM**

**Appreciation:** a currency is said to appreciate if the value of the currency increases with respect to another currency.

**Effect of appreciation of currency on exporters**

A currency is said to **appreciate** if the value of the currency increases with respect to another. When this happens, the exchange rate of that currency rises. The table below explains how a rise in exchange rate affects businesses and the country as a whole.

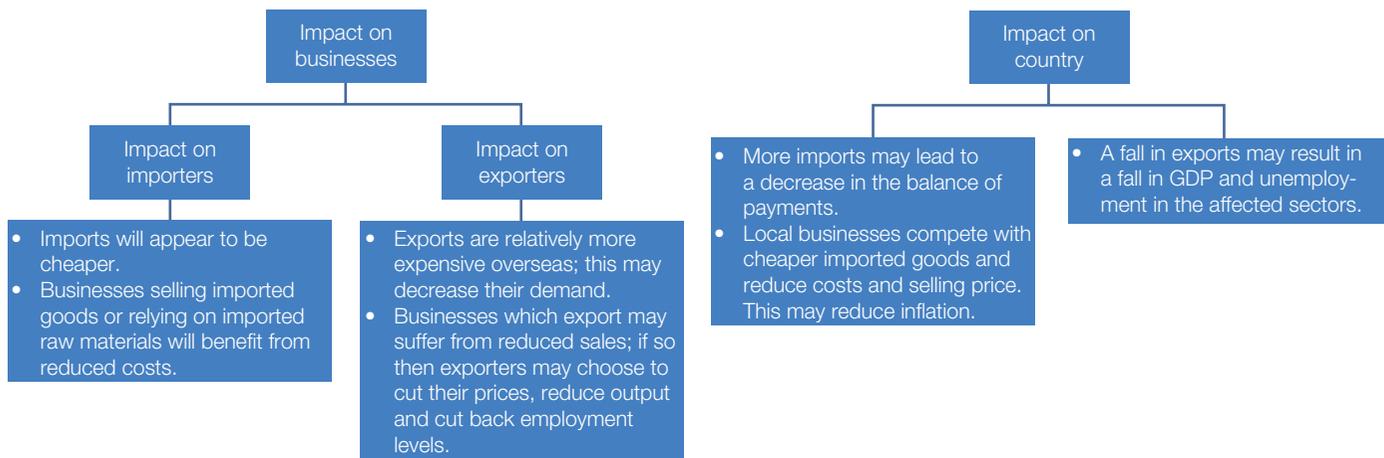


Figure 26.3 Effects of exchange rate appreciation

**EXAMPLE**

Let's return to Jing Chen and his garment business in Singapore. He exports garments from Singapore to the USA. If the exchange rate between the Singapore dollar (SGD) and the US dollar is 1 SGD = 0.78 USD, an export of garments from Singapore worth SGD 1000 will cost 780 USD (to an importer in the USA). If the SGD appreciates and the exchange rate rises to 1 SGD = 0.81 USD then an export of 1000 SGD costs 810 USD (to an importer in the USA). So appreciation in exchange rate leads to an increase in export prices in other currencies. Since exports are relatively more expensive overseas, this may decrease the demand for them by importers.

An appreciation in exchange rate makes it harder to sell overseas. Essential items generally do not get affected by fluctuations in exchange rate.

## The global nature of the car industry

Car manufacturing is a global industry. The different stages are often spread out all over the world. Car companies often develop production bases in some of the countries they sell their cars to. In addition, car companies have their design and research and development centres in different countries in order to use their knowledge base and expertise. The parts they use are often bought from suppliers across the world. After production is complete, cars are shipped to dealerships around the world to be sold.

South Africa's attractive business environment provides a strong platform for export and manufacturing, cost reduction and new market access. Many of the major multinational firms use South Africa to buy components and assemble vehicles for the local and international markets.

With dealers, manufacturers and customers being situated in different countries, the car industry is especially affected by the ever-changing exchange rates of national currencies. The South African rand (ZAR) is the currency of South Africa.



A car plant of a multinational company in South Africa

Sources: [www.southafrica.info/business/economy/sectors/automotive-overview.htm#Us1eR\\_RdWuJ](http://www.southafrica.info/business/economy/sectors/automotive-overview.htm#Us1eR_RdWuJ) and [www.unido.org/fileadmin/import/11902\\_June2003\\_HumphreyPaperGlobalAutomotive.5.pdf](http://www.unido.org/fileadmin/import/11902_June2003_HumphreyPaperGlobalAutomotive.5.pdf)

### TASK

- a Identify the features that make the car industry global.
- b Why is the car industry likely to be affected by fluctuations in exchange rates?
- c Why do you think multinationals use South Africa for car production? How do you think local sales of cars made in South Africa would be affected by the appreciation of the ZAR against other foreign currencies?
- d How would the international sales (export) of cars made in South Africa be affected by the appreciation of the ZAR against other foreign currencies?
- e How would the international sales (export) of cars made in South Africa be affected by the depreciation of the ZAR against other foreign currencies?

### TEST YOURSELF

- 1 Define 'currency depreciation'.
- 2 How do exchange rate changes affect international trade?
- 3 Discuss the impact of exchange rate appreciation on importers and exporters.
- 4 Discuss the impact of exchange rate depreciation on importers and exporters.

## Revision checklist

- Globalisation is the process by which countries are connected with each other because of the trade of goods and services.
- Globalisation is characterised by growth in international trade and the global recognition of brands.
- In order to grow and enter foreign markets, companies often set up operations in different countries to become multinationals.
- Multinational companies pose both advantages and disadvantages to a host country.
- Because of the disadvantages of globalisation, countries often set tariffs and quotas to act as barriers.
- The exchange rate of a country is the value of one currency compared to another.
- Supply and demand for a currency in the international market is the main factor that determines an exchange rate.
- Exchange rate changes have a huge impact on a country's economy and businesses.
- An appreciation in the exchange rate usually benefits importers and is not good for exporters.
- A depreciation in the exchange rate usually benefits exporters and is not good for importers.

## Exam-style practice questions

- 1 Medico Technologies is a multinational company. It manufactures medical equipment and is based in New Zealand. It is the main supplier of medical equipment to hospitals and clinics in New Zealand, Australia and Singapore. Medico Technologies has experienced rapid growth in the last few years. It has grown by setting up joint ventures and exporting directly. It is thinking of expanding further and setting up operations in emerging countries like Brazil.
  - a Define 'globalisation'. [2]
  - b Define 'multinational company'. [2]
  - c Outline **two** effects that the appreciation of exchange rates will have on Medico's business. [4]
  - d Explain **two** steps that the government of Brazil can take to control the impact of MNCs and protect local businesses. [6]
  - e Do you think that the entry of an MNC such as Medico Technologies will have a positive impact on the host country, Brazil? Justify your answer. [6]
  
- 2 Halim Leather is a leather manufacturing company in Bali, Indonesia. After ten very successful and profitable years it has recently become a public limited company and been listed on the country's stock exchange. It is looking for ways to expand its market outside Indonesia. It wants to start by exporting some of its products abroad and then eventually set up operations in an attractive host country and become a multinational company. The Indonesian currency, the Rupiah, has, however, depreciated against all major currencies in the last year.
  - a Define 'host country'. [2]
  - b Identify **two** features of a public limited company. [2]
  - c Outline **two** factors that Halim Leather should look for in the host country, before setting up operations there. [4]
  - d If Halim Leather decides to export, explain **two** effects of a depreciation of exchange rate of the Indonesian rupiah against other major currencies on the company. [6]
  - e Do you think becoming a multinational company will help Halim Leather grow successfully? Justify your answer. [6]

## Exam-style case study

### Halo Enterprises

Halo Enterprises is a retail company that manufactures beauty products and is based in Country X, which is in Europe. The company is dedicated to offering the best ethical, natural and eco-certified beauty products available. Its products are made with natural and organic ingredients; they contain no animal ingredients or alcohol and are never tested on animals. It also uses eco-friendly packaging and aims to be sustainable by considering the impact of its business activity on the environment.

