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Theme 1 – Investigating Small Business

1.1 Enterprise and entrepreneurship

Topic overview

Although this is a separate topic, students need to relate these concepts to the contexts in which an enterprise and an entrepreneur will be operating. They must be aware of the local and national business environment and how this might impact on a small business. Students must be aware of this sections relationship with the other areas in this theme and how these areas may impact on business decision-making.

Section	Key things to learn
The dynamic nature of business	New business ideas and their sources Adapting existing ideas Changes in technology Changes in customer requirements
Risk and reward	Types and impact of business risks Types and impact of business rewards
The role of business enterprise	The role of enterprise in business activity Production of goods and services Meeting customer needs Adding value The role of the entrepreneur

Dynamic nature of business

Where do business ideas come from? In practice, there are many ways in which a business opportunity and idea is first spotted.

Firstly, the world in which we live in is always rapidly changing and therefore businesses are constantly faced with change. These changes include new **legislation,** changes in the **economy,** new **technology**, which may result in some goods and services becoming obsolete, **political** events and even the weather. **Consumer tastes** will change as new fashions arise and as new ideas and developments come along.

Successful businesses will come up with new ideas, adapt existing products and change their location and their staff as different circumstances arise. Change is a massive opportunity! However, it is also a considerable **threat** to those businesses that ignore the changes that are taking place in the market. Businesses should avoid standing still, as those that try to will generally end up failing!

Some of the key changes that give rise to new ideas are summarised below:

Type of change:	Explanation:
New technology	Ideas for new products might come about due to advances in technology. Computers, smartphones, digital cameras and so on, are all examples of products where new technology is constantly allowing new products to be developed and launched for sale.
Change in consumer wants	Fashions and consumer tastes are always changing. As well as the more obvious areas of clothing, designs will also change in areas such as cars, furniture, buildings and many more consumer goods. There are also new trends in terms of healthy eating, fitness and specialist types of holidays.
Products and services becoming obsolete	Over time products become outdated as new products are developed, which is often linked to changes in technology. Other reasons for products becoming obsolete are changes in the economy, for example increased wealth will decrease demand for **inferior products**, such as supermarket value products and bus travel.

Original ideas

One of the key characteristics of many entrepreneurs is their creativity. Entrepreneurs will often produce many original ideas for new goods and services. In many cases, these will not prove practical or profitable to develop on a larger scale and take to market! Some ideas however, will be worth pursuing. At this point, the entrepreneur will undertake research and development of the idea.

Adapting existing products

Many new products are developed from existing goods or services, whereby the entrepreneur thinks of a way of improving them. Consider any technology based product, such as the computer or the mobile phone, and it is clear how much and how quickly the product has been adapted and developed in recent years.

Business experience

Many ideas for successful businesses come from people who have **experience** of working in a particular market or industry. For a start-up business, there are several advantages of applying this experience to a new business idea:

- ☑ Better and more detailed understanding of what customers want
- ☑ Knowledge of competitors, pricing, suppliers etc.
- ☑ Less need for start-up market research
- ☑ Entrepreneur is able to make more realistic assumptions in the business plan about sales, costs etc.
- ☑ The entrepreneur may have contacts in the industry, who might then become the first customers of the start-up!

All of the above help the business planning process and it can be argued that they reduce the risk of starting up a business.

On the other hand, it can be argued that "familiarity breeds contempt". In other words, detailed experience of an industry means that the budding entrepreneur does not have a fresh view. Someone who is new to a market may be able to exploit approaches that have worked in other industries, to make an impact with their idea.

Personal experience

Many ideas come to entrepreneurs from their day-to-day dealings in life or from their hobbies and interests.

For some of us, frustrating or bad experiences are a source of irritation. For the entrepreneur, they might suggest a business opportunity.

It is often said that one of the best ways to spot a business opportunity is to look for examples of poor customer service (complaints, product returns, persistent queues etc). Such examples suggest that there is an opportunity to do something better, quicker or cheaper than the existing offer!

Hobbies and interests are also a rich source of business ideas, although an entrepreneur would have to be careful to avoid assuming that, just because they may have a passion for collecting "rare can openers", there is a ready market from people with similar interests! Many people have tried to turn their hobby into a business and found that it generates only a small contribution to household income and therefore it would not prove to be a sustainable future business for the entrepreneur.

Observation

Simply observing what happens on a day to day basis can be a good way of spotting an idea. Often an idea will be launched in another country that has not yet been tried in other similar economies. For example, successful entrepreneur Stephen Waring, fortunately attended a wedding in the USA and by luck sat next to someone who ran a household service business, treating lawns. After some brief market research, Stephen found out that there was no similar business in the UK, so he launched one in 1986. Green Thumb has since become a hugely successful franchise business providing lawn care and grass maintenance for nearly 500,000 houses in the UK.