Despite the economy going through a recession, Halo has experienced tremendous growth in the last ten years and is thinking of expansion into international markets as a growth strategy, either by exporting its goods or by setting up operations in the host countries. The company wants to find out which is the best country to focus on. It has gathered relevant information on Countries Y and Z (see Appendices).

#### Appendix 1

Fact file for Countries Y and Z

	Country Y	Country Z
Location	Southern Asia	Southern Africa
Population	50 million	10 million
Language	English – the preferred language for communication – and eight other official languages.	English and three other regional languages.
Proximity to a port	The country has two ports that are used for international trade.	The country is landlocked (entirely enclosed by land).

#### Appendix 2

Economic and political profiles of Countries Y and Z

	Country Y	Country Z
Expected GDP growth rate	3%	5%
Average change in inflation in the last year	+2.5 %	+1%
Average interest rates in the last year	5%	2.5%
Exchange rate with respect to the currency of Country X	Currency X : Currency Y 1:15	Currency X : Currency Z 1:5
Unemployment rate	12%	7%
Barriers to entry	Tariffs and quotas exist for many sectors of trade.	Very few tariffs and quotas exist.
Health of economy (stage of business cycle)	Growth	Boom
Regulatory framework	Protectionist/strict policies that are not very encouraging for foreign firms to invest in the country.	Liberal policies that encourage foreign investment.

Cont.

	Country Y	Country Z
Economic trade unions	Member of a few regional trade agreements.	Not a member of any trade agreements.
Political stability	The country has been politically stable and is a peaceful country, although elections are coming up and the political party in power may change.	Country Z has had two elections in the last four years.
Infrastructure	Power availability and rail networks are quite good, although the road network and technological development are quite poor. The country also has two ports that it currently uses for international trade.	The road and rail networks within the country are very good. The country suffers from a shortage of reliable power supply. Technological advancement is one of the country's main objectives and it is exploring alternative sources of energy to improve its power supply. Transportation by air is the main means of international trade.

### Appendix 3

Below is an extract from a local newspaper in Country Z:

#### Threat of closure due to anti-world-trade sentiments

Pressure groups have been lobbying against the operations of the multinational company ABC. The company just started operations five months ago and already faces the threat of closure. The pressure groups claim that the local businesses have been affected badly ever since ABC has flooded the local market with its goods. The pressure groups are also concerned about the external costs and damage to the environment caused by multinational companies in the country.

- 1 a Explain **two** benefits that the host country, Country Z, will have because of Halo Enterprises setting up operations there as a multinational.

Benefit 1:

Explanation:

Benefit 2:

Explanation:

[8]

- b Explain the advantages and disadvantages of the following **two** countries for Halo Enterprises when choosing a new location. Which country do you think Halo Enterprises should choose? Justify your answer.

Country Y:

Country Z:

Recommendation:

[12]

- 2 a** Pressure groups are currently posing a threat to multinationals in Country Z. When considering which country to set up operations in, explain why Halo Enterprises should consider pressure groups as both an opportunity and a threat.

Opportunity:

Explanation:

Threat:

Explanation:

[8]

- b** The exchange rate of Country X's currency with respect to Country Y's currency has been fluctuating in the past year. Explain how each of the following might affect Halo Enterprises if it decides to export to Country Y.

Which of these do you think is the most beneficial for Halo Enterprises? Justify your answer.

Appreciation of Country X's currency:

Depreciation of Country X's currency:

Conclusion:

[12]

- 3 a** Based on the information in Appendix 2, compare **two** economic features of Country Y and Country Z and explain their impact on business activity.

Feature 1:

Impact on business activity:

Feature 2:

Impact on business activity:

[8]

- b** Before Halo Enterprises can set up operations in either of the countries, it needs to put forward a proposal to the government showing the social costs and benefits of its operations.

The government of Country Z is aware of the increasing threat of pressure groups and wants to do a very detailed cost–benefit analysis of Halo Enterprises' proposal before giving it approval. Explain how Halo Enterprises activities might cause positive and negative externalities.

Do you think the government of Country Z should approve Halo Enterprises' proposal? Justify your answer.

Positive externalities:

Negative externalities:

Conclusion:

[12]

- 4 a** What are tariffs and quotas? Explain how they may impact the business activity of Halo Enterprises if it decides to export to or set up operations in Country Y.

Tariffs:

Impact on Halo Enterprises:

Quotas:

Impact on Halo Enterprises:

[8]

- b** Explain how the following three issues could affect Halo Enterprises.

Which do you think is the most important issue? Justify your answer.

Being ethical:

Being environmentally friendly:

Being sustainable:

Conclusion:

[12]

**Total available marks 80**

## Preparing for assessment

Now that you have learnt all about the concepts and terms within your Business Studies course, it is important that you feel confident about applying that knowledge in your responses to questions.

This chapter will help you to prepare for assessment. As well as looking at some question types that you may encounter, some sample answers (written by the authors) have been provided. These will give you opportunities to consider ways in which you could approach a question and how answers may be improved.

### The layout of the exam

Cambridge IGCSE and Cambridge O Level Business Studies have the same assessment structure. Whichever qualification you are studying for, you will be required to complete **two** examination papers. Both papers are equally important, so remember to allow yourself enough time to revise everything you have learnt throughout your course.

#### Paper 1 – short answer and data response questions

This paper consists of short answer questions that are used to check your knowledge and understanding of the concepts. The paper is split into **four** compulsory questions, and each question has five parts to it.

#### Paper 2 – case study

The case study in Paper 2 will provide you with an opportunity to apply your knowledge and understanding to a realistic business scenario.

### The assessment objectives

Your teacher might have referred to these in class. Assessment objectives are just statements about what will be tested in examination. Business Studies is a skills-based subject, so knowledge alone is not enough to do well. It is important that your responses show a range of skills.

The four skills that you will be required to demonstrate are:

- AO1 Knowledge and understanding
- AO2 Application
- AO3 Analysis
- AO4 Evaluation.

**AO1 Knowledge and understanding:** this involves showing your knowledge and understanding of terms, concepts, theories and techniques.

This means being able to give clear and precise definitions of basic terms and concepts such as ‘market research’. You might be asked to show that you clearly understand what the term means by using it appropriately or describing it in detail.

Knowledge is also identifying relevant points in a variety of different business situations. You could be asked to identify key features or state the implications of market research for a particular business. For example, small businesses will not be able to afford to undertake a large-scale customer survey. A large business (like a smaller rival) may not gain the information required if the wrong questions are asked.

Remember to make your explanation as clear and precise as you possibly can. It doesn't have to be the same wording as the textbook as long as what you mean is clear.

**AO2 Application:** using your knowledge and understanding of terms, concepts, theories and techniques and applying them to a variety of business problems or issues.



**TOP TIP**

Just quoting the name of the business is not application.

Remember to apply your knowledge of business studies to select what is appropriate for a particular situation. Remember that whatever the organisation – factory, farm or retailer – the principles are the same. You have to decide what is important for each business depending on the type, size and what you know about its business circumstances. It is likely that you may be provided with some background information about the type of business. Try to **focus** your answer on the specific business mentioned. This is called '**context**'. It is important to use the information given when answering questions – this is application. Don't just state the business's name but try to think about what it makes or sells.

For example: 'Identify **two** possible consequences of low productivity for Kelvin's business.'

If you don't apply your knowledge of Kelvin's business in your response, you will not have fully answered the question.

Application can also be shown in *calculation* questions or if you are asked to select something appropriate for a particular business, e.g. methods of advertising that a small business might use.

**AO3 Analysis:** this involves selecting, explaining or interpreting information to show good understanding of terms and effects of decisions.

This means don't just list points but try to develop your reasons to show how or why it is an issue that needs to be considered. You could be asked to select and interpret some data, or a chart, and explain what this might mean for a given business situation.

For example, imagine the question is based on a small business (Company A) that has cash-flow problems. The question might be: 'Explain two possible sources of finance that Company A might use to solve its cash-flow problem.'

Remember, not all the knowledge points you have learnt will be relevant, so you will have to choose the relevant sources and then explain how or why these particular sources might be appropriate for this business.

**AO4 Evaluation:** this is presenting developed arguments or reasoned explanations, and being able to make judgements and decisions.

Evaluation is a difficult skill to learn, so practice is important to help you develop and improve your application of it. If you are asked to give your opinion, remember that an opinion alone is not evaluative – explain how and why you have reached this point of view. This involves developing arguments and making decisions which you can support with reasons. Focus on identifying and explaining relevant points that support what **you** are saying. You might think about exploring at least one point which offers an alternative view in order to demonstrate a more considered response.

For example: ‘Using the information in Appendix 2, and other case material, do you think XXX was right to choose option A? Justify your answer.’

Remember, the more you practise all these skills, the more confident you will become at answering whatever question is asked.

### Command words

Command words can help you work out what is required in a particular question. This should give you a clue as to which skills you should focus on in that question. Identifying the command word can tell you how to approach the question. For example, if the command word is ‘explain’, a list of points is not acceptable as this will only show knowledge.

Another way to help you work out which skills you will need to demonstrate is to look at the number of marks available for each question. The more marks available for a question, the wider the range of skills that is likely to be required.

## Exam technique

Doing well in your course requires you to do more than just learn facts. You need to be able to understand concepts and become confident enough to use what you know to answer a range of questions in a number of unfamiliar situations. You must practise answering questions to develop your application, analysis and evaluation skills.

When you answer examination questions you also need to know how to make the best use of all the knowledge and skills you have managed to learn during your Business Studies course. This is called ‘examination technique’.

- It’s likely that your teacher will give you past exam questions to try out. Read the feedback you are given, and act on it the next time you answer an exam question.
- Remember, it isn’t how much you write, but what you write that is important. Read the question very carefully, so you have a clear idea of what you are being asked to do. Focus on this as you write your answer. You have to answer the question set, not the one you wish had been set.
- The number of marks will help you know the level of detail required. For example, if there are only 2 marks for a question, you will likely only need to provide clear and simple answers.
- There are lines provided in the answer book to help you. Remember that these can act as a guide to show you how much you might be expected to write.
- Use the command words to help you decide which skills are being assessed in a question.

So let’s look at some example answers which have been written by the authors. The sample mark schemes have also been written by the authors.



#### TOP TIP

Remember, you don’t have to agree with the question. Just make sure you can support your point of view.



#### TOP TIP

Focus on the **command** words used in the question. This is the best guide to help you answer the question. It will tell you which skills are being tested in each question.

### How to approach short answer and data response questions

Always start by reading the stem of the question. This gives information on a particular business situation, upon which all parts of that question will be based. Unless indicated, questions will each have their own context, so don't use the information from one question to answer another one.

Call4Cab is a small but successful taxi business, owned by Omar. He is a sole trader, with three employees. The profits of Call4Cab have increased steadily over the past five years. Omar wants to expand his business. He is thinking of offering a chauffeur service for events such as weddings and celebrations. He will need a luxury car for this service. Omar is thinking of the best way to promote this service to people in the city. Table 27.1 has some cost information.

Variable cost per journey	\$20
Fixed costs	\$500 per week
Number of journeys	20 per week
Average price per journey	\$50

Table 27.1 Cost information for Call4Cab

- a Define 'fixed costs'. [2]
- b Calculate the weekly total costs of the new airport service. [2]
- c Identify **two** ways that the size of Omar's business can be measured. [4]
- d Explain **two** ways that Call4Cabs could promote this new service. [6]
- e Omar could use a long-term loan to buy the vehicle or he could lease a luxury car. Which do you think is the better option for his business? Justify your choice. [6]

#### Tips for answering these questions

- Part (a) is a definition question to check your knowledge. Always try to give a clear explanation of the term if you can.
- Part (b) is a calculation, so include the formula you use, and show all your workings just in case you make any mistakes. Be careful to select the right numbers to work out total cost.
- Part (c) makes a direct reference to Omar's business, not any business. This means you need to link the measure to Omar's business, so that it is **applied**. Use the information in the stem to help you.
- Part (d), like (c), requires you to apply your answer to Call4Cabs. Your answer will have to be more detailed, though, as there are 6 marks available for this question. Most methods could be possible as knowledge but you will have to explain why they are suitable to Omar to promote this service.
- For part (e) you have to make a decision. You can pick either method, as long as you can give reasons for that choice. Don't be tempted to suggest different methods, because the wording of this question does not allow you to. Remember to consider both options in your answer.

If you answered these questions yourself, what points would you make? Why not write down what you think your answers would be and get someone else to mark them for you.

One way to improve how to answer questions is ask someone else to look at any sample questions you have answered. This can be helpful, as they can check that what you have written is easy to understand and clearly written. If you read someone else's answers, it's also a good opportunity to learn different approaches to answering questions.

### ACTIVITY 27.1

Read the following sample answers (written by the authors). How many marks would you give each of the following responses to the questions above? Extracts of the mark scheme are included to help you decide.

Afterwards, compare the marks you would give with the comments provided.

**a Define 'fixed costs'.** [2]

**Answer:** Costs that do not vary with the number of items sold or produced in the short term.

Sample answers:

- i Costs which are fixed.
- ii Costs which don't change with the level of output.
- iii Cost that stay the same.

Comments on part (a):

- i The words have simply been reordered. This answer hasn't actually explained the term, so no credit can be given.
- ii This response gives a clear explanation. Remember, it doesn't have to be a textbook definition to get both marks.
- iii This shows some understanding, but the link to level of output hasn't been made.

**b Calculate the weekly total costs of the new airport service.** [2]

**Answer:**

Total costs = fixed costs + variable costs

$$\$500 + (20 \times 20)$$

$$\$500 + \$400$$

Total costs = \$900

Sample answers (written by the authors):

- i  $TC = FC + \$40$
- ii \$1000
- iii  $TC = \text{total fixed costs} + \text{total variable costs}$   
 $= 500 + 400$

Comments on part (b):

- i The formula is incomplete, and \$40 is wrong as it should be \$400. Always include all your workings to maximise your chances of success.
- ii This response has calculated total revenue, which is not the question set.
- iii The formula is correct, so could be rewarded. It has used the right numbers but the final answer has not been calculated, which the question requires.

Note: For any numerical question, it is important to include the units. For example, some ratios such as gross profit margin are expressed as a percentage. If you don't include the % symbol, it might suggest that you don't fully understand the method. So you should always include the units as it is an important part of the answer.

**c Identify two ways that the size of Omar's business can be measured.**

[4]

Extract from sample mark scheme:

Knowledge [2 × 1] – award 1 mark for each relevant way [max 2].

Application [2 × 1] – award 1 mark for each relevant explanation in context.

Relevant points might include:

- Number of employees [k] – Omar only employs three drivers, so with so few drivers he cannot really be described as a large business.
- Capital employed [k] – as Omar is a sole trader he is not likely to have large amounts of capital employed.
- Level of revenue [k] – with only three drivers, he is not likely to be able to have a large level of sales as they can only drive for a certain number of miles before they have to rest.
- Market share [k] – with only three drivers, it is unlikely to be the largest taxi business in the city so it won't have a lot of passengers.