It is worth looking at other examples of successful business start-ups, in order to appreciate the wide and diverse range of sources of ideas that these firms are built upon. Here are some good ones:

Business	Entrepreneur	Where the Idea Came From
Propercorn	Casa Stavrou and Ryan Kohn	Casa, recognised that consumers tastes were changing. Consumers were looking for healthier alternatives to their favourite snack foods. Demand for organic, low sugar, low fat snacks, crisps and biscuits was rising. With the help of her best friend, Ryan, they decided to create a snack that they felt was satisfying, delicious and healthy. Propercorn, was born and is now sold in 11 countries and stocked in major supermarkets
King of Shaves	Will King	Will found traditional wet-shaving painful, due to his sensitive skin. His girlfriend suggested using oil to smooth the process. An oil-based solution to shaving was developed and is now a world leader.

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Mallzee	Cally Russell	Cally was frustrated with the process of shopping online for clothes. He felt it was time consuming having to visit different sites to source his favourite brands. He create an app – Mallzee. The personalised shopping app allows shoppers to access their favourite stores within one app, making it simpler and easier to buy clothes online.
Superjam	Fraser Doherty	Fraser turned his grandmother's recipe for sugar-free jams into a best-selling grocery brand.

What makes a good business idea?

Having an idea for a business is the easy bit! It is much harder to work out whether the idea has potential and can be turned into a viable business idea.

Good business ideas therefore, tend to have one or more of the following characteristics:

- ☑ They solve a problem
- ☑ Offer a cheaper or better way of doing something than existing goods or services
- ☑ Are simple and practicable
- ☑ Can be developed and delivered to the market quickly
- ☑ Have a clear focus on meeting the needs of the target customer
- ☑ Anticipate market trends and exploit growth opportunities

Risk and reward

Risk can mean several things:

- the chance of loss or damage
- the probability that something goes wrong, leading to a loss
- when a hoped-for outcome does not happen

If setting up a new business was risk-free i.e. guaranteed to succeed, then we would all do it! The bad news for entrepreneurs is that investing in a start-up business is highly **risky**.

What is the risk? The main risk is that the **business will fail** and that the entrepreneur will **lose his/her investment**. In the case of a sole trader or partnership, the entrepreneur may also end up **personally liable** for the debts of the failed business (an important reason why many start-ups select private limited companies as their chosen form of business organisation).

Prior to complete failure, the business may also struggle for customers and to generate sufficient revenue to cover costs initially or on an ongoing basis. This may leave the entrepreneur with **a lack of security** – will he/she have enough funds to continue to trade successfully in the future, without being reliant on other sources of finance to keep the firm going? Will the entrepreneur have enough money to pay themselves a decent wage, to maintain his/her desired standard of living?

Another risk is that a failed business may leave the entrepreneur struggling to finance another business or successfully be appointed for a job in someone else's firm. This may be the result of the entrepreneur finding it difficult to face and accept the overall failure itself. There is no reason why people should be ashamed of failing in business, but in reality many are.

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Taken together, it can be seen why these risks are often the reason why an entrepreneur continues to keep a business going, even when the business is struggling badly. When you are "risking it all" then you put all your effort into making the business a success!

Learning the lessons of failure

A good way of thinking about the risks being taken, is to consider why start-up and small businesses fail. If an entrepreneur can learn from and avoid these mistakes, then any new business that is set up has a greater chance of survival and success.

Here are the main reasons why businesses fail:

Poor management	Plain and simple. Planning is inadequate leading to poor decision-making, costs are not kept under control, business owners or management do not understand their market and customers well enough and/or a poor quality product is provided
Poor market research	In starting a business or keeping an existing business successful, there is a need to undertake market research. This will need to be reliable enough to predict future sales. It is often not carried out as it is too expensive or, if it is completed, the data is frequently out of date or not fully relevant
Sales lower than expected	It is very easy to over-estimate the sales that will be achieved by a start-up. The business plan can be over-optimistic about the price that customers will accept and the volumes they will buy
Start-up costs too high	Another common weakness of start-up business planning. Sometimes costs are simply missed out altogether or alternatively the amounts are under-estimated. This is a big concern at the start-up stage, where finance is limited. A delayed product launch or store opening may be the cause of start-up costs being higher than expected
Unexpected shocks	These can come in various forms, for example flash floods that hit different places in the UK from time to time, a new competitor entering the market, a global recession, a change in government and the UK leaving the EU (BREXIT)
Too reliant on a small number of customers	A start-up that is too reliant on one or a few customers is at greater risk of failure than one which has a broader, more diverse customer base. If the customer relationship breaks down and/or the customer stops buying products from the business, then it puts the business at risk
Poor quality	This is linked to poor management. Persistent poor quality goods or services will ultimately kill a business, as rival businesses will produce superior products that customers will undoubtedly prefer

By identifying the cause of failure, this allows a business owner to come up with solutions. Better still it allows a business to improve its planning, so that in the future it can minimise its risk and prevent it happening again – if it is not too late!

Reducing risk

There are many ways of reducing risk in a new or small business. Some of the key ones are as follows:

- **Plan –** for example prepare a realistic business plan
- **Research** – market research should be valid, up to date and specific to the business's needs
- **Be cautious** – the business should avoid growing too fast

- **Finance with care** – shares and retained profits are safer than loans, as these sources of finance do not need to be paid back
- **Avoid costs** – premises and staff are expensive
- **Protect** – a company with **limited liability** will protect investors
- **Monitor and review** – look back and look forward, ensure the business is on track to where it should be; this can be achieved by monitoring finances and reviewing regularly the aims and the objectives of the business to assess progress

Rewards from enterprise

As well as risks, there are also many rewards for being in business. For some entrepreneurs, many of these arise from achieving their own personal objectives. These include:

- a personal sense of satisfaction of opening and running a **successful business**
- building something from scratch i.e. their own enterprise
- being in full control and therefore having the **independence** and ability to make all the decisions
- making that first sale!
- opening in a new location
- employing more people
- getting an industry award or receiving some good publicity
- getting great feedback from customers
- having social objectives for society as a whole e.g. helping others and attempting to meet a social need

These are the kind of **non-financial rewards** that give entrepreneurs a "buzz".

However, ultimately, it is the financial rewards of making **profit** that justify the effort and make taking the risk worthwhile. Famous entrepreneurs, such as Sir Richard Branson (Virgin), Sir Alan Sugar (Amstrad), James Dyson and Charles Dunstone (Carphone Warehouse), have all built very **successful businesses** that are either worth or have been sold for millions of pounds.

Sarah Willingham, who has appeared as one of the "Dragons" on Dragons Den, is another example of a successful entrepreneur. Sarah worked in the restaurant industry from the age of 13 and has now managed some of the world's most successful restaurants, including launching Pizza Express in Asia and Planet Hollywood in Paris.

In 2004, she saw the opportunity to turn a failing chain of six Indian restaurants into a successful investment. Sarah raised enough finance to buy "The Bombay Bicycle Club" which she sold three years later for well over a million pounds, having made it into the largest and most successful Indian restaurant chain in the UK.

There is a strong tradition of entrepreneurs who have built and sold one business for a substantial amount of money, to go on to build other successful businesses. They never lose the entrepreneurial buzz!

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Role of Business Enterprise

The term "enterprise" has two common meanings.

Firstly, **an enterprise** is simply another name for a business. You will often come across the use of the word when reading about start-ups and other businesses…"Richard Branson's enterprise" or "Julie set up her successful enterprise after leaving teaching".

Secondly, and perhaps more importantly, the word **enterprise** describes the actions of someone who takes a **risk** by setting up, investing in and running a business.

Someone who shows enterprise by setting up a business is called an **"entrepreneur".**

Purposes of enterprise

The role of the enterprise will normally revolve around making a profit for the **entrepreneur**. There are a variety of ways that the enterprise can achieve this:

Purpose of enterprise activity	Explanation
Producing goods and services	An entrepreneur will organise the business operation and bring together the resources that are required to ensure that goods or services are produced efficiently and will reach the customer so that a profit can be made
Meeting customer needs	An enterprise should sell goods or services that meet a specific customer need. If an enterprise just produces a product because the entrepreneur knows how to make it, without demand being present in the market, the business will end up with unsold stock
Adding value	In order to make a profit, the enterprise will need to sell at a price that is higher than its costs. This is known as **value added** and can be increased in different ways such as: ☑ **Convenience:** customers may be prepared to pay more for a service at home rather than having to go to the shops ☑ **Branding:** if an enterprise can establish itself as being a good quality or reliable brand, then the business can charge more ☑ **Design:** the use, appearance and cost of a product are all important factors and can add value to its production ☑ **Quality:** customers will have an expectation of the quality of a product and the more a product meets or exceeds this, the more value will be added in its production ☑ **Unique selling point (USP):** if a product is different to that of its competitors in some good way, then the enterprise has the possibility of charging a higher price because of this difference. This might be the name of the product or a particular feature that it possesses

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What is an entrepreneur?

There are many definitions of what is meant by an entrepreneur, but they tend to say the same thing, which is that an entrepreneur is…

"someone who takes a calculated risk through starting a business."

An entrepreneur is someone who is enterprising. In other words they:

- take the initiative and can organise resources to try and exploit a business opportunity
- take time to understand and calculate the risks involved
- make an investment, often of their own money, to set up the business
- go ahead, despite the risk that the business venture might fail
- are capable of making accurate business decisions

An entrepreneur will have many different reasons for starting a business and these will vary between different entrepreneurs:

Financial objectives	**Making a profit** – this is achieved through creating more revenue than the costs involved in running the business. Alternatively a profit could be made from selling the business or business idea to another business for a lot of money. **Investing money** – some entrepreneurs have a sum of money, which they have gained through redundancy or inheritance, and they want it to provide a return to them i.e. they would like to use the money to make more money in the future.
Non-financial objectives	**Work-life balance** – entrepreneurs can have more choice over what work they do and when they do it. They can often run their business from home, giving them more freedom and flexibility. **Skills and interests** – entrepreneurs often have business ideas that are linked to their own skills or interests. This can be very motivating for the entrepreneur, as they will have a genuine passion for the business idea and therefore will be highly motivated to make the business succeed. **Being their own boss** – many entrepreneurs want to be independent to make their own decisions and not be part of a large organisation. Their current job might also be boring, causing them to be unhappy with their existing situation.