Application could include reference to: sole trader; taxi business; cars; drivers; journeys; mileage; passengers.

Sample answer (written by the authors):

Way 1: *the number of employees*

Explanation: *Omar only has three employees. A larger business would have many more drivers so he can operate more taxis to get more passengers.*

Way 2: *profits*

Explanation: *Omar's profits have increased for the past five years, but he still doesn't have a lot of money to invest in the business as he is thinking of taking out a loan to buy the new car.*

Comments on part (c):

Way 1: This response has identified employees as a measure, and by linking it to both the idea of drivers and three employees it is clearly applied.

Way 2: Profit is not accepted as a measure of size, as there are too many other factors that can affect whether a business makes a profit. The explanation does not include any valid points as it is still focused on profit.

**d Explain two ways that Call4Cabs could promote this new service.**

[6]

Extract from sample mark scheme:

Knowledge [2 × 1] – award 1 mark for each relevant way [max 2].

Application [2 × 1] – award 1 mark for each relevant reference to Call4Cabs.

Analysis [2 × 1] – award 1 mark for each relevant explanation.

Relevant points might include:

- Leaflets [k] – Omar could have leaflets in his taxis which he could hand out to existing customers [app]; this means he is targeting his promotion at people who already trust his business [an].
- Specialist wedding magazines [k] – this will target his promotion at people who want to use a chauffeur service as it is not something people will use every day [an].
- Price promotions [k] – he could offer people discounts on the chauffeur service to encourage people to try out the new service [an].
- Radio [k] – many local people listen to the radio, so it's a good way to raise awareness [an].
- Fliers [k] – these could be handed out at wedding fairs [app] as this is where people who might use a chauffeur service would go to find out which companies offer this service [an].
- BOGOF [k] – if people use the service Omar could offer them a free taxi ride [app] this would encourage people to try the new service as they are getting something extra as well [an].

- Internet [k] – everyone uses the internet these days so there is a wider target market to appeal to [an].
- Advertise it on the taxis [k] as there are lots of people in a large city [app] who might see the advert and be interested [an].

Sample answer (written by the authors):

Way 1: Advertise it in local newspapers.

Explanation: So the potential customer will read it as it is a habit where they are able to notice the advertisement. They are able to keep it so they will call the Call4Cabs number anytime they want to use the service.

Way 2: Promote it on the side of the taxis

Explanation: As in the city there are likely to be many people who could see the advert when the taxi drives past so it increases their awareness of the new service.

Comments on part (d):

Way 1: The first method is valid, and an advantage of it has been explained. However, this could apply to any business so there is no application to Call4Cabs. Remember the name alone is not application.

Way 2: The second has linked the idea of Call4Cabs being in a city, so there would be plenty of people to see the advertisement. This is a relevant point for this type of business.

Note: As in this example, both parts (c) and (d) of a question may contain the word 'explain'. To understand the level of detail required, always check how many marks are available. In the measurement of size question, there are only 4 marks, so a simple (relevant) explanation is all that is needed. If it was a 6-mark question, the answer should be developed further.

These types of questions could also be asked as part of a case study question. The only difference is that they may have more marks allocated to them. This means that you have to develop your answers even more.

For example, a more detailed explanation of level of revenue might be:

With only three drivers, he is not likely to be able to have a large level of sales as they can only drive for a certain number of miles before they have to rest. If Omar had more drivers, he could offer more passengers taxi journeys, which could increase the level of sales turnover.

Don't worry as there will be plenty of information in the case study that you can use.

- e Omar could use a long-term loan to buy the vehicle or he could lease a luxury car. Which do you think is the better option for his business? Justify your choice.**

[6]

Extract from sample mark scheme:

Knowledge [1] – award 1 mark for identification of relevant issue [max 1].

Application [1] – award 1 mark if relevant reference made to Omar’s business.

Analysis [2] – award up to 2 marks for relevant development of point(s).

Evaluation [2] – justified decision as to which is the better option for Omar to choose.

Relevant points might include:

#### Leasing

- Pay month by month for the use of the car [k].
- Never own the asset [k] so has no fixed asset to sell if needed at the end of the lease.
- Costs of repair and maintenance are carried by leasing company [k] so lower variable costs for Omar [an].
- Leasing charges can be high [k] so he might end up paying out more than the total cost of buying the vehicle [an].

#### Long-term loan

- Have to pay interest and repay the loan [k], which will increase costs.
- Will have an asset which can be sold afterwards [k].
- Bank might want security against Omar’s assets [k], so Omar might lose his personal possessions if he cannot repay [an] as he is a sole trader [app].

Sample answer (written by the authors):

*I think he should lease the vehicle. Leasing means he won't have to find a large sum of money straightaway. Even though he never owns it, so he doesn't have a fixed asset that he can sell, he won't have a large debt to repay which he would have if he took the loan. He might have five years of profit but this was for the taxi profits. This is a new service, so there is no guarantee that he will get enough customers who want to use it. If that's the case, he can return the lease car, but if he has the loan, he is stuck with a vehicle and a large loan. If he can't repay the loan, the bank could take his personal assets away as he is a sole trader. So I think leasing is better as it's less risky for him.*

Comments on part (e):

The answer starts with an evaluative comment which is backed up by points made. The references to ‘new service’ and ‘taxi profits’ show good application. There are a number of knowledge points included both for and against each method, which have been developed to show why they are issues that could influence Omar’s choice.

## How to approach case study questions

Here are some simple points to remember when answering case study questions.

- Always start by reading through the case study insert before you start to answer any questions. When reading, make a note of any important details that you find out. Like the short answer paper, this gives valuable background information about this specific business. For every case study question, you must base your answers on the information in the case study. Use the information provided to help you when you write your answer. Try to avoid making general statements – make sure all points are relevant to this business.
- Don't write any answers on the insert as this will not be marked. Remember to write all your answers in the answer booklet.
- When answering the longest questions it is sensible to try to prepare a brief plan before you start writing. This can help you focus your answer on the particular question set.

Case study questions require more development. This means you will need to expand your explanations, so don't just write down a list of points. Try to think in terms of what each point means and how this could affect the business. In most instances, you only need to discuss three or four points (depending on the question). Knowledge is usually only level 1; if you are aiming for a top-level grade you will need to show analysis and evaluation as well.

Read the following extract from a sample case study paper. (In the actual exam, there may be appendices as well.)

Early Riders is a private limited company. The business manufactures various styles and sizes of children's bicycles, using batch production. These bicycles are sold to a number of large retail shops around the world.

Early Riders is thinking of moving its operations to another country, due to increasing costs and new government legislation. 'Laws just mean extra costs, and I am determined to keep our profit margin high,' said the finance director.

The business is located on the edge of the capital city in Country X near to a small airport. The components to make the bicycles are purchased from local suppliers, but some items, such as tyres, are imported to ensure that the quality is good.

Early Riders employs 75 production staff and 15 office staff. The employees in the production department are all unskilled, have had little training and are paid by time rate. The management style is autocratic. The working conditions are good but each employee does the same job every day. The human resources director is worried about the number of employees leaving each year.

**a** Explain **one** advantage and **one** disadvantage to Early Riders of using batch production. [8]

**b** The human resources director is worried that a high number of employees leave the company each year because of poor motivation. Consider the following **three** methods for increasing the motivation of production employees.

Which method do you think will be most effective? Justify your answer.

Job rotation:

Increase wages:

Fringe benefits:

Recommendation:

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**Tips for answering these questions**

- For part (a) you don't have to define batch production. Don't include **two** possible advantages (or disadvantages). Make sure you place your answer under the right heading.
- For part (b) explain why you think each method might help increase motivation. Think about the disadvantages and advantages of each method. In your evaluation, make a choice and say why this method is better than the other two options that you have considered.