In recent years the media has glamourised the challenge of starting and growing a business. A quick search on Amazon.co.uk will display many books by entrepreneurs and other "business experts" describing "how I made my first million" etc. Television shows, such as Dragons Den and The Apprentice, have proved hugely popular by showing the challenges faced in setting up a business or gaining investment for a business idea. Entrepreneurs such as Lord Sugar, Sir Richard Branson and Sir James Dyson have earned enormous fortunes and provide inspiration for the next generation of budding business leaders.

It is important, however, to realise that starting a business is rarely glamourous. In fact it is nearly always very **hard work**. For every success story, there are almost certainly many more business failures or businesses that do not meet the expectations of the people who set them up.

Not surprisingly, much research has been done to examine the personality and other characteristics of successful entrepreneurs, to see if there is a guaranteed method or route to success. You will find many

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lists of "what is takes to be an entrepreneur", but they tend to cover the same points. The following is a summary of the key findings:

What makes a good entrepreneur?

Successful entrepreneurs tend to have many of the following characteristics and skills:

- **Innovative –** entrepreneurs have lots of ideas and are passionate about their product or service.
- **Risk-takers** – they are prepared to take a calculated risk in order to maximise their rewards.
- **Hard working** – they are prepared to work long hours, especially in the early stages of the business.
- **Organised** – running a business can be very time consuming. They will know how to use their time, so that the business runs efficiently and effectively.
- **Determined** – they are able to handle problems and overcome hurdles. Setting up a business is difficult, as well as time-consuming.
- **Persuasive –** entrepreneurs are good at convincing other people and businesses about their idea, for example, persuading suppliers to supply their new business or convincing a potential employee to leave a current job and join the start-up, which could be seen as a very risky move. They are also good at persuading customers to buy their product or service.
- **Leadership –** an entrepreneur must be able to lead his or her own business. They must be willing and able to effectively perform more than one role.
- **Lucky –** every business needs some good luck e.g. being in the right place at the right time; however the more research, planning and preparation that goes into the business start-up, the more likely the business is to succeed.

The important thing to remember about this list is that an entrepreneur is unlikely to possess all these characteristics! Anyone who starts a business has strengths and weaknesses. However, a successful entrepreneur would recognise where their weaknesses lie and take steps to address them, for example recruit someone with the right skills to support the entrepreneur in the business in this area.

1.2 Spotting a business opportunity

Topic overview

Although this is a separate topic students need to relate these concepts to the contexts in which an enterprise and an entrepreneur will be operating. They must be aware of the local and national business environment and how this might impact on small business opportunities. Students must be aware of this topic's relationship with the other topics in this theme and how these areas may impact on business decision-making.

Section	Key Things to Learn
Customer needs	Being aware of different customer needs such as price, quality, choice and convenience The importance of fulfilling customer requirements
Market research	Objectives of market research Methods and techniques Qualitative versus quantitative research Use of social media in market research Importance of reliable data
Segmentation	Benefits and methods of segmentation Market mapping to identify gaps in the market
The competitive environment	Strengths and weaknesses of competition How competition affects business decisions

Customer needs

In order to successfully sell a product or service, a business will need to know what its customer needs are. These can be summarised as:

providing the right product, of the right quality, at the right price,

at the right time, in the right place

These can be explained in a little more detail:

Quality: customers will want the product to be of the quality that they require and expect. This is not necessarily high quality, as they may be happy with a cheaper product of a reasonable quality. There will be some legal requirements related to quality, covered later in this companion.

Price: Customers will expect to pay a reasonable price for the good or service. Price can vary depending on quality, timing, delivery arrangements and the popularity of the particular item. The price of rush hour trains is a good example of how price can change according to different circumstances, in this instance – the time of day!

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Competition and choice: Most customers would like to have a range of options for their possible purchase. This could include different brands, different quality and price combinations and even different varieties of the same product.

Convenience: The growth in on line shopping and home delivery highlights how customer needs have changed in recent years. Most successful retailers will now have websites and e-sales options that are more convenient and increasingly expected by customers. Opening hours and location are also factors that are affected by customer needs.

Meeting customer needs

Customers are arguably the most important **stakeholder** in a business. Without customers there is no business.

Historically many businesses were more production focused. They produced what they were good at producing and customers purchased the goods because there was no choice. In the global economy that we now live in, this is not an option. There is too much competition and businesses spend large amounts of time and money being customer focused.

A new entrepreneur will start with finding out and identifying what a customer wants and needs through market research. He/she will then design a good or service that meets these needs and decide on a price to charge that customers are prepared to pay. This will help the business to generate sales early on and continue to make sales, which will help to **secure the survival** of the business.

Market research

Initially, the entrepreneur comes up with what he/she believes is a good business idea. But, how does the entrepreneur check that this business idea will actually meet customer needs and therefore has the potential to become a viable business? The answer is for the entrepreneur to conduct some **market research**.

Market research for a start-up or small business needs to focus on the fundamental issues, such as:

- ☑ How big the market is (measured by sales or volume)
- ☑ How fast the market is growing and the potential for the market to grow further
- ☑ Who the existing competitors are and their share of the market
- ☑ How the market is divided up into segments, for example low price or high quality
- ☑ What kind of customers there are in the market. It is important for a business to know what their customer preferences are in terms of when and where they buy, and the prices they wish to pay

An entrepreneur needs to be satisfied that there is sufficient **demand** for the product before the business sets up. However, at the start-up stage, funds are often in short-supply, which restricts how much market research an entrepreneur can carry out. Because of this, the entrepreneur should ensure that he/she is conducting effective market research i.e. ensuring he/she has the **right information to make good decisions**, rather than being overwhelmed with too much information taken from detailed reports and statistics.

It is worth remembering that a small business can learn much about the market by simply trading, talking to customers and suppliers on a frequent basis and reading the trade newspapers and magazines. This type of market research is not only cheap or even free, but is very effective and will help the entrepreneur to recognise what the business is doing right and what changes it should make.

Purpose of market research

The aim of market research is to gather information. This will enable the business to be informed in its decisions and so reduce the risk of failure. Businesses will produce goods and services that the customers want at a price they can afford. This will not just be based on guess work, but on accurate and up to date data.

The following list describes some of the areas that market research can be used for:

- ☑ **Customers/target market** – what type of person will buy the product or are currently buying it? What price will they pay and what features do they expect? Where would they like to purchase the product? Overall, market research should be used to identify and understand customer needs as exactly as possible
- ☑ **Promotion** – how do my customers find out about products such as mine?
- ☑ **Identifying a gap in the market** – which firms are my rivals? What prices do they charge and what are their products like? Is there room in the market for a new business to open up offering a similar product?
- ☑ **Demand** – how will customer needs change in the future? Are incomes increasing? How will technology change what customers want and how they expect to buy it?

Limitations of market research

No market research will be completely accurate. If it is concerned with the current market, it will normally be based on data from a **sample** of the market. This may or may not be accurate. Costs will restrict the quantity and frequency of market research and researching future markets may not turn out as predicted. Rate of change in a market may also make research of limited value. In the IT industry, this has meant some businesses being more producer focussed in bringing out new models, rather than seeing what customers want first and then developing products to meet these specific needs.

Primary and secondary research data

An important distinction can be made between two broad kinds of market research data:

- **Primary data:** data collected first-hand for a specific purpose by the business
- **Secondary data**: research data that already exists that has been collected for a different purpose

Primary research can be designed to get exactly the data a business needs. The problem with this form of research, however, is that it is usually **time-consuming and expensive**. Getting a market research agency to conduct the primary research is one option often undertaken by big businesses, but the costs are high and the business must wait for the results. Often for new businesses, primary research is done by the entrepreneur, often informally through speaking to potential customers or completing basic surveys or questionnaires.

There are various methods of primary research:

Observation, for example counting customers, watching what they buy and when; can also use video recordings or sales data from till readings for example	Works well in retail markets, for example sit outside a shop and watch how many people walk by, look at the window displays, stock layout etc. Can see what consumers buy, rather than what they say they will buy!	Expensive and time consuming, though larger businesses will use data from tills which can provide detailed sales records.
Surveys and questionnaires Surveys are the process of getting market data, often using a questionnaire and analysing the results	Questionnaires can be undertaken by post, by telephone, face to face or more commonly online. These can be given to existing and potential customers. They are relatively cheap and can produce good quality data, if the **sample size** is large enough. Data collected is usually quantitative and therefore easy to analyse.	Questions need to be well designed, but reply rates are often very low, especially for telephone and postal methods. They can be expensive and time consuming for a large sample to be obtained which truly represents the views of the general population.
Interviews These are often conducted face to face, but can also be conducted by phone	This is a good way to get detailed insights from an individual. Answers can be checked and followed up. These are often used in combination with questionnaires.	Interviews are costly in terms of time and may be unrepresentative, as only small numbers will be undertaken. Results can be influenced by the researcher asking leading questions.
Focus groups Groups of actual or potential customers are brought together to discuss a product or market	Focus groups are a good way of getting detailed information about customer tastes and preferences. They provide detailed information and opinions.	These can be costly and time consuming to conduct and need careful management to keep individual opinions independent of others opinions. Only a small amount of data is collected, so may not reflect the viewpoints of others fully.