**ACTIVITY 27.2**

Read the following sample answers (written by the authors). How many marks would you give each of the following responses to the questions above? Extracts of the mark scheme are included to help you decide.

Afterwards, compare the marks you would give with the comments provided.

**a Explain one advantage and one disadvantage to Early Riders of using batch production.**

[8]

Extract from sample mark scheme (written by the authors):

Knowledge [2 × 1] – award 1 mark for each relevant advantage or disadvantage identified [max 2].

Analysis [2 × 1] – award 1 mark for a relevant explanation for each advantage/disadvantage.

Application [2 × 2] – award 2 application marks for each relevant advantage/disadvantage.

Relevant advantages might include:

- Batch production is a flexible way of working [k] this will help the company respond effectively to any sudden change in demand for one particular style or size of bicycle [app]. By switching production to these models [app] sales will increase leading to higher revenue/profits [an].
- Employees will have some variety of jobs [k] so this should make the work more interesting and increase job satisfaction [an]; this is important as employees being more motivated increases efficiency.
- Movement of part-finished bikes or finished bikes is reduced [k/app] this makes production faster and more efficient [an] so helping to eliminate waste, helping to keep the profit margin high [app].

Disadvantages might include:

- Batch production can be expensive [k] as more equipment may need to be purchased which will increase the amount of training needed [an]. This could be a problem as it will increase costs, which could reduce the profit margin even further [app].
- Increased storage costs [k] as more warehouse space is required for parts and finished bikes [app] to be stored while they are waiting to be finished or sent to the large stores [app].

- Time delay due to switching between batches [k] might mean that at busy times there might not be enough finished bicycles ready for delivery [app] so this might affect customer satisfaction [an].
- A fault in a part of the batch will often affect the whole batch [k]; if the quality of local parts or tyres [app] is not up to standard, all the bicycles will be affected [an].

Application marks may be awarded for appropriate use of the following:

- different sizes
- children's bicycles
- components bought from local suppliers
- tyres imported
- located near an airport
- employs 75 production staff and 10 office staff
- good working conditions
- sold to large retail shops around the world.

Don't worry if the points you have mentioned do not feature in the list. A mark scheme does not include every possible answer. If the point made is relevant, it will usually be rewarded.

Sample answer (written by the authors):

Advantage: *It is a more flexible way of working.*

Explanation: *It's relatively easy to change production from one style of product to another to meet demand. So if there is an increase in the number of orders for a particular size or style of girls' or boys' bicycle then Early Riders can quickly meet this demand. This means the large stores have the bikes they want, which can increase its sales.*

Disadvantage: *Part-finished goods have to be moved around the factory.*

Explanation: *This will increase transporting and storage costs, and it will take time which reduces employees' efficiency. Inefficient employees need to be trained. Efficiency is important for any business as this can help it lower costs and increase profits.*

Comments on part (a):

Advantage: This is a valid reason. There is some development linking how flexibility can benefit Early Riders' business. There is clear application in terms of understanding both that it makes a variety of models, and how the ability to meet demand helps it meet its customers' demand.

Disadvantage: The disadvantage is a valid point, and there is some development of why it is a disadvantage. However, this is a general point, which is applied to this business. The focus of the second part is more on efficiency rather than batch production.

- b The human resources director is worried that a high number of employees leave the company each year because of poor motivation. Consider the following **three** methods for increasing the motivation of production employees.

Which method do you think will be most effective? Justify your answer.

Job rotation:

Increase wages:

Fringe benefits:

Recommendation:

[12]

Extract from sample mark scheme (written by the authors):

Motivation theories can be rewarded if used to explain how the method helps to motivate employees but theories are not essential.

Knowledge/analysis/evaluation – award up to 10 marks using the levels-based mark scheme below.

Level	Knowledge/analysis/evaluation
3	7–10 marks Well-justified recommendation as to the best way to increase motivation.
2	4–6 marks Detailed discussion of ways to increase motivation.
1	1–3 marks Outline of how to increase motivation.
0	Zero marks. No creditworthy response.

Award up to 2 marks for application. Good application [2] well applied to the case. At least **two** examples of reference to, or use of, the case material. Limited application to the case [1]. At least **one** example of reference to, or use of, case material.

Application marks may be awarded for appropriate use of the following:

- different sizes
- children's bicycles
- components bought from local suppliers
- tyres imported
- located near an airport
- employs 75 production staff and 10 office staff
- time rate
- good working conditions
- sold to large retail shops around the world.

Sample answer (written by the authors):

*Job rotation: Adds some variety to employees' jobs, which can help make the work more interesting for employees. Because they are making exactly the same thing in each batch, it can be boring. Job rotation could be used to give them more jobs or they could swap from putting wheels on to adding brakes.*

*Motivation is a problem for Early Riders, so giving some variety to what they do is likely to make employees less bored so this can help reduce the number of employees leaving each year. However, they will have to train employees, which could further increase their costs, which could lower their profit margin. But if they end up spending less money having to keep recruiting new employees, it might be cost-effective.*

*Increase wages: As they are unskilled, the only way to motivate them is to give them more money. Taylor's theory said that everyone wants more money, so will work harder if they are paid more. The only problem is that not everyone is motivated by money. Maslow said that people have other needs such as social, and esteem, so just paying them more might not satisfy them. Easy Riders might end up with higher costs for wages but people still leave.*

*Fringe benefits: Many employees might have children, so getting discounts on bicycles might interest them. The business also benefits with extra sales. With birthdays and festivals every year, buying bikes as children grow is expensive. If they could have access to cheap, quality bikes that might motivate them and make up for the low wages paid. However, this will only work for people who have, or know, children so it might not work for everyone.*

*Recommendation: I think the best option is job rotation. They do the same job every day so change can be good. Conditions are good, so it's either boredom or money that seems to be the problem. Giving higher wages might work for a short while, but then they might just want more. Money only motivates so much. People have other needs to meet. Discounts will only work if you want to buy a bicycle, so it can't work all the time. If they offer rotation, employees can be interested, and if they learn new skills, they could get promoted as well. Even if it costs money to train them, it has to be worth it, if they keep the employees from leaving and have to spend less money on hiring and training up new people.*

Comments on part (b):

There are plenty of references throughout the answer that link this to Easy Riders. Examples such as wheels, brakes, good working conditions not being a problem and children are sufficient for the application marks.

There is clear development showing how each method could help increase motivation, as well as problems with each method.

In terms of evaluation, a choice has been made which is supported by the points made. As part of this, the answer has tried to explain why job rotation is better than the other two methods.

## Revision tips

There is no one way to revise. Everyone is different, and methods of revision that work for one person might not suit someone else. You need to find out which approach is likely to work for you.

Here are some simple points to bear in mind:

- **Check what you need to learn** – you only need to learn about concepts that are included in the syllabus. Business Studies is a vast topic that covers many more concepts than the ones you will need to understand for the Business Studies examination you are entering. Your teacher will tell you what you need to revise.
- **Make a revision timetable** – plan your time. Set aside a time every week for study. You will be sitting exams in more than one subject so allow yourself plenty of time to revise for everything. Remember to give yourself time to relax as well.
- **Revise effectively** – do not spend hours just looking at your textbooks or workbook. Split up your time into smaller revision periods, such as 30–40 minutes. This can help you focus on what you have to do. Give yourself a break. Rest is important and it gives you time to reflect on what you have learnt.
- **Revise actively** – don't just read your book. Think about different ways to remember ideas. For example, make notes, construct summary charts, create your own mnemonics or mind maps.

delay	C reditors (trade payables)
sell old	A ssets
	S peed up trade receivables
	H elp
	F actoring
short term	L oan
	O verdraft
manage	W orking Capital

Figure 27.1 Mnemonics

Production methods			
	+	-	when use
Job			
Batch			
Flow			

Figure 27.2 Summary chart



Figure 27.3 Mind map

- **Check your progress regularly** – checking what you have learnt is important. There are revision questions in the textbook. There are also revision guides that you can use to help work out what you need to know.
- **Ask for help** – if you have not understood or cannot remember something you need to know. If there are topics or concepts you do not understand, re-read your notes or ask your teacher for help.
- **Practise past or sample questions** – this will help you get to know the style of questions that you will come across. By practising questions in exam conditions, it can help you to time your answers accordingly.