Secondary research

For new businesses, secondary research will be the main source of market research. This is because it costs less and is quicker and easier to obtain. Examples of secondary research, which can often be obtained free using the **internet** or by visiting local libraries, are:

Government information	Provide detailed insights on the economy and on many industry sectors. There is also **population data** published by the government based on the census.
Competitor websites	Valuable information on marketing activities of competitors including their products, prices and promotional activities and materials. This may include product ratings, which are often independent.
Customer reviews	The internet provides data from product users who give ratings and feedback about a particular product. In some cases these are independent sites e.g. Trip Advisor, in other cases they are provided by the business itself e.g. Amazon.
Trade associations, trade press and magazines	Most industries have an industry association - they are a good source of market analysis, which is particularly useful for new businesses which may have little or no experience of the market.
Newspapers (printed press)	Financial and economic information is provided on a daily basis. Newspapers provide local, national and international data which is up to date. They also provide case studies of other local businesses.
Market research reports	Organisations such as Mintel and Keynote produce a wide variety of expensive reports that analyse individual markets.

Benefits and drawbacks of secondary research

By its nature, secondary research will vary in terms of its usefulness. Some **drawbacks** are as follows:

- ☒ The research has been created for a different user and a different purpose, so may not be exactly what the business is looking for
- ☒ Data may be out-of-date, as it will have been completed in the past
- ☒ Information might be biased, because of its previous use or inaccuracy
- ☒ Data is generally available to everyone, so competitors will see the same information

However, secondary research has many **benefits** particularly to a new business:

- ☑ The information is readily available, particularly online, so research can be done quickly
- ☑ It is generally cheaper than primary research and in many cases it is free
- ☑ Good secondary research provides an excellent overview of a target market and can save time compared to primary research, particularly if the market is distant or spread over a wide area

Quantitative and qualitative market research

The distinction between primary and secondary research is really about the different **sources** of market information. A different way of thinking about market research is to consider two main **approaches** – qualitative and quantitative market research.

Qualitative research

Qualitative research is based on **opinions, attitudes, beliefs and intentions**. This kind of research deals with questions such as "why?", "would?" or "how?"

Qualitative research aims to understand why customers behave in a certain way or how they may respond to a new product. Given that these opinions are often obtained from small numbers of people, the findings are not necessarily statistically valid and may be difficult to draw conclusions from. However, such data can highlight potential issues, which can then be explored through quantitative research.

Focus groups and interviews are common methods used to collect qualitative data. This kind of data is often revealing and useful, but it is costly and time-consuming to collect, particularly for a start-up.

Quantitative research

This is research based on larger samples and therefore should be more reliable, but it can be time consuming to analyse and carry out. Quantitative research is concerned with data and addresses questions such as "how many?", "how often", "who?", "when?" and "where?" Questionnaires, that contain closed questions, are the most common method to gain quantitative market research.

The results of quantitative research will generally be in numerical form, for example:

- 35% of customers rate the new product as "attractive"
- 70% of potential customers use the internet to buy their hotel accommodation in Dorset
- 3 out of 5 customers will buy a new food product after being offered a free in-store sample
- Average ratings of a product are 8.5 out of 10

Social media and market research

Most market research is out of date before it can be used. It takes time to collect, analyse and present findings. Social media, as a form of market research, has many **advantages** compared to more conventional methods:

- ☑ It is very quick. If a small business uses Facebook and/or Twitter then reactions to new products or situations will be on Facebook in minutes and can provide instant feedback
- ☑ Provides an insight into the market in which the business is competing through the social media of competitors
- ☑ There are free tools available that allow businesses to collect social media statistics. Although there will be some costs incurred by the business in terms of staff time analysing this data, overall using social media will be very much cheaper than undertaking questionnaires, surveys and consumer panels.
- ☑ Users are engaged in the comments process and will interact with the business and each other. Comments can also be followed up, for example using Facebook private messaging, to gain further data and information.
- ☑ Can allow links to the promotional use of social media which may form part of the firm's overall marketing plan.

However, there are disadvantages:

- ☒ Although it is claimed that 80% of people with internet access engage with social media, it is much harder for a business to engage with its actual and potential customers. This could mean that the feedback provided through social media comments is not representative of actual opinions and may just represent a small number of comments of people who do not like change or new ideas.
- ☒ There is a danger of social media becoming too negative and this message spreading very quickly in a viral fashion.

- ☒ There will be a need for staff training involved in this process, which will increase costs and be time-consuming.
- ☒ For a small business, the monitoring of social media can become very time-consuming, which can detract from other important roles in the firm.

Reliability of Data

Important business decisions will be made on the basis of market research and therefore it is vitally important that it is reliable. Reliability will mean that the results indicate the true situation that the research is trying to find out, for example, the research reflects the views of the whole target market accurately.

However, there are many different reasons why market research results might not be reliable. These can be summarised as follows:

Bias: Most market research involves taking samples. The choice of these samples may well involve some bias either through the time, location or type of people chosen. Smaller samples are more likely to be biased, but large samples are expensive and time-consuming to conduct.

Out of date: Any research will be out of date once it has been collected. But some, especially secondary data, can be very out of date and not a reliable representation of the current situation facing a business. This can result in incorrect decisions being made.

Inaccurate: Either the question or the answers can result in inaccuracies. If the question is not clear, then the answers given will be of little use. Quantitative data will often have numerical scores rating products, but these often mean different things to different people. For example, some people will not give 5*s, whilst others will. Qualitative data will give people's opinions, but the opinions given may not cover all the areas required and respondents may be reluctant to make negative comments, particularly if interviews are conducted face to face.

There are many examples where specialist market research companies get it wrong, so small and new businesses must be particularly careful not to base too much of their decision making on too little market research.

Market segmentation

Once a business has undertaken market research, it will have a clearer idea of who its customers or potential customers are likely to be. The business may then decide to concentrate on certain groups of customers, in order to gain some advantage over its competitors. This also means that the business can develop some expertise and reputation when targeting this specific group.

This means that most businesses do not try and sell to the whole market population. They choose a smaller part or **segment** of the market to concentrate on. This is particularly the case with small business start-ups. Businesses are then in a better position to meet their distinct customer needs more exactly.

The table below summarises some of the benefits to a business of segmenting the market:

Better matching of customer needs	Customer needs differ; creating separate products for each segment provides customers with a better opportunity to buy products that meet their specific needs; this will increase sales
Better opportunities for growth	Market segmentation can build sales, for example customers can be encouraged to "trade-up" after being introduced to a particular product with an introductory, lower-price
More effective promotion	By segmenting markets, the target customers can be reached more often and at lower cost, as there is less waste in the promotion used
Gain a higher share of the market	Through careful segmentation and targeting, businesses can often become the market leader, even if the market is small

There are many ways in which a market can be broken down into segments.

A very popular method of **"demographic"** segmentation looks at factors such as age, gender, and income. These are described briefly here, along with other common methods of market segmentation:

Gender	We all know that males and females demand different types of the same product; great examples include the clothing, hairdressing, magazine, toiletries and cosmetics markets
Age	Businesses often target certain age groups; good examples are toothpaste, look at the variety of toothpaste products that are available to buy that target children and adults, and toys, for example pre-school, age 5-9, age 10-12, teenagers and family!
Location	Another approach is known as geographic segmentation, which will divide the market up by area. This could be as wide as a country or continent, for example the "European market", but for some small businesses it could just be the local town or village, which usually relates to small service businesses such as shops and cafes
Social class	Many businesses believe that a consumers "perceived" social class influences their preferences for cars, clothes, home furnishings, leisure activities and other products and services
Income	Because it is perfectly possible to earn large sums of money in all occupational classes, segmentation by income level is also undertaken. Producers of luxury goods and services will often use this type of segmentation, so that they do miss out on potential customers
Lifestyle	This method of segmentation is where potential consumers are grouped by their activities, interests and opinions; examples include hobbies, types of holiday preferred or whether people are interested in politics or not

Limitations of segmentation

Whilst it is possible for small businesses to gain considerable benefits from segmenting the market there are however some disadvantages:

- ☒ **Lack of information and data:** some markets are poorly researched with little information about different customer needs and wants. This is particularly relevant for small businesses, where any research conducted may be inaccurate, insufficient or out of date.

- ☒ **Difficulty in measuring and predicting consumer behaviour:** humans don't all behave in the same way all of the time. The way that they behave also changes over time. A good example is the "grey generation" i.e. people aged over 50. The attitudes and lifestyles of the grey generation have changed dramatically in recent years. This can lead to missing potential customers through inappropriate targeting with relevant products.
- ☒ **Customer segments can be hard to reach, once they have been identified:** it is one thing spotting a segment; it is another finding the right way to reach target customers with the right kind of marketing message in that segment! They may be difficult to reach and inform about goods or services.
- ☒ **All market objectives:** some small businesses will not just want to target one segment; they may have ambitions on a bigger scale, so will be looking to expand their geographical area or the type of customer.