Use the following checklist to help make sure you are ready to do your best.

- ❑ **Get a good night’s sleep** – it sounds obvious but sleep is important, especially the night before an exam. You need to be alert in your exam. Otherwise you might misread a question, or turn over too many pages and miss a question or be too tired to remember everything you have learnt.

- ❑ **Keep calm** – if you have done your revision, you have nothing to worry about. Being nervous is not likely to help your performance.
- ❑ **Read and follow the instructions** on the front of the paper so you know what you have to do.
- ❑ **Attempt every question** (remember there are no optional ones) – you cannot achieve any marks if you have written nothing down.
- ❑ **Manage your time** – don't spend too long on the questions with only 2 or 4 marks. Allow yourself enough time to answer the longer ones. If you don't know the answer to a question, move quickly on to the next if you can't think of anything to write. You can always go back later to answer it.
- ❑ **Read each question carefully** – make sure you have the right focus to a question. For example, if the question asks about advantages for shareholders, don't discuss issues which affect the employees. If the question asks for three methods, include three methods in your answer.
- ❑ **Look for the command word** in each question, so you can answer the question correctly. For example, evaluation is not necessary if the command word says 'identify'.
- ❑ **Write all answers in the answer booklet** – use the space provided, and don't write on the insert of Paper 2, as this isn't marked. If you need more space, ask the invigilator for additional paper.
- ❑ **Show all calculations** (and formulae) – it's easy to make a mistake copying out the answer. If you show your method, your answer may be given some credit. Remember as well, if data is provided, there is usually a question that will require you to use it.
- ❑ **Write in sentences** – a list of bullet points usually shows knowledge, which might not be enough to achieve top-level marks in all types of questions.
- ❑ **Apply** – base your answers on the scenario. Remember, don't just quote the business name. Think about what it makes or sells, or the issues that this business is facing. Use the information provided in the question and/or case study to guide you.
- ❑ **Aim for a balanced answer** – try to include both advantages and disadvantages if the question requires evaluation.
- ❑ **Make a decision or recommendations** if asked for one – it doesn't usually matter what you decide, as long as you can support your choice.
- ❑ **Check** – leave time at the end of the exam to check what you have written. Have you attempted every question?

# Glossary

- Absenteeism** employee's non-attendance at work without good reason.
- Acid test ratio** ratio between liquid assets and current liabilities.
- Adding value** selling a product for more than it cost to produce it.
- Advertising** paid-for communication with consumers which uses printed and visual media. The aim is to inform and persuade consumers to buy a product.
- Annual General Meeting (AGM)** a meeting for shareholders that limited companies must hold once every year.
- Appreciation** a currency is said to appreciate if the value of the currency increases with respect to another currency.
- Appropriation account** records the distribution of profit after tax; usually dividends and retained profit.
- Assets** resources that are owned by a business.
- Autocratic leadership** a leadership style where the leader makes all the decisions.
- Average costs** the cost of producing a single unit of output.
- Balance of payments** the difference between the value of export and import of goods and services of a country over a year.
- Bank loan** provision of finance by a bank which the business will repay with interest over an agreed period of time.
- Barriers to trade** usually taxes, quotas or bans that one country places on the goods of other countries to prevent or increase the cost of them entering that country.
- Batch production** the production of goods in batches. Each batch passes through one stage of production before moving on to the next stage.
- Below-the-line promotion** promotion that is not paid-for communication but uses incentives to encourage consumers to buy.
- Bonus** an additional reward paid to employees for achieving targets set by managers.
- Brand** a name, image or symbol that distinguishes a product from competitors' products.
- Brand image** the general impression of a product held by consumers.
- Break-even** the level of output where revenue equals total costs; the business is making neither profit nor loss.
- Business activity** the process of producing goods and services to satisfy consumer demand.
- Business environment** the combination of internal and external factors that influence the operations of a business.
- Business plan** a detailed written document outlining the purpose and aims of a business which is often used to persuade lenders or investors to finance a business proposal.
- Business start-up** a newly formed business. They usually start small, but some might grow to become much bigger.
- Capital expenditure** spending by a business on non-current assets such as machinery or buildings.
- Capital goods** physical goods used by other businesses to help produce other goods and services such as machinery and delivery vehicles.
- Capital intensive** a production process using a high quantity of capital equipment compared with labour input.
- Capital productivity** a measure of the efficiency of capital by calculating the output per capital employed.
- Cash-flow forecast** an estimate of the future cash inflows and outflows of a business.
- Centralised organisation** one where all the important decision-making power is held at head office, or the centre.
- Chain of command** the route through which authority is passed down through an organisation.
- Chain of production** the production and supply of goods to the final consumer involving activities from primary, secondary and tertiary sector businesses.
- Channels of distribution** how a product gets from the producer to the final consumer.
- Chief executive officer (CEO)** the most senior manager responsible for the overall performance and success of a company.
- Collateral** non-current assets offered as security against borrowing.
- Commission** payment to sales staff based on the value of the items they sell.
- Communication media** the methods used to communicate a message.
- Competitive pricing** setting a price similar to that of competitors' products which are already established in the market.
- Consumer** the final user of a product.
- Consumer goods** products which are sold to the final consumer. They can be seen and touched, for example computers and food.
- Consumer markets** markets for goods and services bought by the final consumer.
- Consumer services** non-tangible products such as insurance services, transport.
- Corporate social responsibility (CSR)** businesses taking responsibility for the impact their activities might have on society and the environment.
- Cost-benefit analysis** analysis of the costs and benefits of a project, the focus being on the social costs and benefits.

- Costs of sales** the costs of purchasing the goods used to make the products sold.
- Cost-plus pricing** setting price by adding a fixed amount to the cost of making or buying the product.
- Credit sales** goods sold to customers who will pay for these at an agreed date in the future.
- Crowd-funding** financing a business idea by obtaining small amounts of capital from a large number of people, most often using the internet and social media networks.
- Current assets** resources that the business owns and expects to convert into cash before the date of the next statement of financial position.
- Current liabilities** debts of the business which it expects to pay before the date of the next statement of financial position.
- Current ratio** the ratio between current assets and current liabilities.
- Customer** an individual or business that buys goods and services from a business.
- Customer base** the group of customers a business sells its products to.
- Customer relationship marketing (CRM)** using marketing activities to establish, maintain and improve relationships with customers to build customer loyalty.
- Debenture** a bond issued by a company to raise long-term finance usually at a fixed rate of interest.
- Debt factoring** selling trade receivables to improve business liquidity.
- Decentralised organisation** one where the decision-making powers are passed down the organisation to lower levels.
- Delaying** reducing the size of the hierarchy by removing one or more levels – most often middle management.
- Delegation** passing responsibility to perform tasks to employees lower down in the organisation.
- Demand** the quantity of goods and services consumers are willing and able to buy.
- Democratic leadership** a leadership style where employees take part in decision-making.
- Demographic segmentation** dividing consumers in the market by factors such as age, gender, income, ethnic background and social class.
- Depreciation** a currency is said to depreciate if the value of the currency goes down with respect to another.
- Direct mail** also known as ‘mailshots’; printed materials which are sent directly to the addresses of customers.
- Direct selling** the product is sold by the producer directly to the final consumer without the need for any middlemen.
- Direct tax** the tax charged on personal income or tax on the profit made by a business.
- Directors** appointed or elected members of the Board of Directors of a company who have the responsibility for determining and implementing the company’s policy. Some directors might also have a management role, for example a marketing director.
- Diseconomies of scale** factors that cause average costs to rise as the scale of operations increases.
- Dismissal** termination by the employer because the employee has broken company rules or is not performing work to the required standard.
- Disposable income** the amount of income left for individuals after taxes have been paid.
- Dividend** a payment, out of profits, to shareholders as reward for their investment.
- Division of labour** production is divided into separate tasks and each employee does just one of those tasks.
- Domestic market** the market for goods and services in the business’s own country.
- E-commerce** the use of the internet and other technologies used by businesses to market and sell goods and services to customers.
- Economic problem** unlimited wants cannot be met because there are limited factors of production. This creates scarcity.
- Economies of scale** the reduction in average costs as a result of increasing the scale of operations.
- Effective communication** information passed between two or more people or groups, with feedback to confirm that the message has been received and understood.
- Entrepreneur** an individual who takes the financial risk of starting and managing a new business.
- Equity finance** permanent finance provided by the owners of a limited company.
- Exchange rate** the rate at which one country’s currency can be exchanged for that of another.
- Expenses** day-to-day operating expenses of a business.
- Extension strategies** marketing activities to extend the maturity stage of a product.
- External recruitment** filling a vacant post with somebody not already employed in the business.
- Externality** the effect of business activities on unrelated parties.
- Factors of production** the resources needed to produce goods and services – land, labour, capital and enterprise.
- Feedback** the receiver’s response to a message.
- Financial rewards** cash and non-cash rewards paid to employees which are often used to motivate employees to increase their efforts.
- Fixed costs** costs that do not change with output.

- Flow production** the production of very large quantities of identical goods using a continuously moving process.
- Four Cs** marketing decisions that put the customer first and help to build and improve customer relationships.
- Four Ps** the right product at the right price with the right promotion in the right place.
- Franchise** a business system where entrepreneurs buy the right to use the name, logo and product of an existing business.
- Free trade** no barriers exist that might prevent trade between different countries.
- Fringe benefits** non-cash rewards often used to recruit or retain employees and to recognise the status of certain employees.
- Functional departments** the main activities of business: finance, marketing, operations, human resources and research and development.
- Geographic segmentation** dividing consumers in the market by geographic area.
- Globalisation** the process by which countries are connected with each other because of the trade of goods and services.
- Government incentives** usually finance such as interest-free loans, or grants provided to businesses to help when locating in a country or an area of a country.
- Gross domestic product (GDP)** the value of all goods and services produced by a country in a year.
- Gross profit** the difference between revenue and cost of sales.
- Gross profit margin %** the ratio between gross profit and revenue.
- Hierarchy** the number of levels in an organisational structure.
- Hire purchase** the purchase of an asset by paying fixed repayment amounts per time period over an agreed period of time. The asset is owned by the purchasing company on completion of the final repayment.
- Home country** the domestic country where a multinational starts/first establishes its operations.
- Host country** the foreign country where a multinational sets up its operations.
- Hourly wage rate** payment to employees based on a fixed amount for each hour worked.
- Hygiene factors** the factors that must be present in the workplace to prevent job dissatisfaction.
- Income statement** a financial statement which records the revenue, costs and profits of a business for a given period of time.
- Indirect tax** the tax charged on the price of goods and services, which is added to the price of goods and services before they are bought.
- Induction training** a training programme to help new recruits become familiar with their workplace, the people they work with and the procedures they need to follow.
- Industrial action** measures taken by a trade union or a group of employees aimed at getting management to settle a dispute in the employees' favour.
- Industrial markets** markets for goods and services bought by other businesses to use in their production process.
- Informative advertising** information about the product is communicated to consumers to create product awareness and attract their interest.
- Inflation** the price increase of goods and services over time.
- Infrastructure** the basic facilities, services and installations needed for a business to function, for example water, power and transport links.
- Interest rate** the cost to a person or business of borrowing money from a lender such as a bank.
- Internal recruitment** filling a vacant post with someone already employed in the business.
- Inventories** the stock of raw materials, work-in-progress and finished goods held by a business.
- Job description** a list of the key points about a job, job title, key duties, responsibilities and accountability.
- Job dissatisfaction** how unhappy and discontent a person is with their job.
- Job enlargement** increasing or widening tasks to increase variety for employees.
- Job enrichment** organising work so that employees are encouraged to use their full abilities.
- Job production** the production of items one at a time.
- Job rotation** increasing variety in the workplace by allowing employees to switch from one task to another.
- Job satisfaction** how happy and content a person is with their job.
- Joint ventures** two or more businesses agree to work together on a project and set up a separate business for this purpose.
- Labour productivity** a measure of the efficiency of employees by calculating the output per employee.
- Labour turnover** the rate at which employees leave a business.
- Laissez-faire leadership** a leadership style where most of the decisions are left to the employees.
- Lean production** the production of goods and services with the minimum waste of resources.
- Leasing** obtaining the use of a non-current asset by paying a fixed amount per time period for a fixed period of time. Ownership remains with the leasing company.
- Legal controls** laws that control the activity of businesses.
- Level of unemployment** the proportion/percentage of the population that are capable of working but are unable to find a job.
- Liabilities** debts of the business that will have to be paid sometime in the future.

- Limited liability** the shareholders in a limited liability company which fails only risk losing the amount they have invested in the company and not any of their personal wealth.
- Liquidity** the ability of a business to pay its short-term debts.
- Long-term finance** debt or equity used to finance the purchase of non-current assets or finance expansion plans. Long-term debt is borrowing that a business does not expect to repay in less than five years.
- Loss-leader pricing** setting the price of a small number of products at below cost to attract customers into the outlet in the hope that they will buy other products priced to earn profit.
- Manager** an individual who is in charge of a certain group of tasks, or a certain area or department of a business, for example a factory manager.
- Margin of safety** the difference between the current level of output and break-even output.
- Market** all customers and consumers who are interested in buying a product and have the financial resources to do so.
- Market-orientated** products are developed based on consumer demand as identified by market research.
- Market research** the process of collecting, recording and analysing data about the customers, competitors and market for a product.
- Market segment** a part of the whole market in which consumers have specific characteristics.
- Market segmentation** dividing the whole market into segments by consumer characteristics and then targeting different products to each segment.
- Market share** the revenue of a business expressed as a percentage of total market revenue.
- Market skimming** setting a high price for a new product that is unique or very different from any other product on the market.
- Marketing budget** the amount of money made available by a business for its marketing activities during a particular period of time.
- Marketing mix** four marketing decisions needed for the effective marketing of a product.
- Marketing strategy** a plan to achieve the marketing objectives using a given level of resources.
- Mass marketing** selling the same product to the whole market.
- Micro-finance** small amounts of capital loaned to entrepreneurs in countries where business finance is often difficult to obtain. These loans are usually repaid after a relatively short period of time where the owners have unlimited liability for any debts of the business.
- Middlemen** these are the intermediaries in the channels of distribution, for example wholesalers and retailers.
- Mixed economy** an economy where the resources are owned and controlled by both the private and the public sectors.
- Mortgage** long-term loans used for the purchase of land or buildings.
- Motivation** the factors that influence the behaviour of employees towards achieving set business goals.
- Motivators** the factors that influence a person to increase their efforts.
- Multinational company** an organisation that has operations in more than one country.
- Need** a good or service which is essential to living.
- Net cash flow** cash inflow minus cash outflow.
- Niche marketing** developing products for a small segment of the market.
- Non-current (fixed) assets** resources owned by a business which will be used for a period longer than one year, for example buildings and machinery.
- Non-current liabilities** debts of the business which will be payable after more than one year.
- Non-financial rewards** methods used to motivate employees that do not involve giving any financial reward.
- Objective** a statement of a specific target to be achieved. They should be SMART.
- Off-the-job training** training that takes place away from the workplace, for example at college, university or a specialist training provider's premises.
- On-the-job training** training at the place of work, watching or following an experienced employee.
- Opportunity cost** the benefit that could have been gained from an alternative use of the same resource.
- Ordinary shareholders** the owners of a limited company.
- Organisational structure** the formal, internal framework of a business that shows how it is managed and organised.
- Overdraft** an agreement with the bank which allows a business to spend more money than it has in its account up to an agreed limit. The loan has to be repaid within 12 months.
- Owner's equity** the amount owed by the business to its owners. It includes capital and retained profits.
- Partnership** a business formed by two or more people who will usually share responsibility for the day-to-day running of the business. Partners usually invest capital in the business and will share profits.
- Penetration pricing** setting a low price to attract customers to buy a new product.
- Performance-related pay** a bonus scheme used to reward staff for performing above the required standard.
- Person specification** a list of the qualifications, skills, experience and personal qualities looked for in a successful applicant.
- Personal selling** sales staff communicate directly with the consumer to achieve a sale and form a long-term relationship between the firm and the consumer.

- Persuasive advertising** communication with consumers aimed at getting them to buy a firm's product rather than a competitor's product.
- Piece-rate** payment to employees based on the number of units produced.
- Pressure group** organisations of like-minded people who put pressure on businesses and the government to change their policies to reach a predetermined objective.
- Price** the amount paid by the customer to the supplier when buying a good or service.
- Price elastic demand** the percentage change in demand is greater than the percentage change in price.
- Price elasticity of demand** measures by how much demand (sales) for a product changes when there is a change in its price.
- Price inelastic demand** the percentage change in demand (sales) is less than the percentage change in price.
- Price leadership** smaller firms set their price based on the price set by the dominant firm in the industry.
- Primary research** the collection of first-hand data for the specific needs of the firm.
- Primary sector** firms whose business activity involves the extraction of natural resources.
- Private limited company** often a small to medium-sized company; owned by shareholders who have limited liability. The company cannot sell its shares to the general public.
- Private sector** the part of the economy that is controlled by individuals and companies for profit.
- Product** the goods and services produced to satisfy a customer need or want.
- Product life cycle** the pattern of sales of a product from introduction to its withdrawal from the market.
- Product-orientated** the firm decides what to produce and then tries to find buyers for the product.
- Product quality** the product meets the needs and expectations of customers.
- Production** the process of converting inputs such as land, labour and capital into saleable goods, for example shoes and cell phones.
- Productivity** a measure of the efficiency of inputs used in the production process, especially labour and capital.
- Profit** the difference between revenue and total costs.
- Profit and loss section** records expenses, interest payments, tax and profit.
- Profit margin %** the ratio between profit before tax and revenue.
- Profit sharing** an additional payment to employees based on the profits of the business.
- Promotion** marketing activities used to communicate with customers and potential customers to inform and persuade them to buy a business's products.
- Psychographic segmentation** dividing consumers in the market by lifestyles, personalities and attitudes
- Public corporation** a business organisation that is owned and controlled by the state.
- Public limited company** often a large company; owned by shareholders who have limited liability. The company can sell its shares to the general public.
- Public sector** the part of the economy that is controlled by the state or government.
- Qualitative research** the collection of information about consumers' buying behaviour and their opinions about products.
- Quality** ensuring that a good or service meets the needs and requirements of its consumer.
- Quality assurance** a system of setting agreed standards for every stage of production.
- Quality circles** groups of employees who meet regularly to discuss work-related problems.
- Quality control** checking the quality of goods through inspection.
- Quality standards** the minimum standard of production or service acceptable to consumers.
- Quantitative research** the collection of numerical data that can be analysed using statistical techniques.
- Quota** a physical limit on the quantity of goods that can be imported and exported.
- Redundancy** termination of employment by the employer because the job is no longer needed.
- Resignation** termination of employment by the employee, perhaps because they have found a job with a different employer.
- Retailer** shops and other outlets that sell goods and services to the final consumer.
- Retained profit** profit remaining after all expenses, tax and dividends have been paid, which is then ploughed back into the business.
- Retirement** termination of employment due to the employee reaching an age beyond which they do not need to work.
- Return on capital employed (ROCE)** the ratio between profit before tax and capital employed.
- Revenue** the amount a business earns from the sale of its products.
- Salary** a fixed annual payment to certain grades and types of staff not based on hours worked or output.
- Sales promotion** incentives used to encourage short-term increases in sales or repeat purchases.
- Sample** a representative sample of the target market selected to take part in market research.

- Scarcity** there are not enough goods and services to meet the wants of the population.
- Secondary research** the collection of data from second-hand sources.
- Secondary sector** firms that process and manufacture goods from natural resources.
- Share issue** a source of permanent capital available to limited liability companies.
- Shareholder** a person or organisation who owns shares in a limited company.
- Shareholders' equity (funds)** alternative term for owner's equity, but can only be used by limited liability companies.
- Shortlist** a list of candidates who are chosen from all of the applicants to be interviewed for the job.
- Short-term finance** loans or debt that a business expects to pay back within one year.
- Social benefit** the positive impact of a business decision on society.
- Social cost** the negative impact of a business decision on society.
- Social enterprise** a business with social objectives that reinvests most of its profits back into the business or into benefiting society at large.
- Sole trader** a business that is owned and controlled by just one person who takes all of the risks and receives all of the profits.
- Span of control** the number of subordinates reporting to each supervisor/manager.
- Specialisation** people and businesses concentrate on what they are best at.
- Sponsorship** payment by a business to have its name or products associated with a particular event.
- Stakeholder** an individual or group which has an interest in a business because they are affected by its activities and decisions.
- Start-up capital** the finance needed when first setting up a business.
- Statement of financial position** an accounting statement that records the assets, liabilities and owner's equity of a business at a particular date.
- Subordinate** an employee who is below another employee in the organisation's hierarchy.
- Supervisor** an individual who checks and controls the work of subordinates.
- Sustainable development** a business activity is said to be sustainable if it has a positive overall impact on the environment and its stakeholders, ensuring its survival in the future.
- Target market** individuals or organisations identified by a business as the customers or consumers of its products.
- Tariff** a tax applied to the value of imported and exported goods.
- Tax** a charge/fee paid to the government on income, goods and services.
- Team working** organising production so that groups of employees complete the whole unit of work.
- Tertiary sector** firms that supply a service to consumers and other businesses.
- Theory of economic man** the view that humans are only motivated by money.
- Total cost** all the variable and fixed costs of producing the total output.
- Trade bloc** a group of countries that trade with each other and are usually part of a free trade agreement.
- Trade payables** the amount a business owes to its suppliers for goods bought on credit.
- Trade receivables** the amount owed to a business by its customers who bought goods on credit.
- Trade union** an organisation of employees aimed at improving pay and working conditions and providing other services, such as legal advice, for members.
- Trading account** records revenue and costs of sales and is used to calculate gross profit.
- Two-way communication** the receiver is allowed to respond to the message and the sender listens to the response.
- Unincorporated business** a business that does not have legal identity separate from its owners. The owners have unlimited liability for business debts.
- Unique selling point** the special feature of a product that sets it apart from competitors' products.
- Unlimited liability** if an unincorporated business fails, then the owners might have to use their personal wealth to finance any business debts.
- Variable costs** costs that change in direct proportion to output.
- Want** a good or service which people would like, but is not essential for living.
- Wholesaler** a business that buys products in bulk from producers and then sells them to retailers.
- Working capital** the capital needed to finance the day-to-day running expenses and pay the short-term debts of a business.

# Index

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