Market mapping

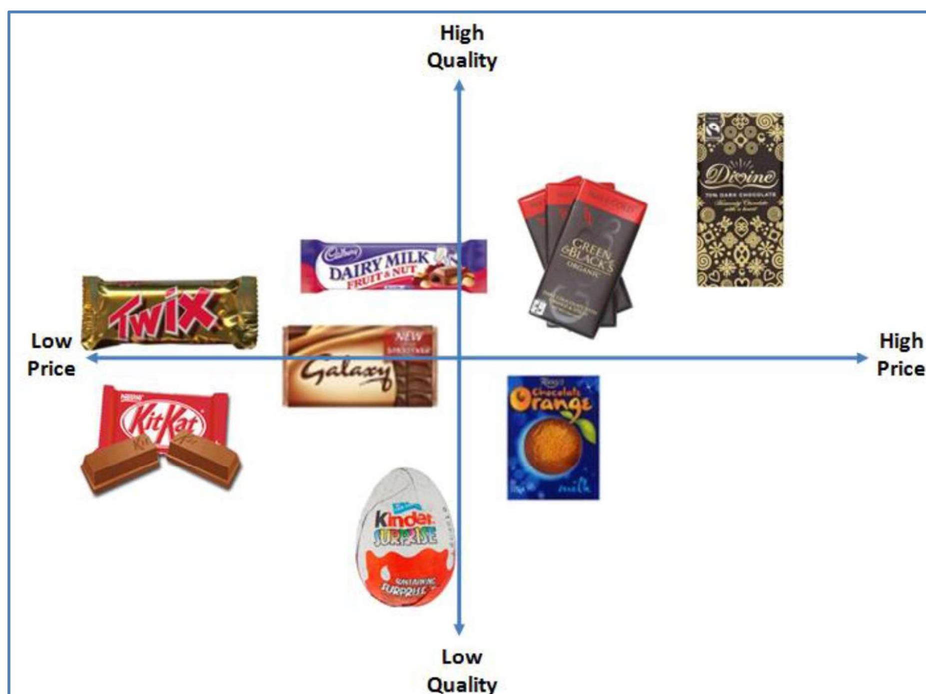
Once an entrepreneur has identified an appropriate segment of the market to target, the challenge is to **position** the product so that it meets the needs and wants of the target customers.

One way to do this is to use a "**market map**". The market map illustrates the range of "positions" that a product can take in a market based on two dimensions that are important to the identified target market.

Examples of those dimensions might be:

- High price v low price
- Basic quality v high quality
- Low volume v high volume
- Necessity v luxury
- Light v heavy
- Simple v complex
- Lo-tech v high-tech
- Young v old

Let's look at an illustrated example of a market map. The map below shows one possible way in which the chocolate bar market could be mapped against two dimensions – quality and price and locates the products of the **competition**:



How might a market map be used?

One way a market map can be used is to identify where there are "gaps in the market," in other words where there are customer needs that are not being met. For example, in the chocolate bar market, Divine Chocolate is a **social enterprise** which aims to provide better income for cocoa farmers in developing countries. It successfully spotted that some consumers were prepared to pay a premium price for very high quality chocolate made from Fairtrade cocoa and therefore developed a product to meet these specific customer needs. Equally, Green & Black's exploited the opportunity to sell premium chocolate made from organic ingredients. Both these brands successfully moved into the high quality/high price quadrant of the market map, before too many competitors beat them to it.

The trick with a market map is to ensure that market research confirms whether or not there is actually any demand for a possible "gap in the market". There may be very good reasons why consumers do not want to buy a product that might potentially fill a gap identified in the market map, for example who would want to pay a high price for a low quality product?

The Competitive Environment

Businesses will try to produce a good or service where they do not face much, if any, competition. However, in reality, all businesses will have some form of competition. This competition might be strong and direct, i.e. there are many businesses producing very similar products, or indirect i.e. competitors are producing goods or services that represent an alternative way for consumers to spend their money. If there is a little competition, this gives even a small business considerable market power.

Competition

When looking at competition in more detail, the first consideration is to determine what a **market** is.

One definition of a market is that it is a place where similar goods and services are bought or sold. Similar would mean that buyers could make choices. This is not always a direct alternative, for example a choice between going to the cinema, going out for a meal or buying a new computer game. Markets are also not always physical places, as much of today's business takes place through online transactions, where competitors' products can be bought and sold. Some of the effects of direct, indirect and no competition on a business can be summarised as follows:

Competition	Description	Impact on business decisions
Direct: product	Businesses have competitors that produce a very similar product.	Businesses will try and make their products different, so they can charge more for them or gain customer loyalty. This may be through reviewing the quality of the product. A local café will aim for good customer service or a children's play area, so that it is different from nearby national coffee shops. This will attract new and regular customers to their particular business.
Direct: price	Prices will be very similar if not identical. For example, petrol prices are normally very close to each other, despite the petrol station visited.	Small businesses might decide to sell their products cheaper, but risk being in a price war. In this case, the bigger business with the most market power will tend to win, as they are more likely to be able to afford to lower their prices.

Competition	Description	Impact on business decisions
Direct: location	In a local area, a business may compete with other similar businesses. For products, this can be across a wide geographical area or even international depending on the costs of distribution.	Small businesses may try and choose an area where they can target their products without competition, or where competitors target different market segments. A small local hairdresser may be able to work out an area where it can avoid competition from similar businesses.
Indirect	Consumers may choose a good or service that has similar characteristics (leisure, transport), but is not a direct competitor. Trains, buses and cars may all be ways of getting to work and therefore do compete with each other for customers, but indirectly.	Some customers will be affected by changes to an indirect competitor; some customers will not change to, or from, the indirect competitor. For example, people may prefer to use a local independent cinema even though other leisure choices exist.
None	A business has no competition or its product is sufficiently different from any alternative.	Small businesses can charge higher prices and make good profits, particularly if they are targeting a particular segment. Quality however, might suffer due to the lack of competition. This can make the business complacent, which can result in competitors being attracted to the market.

The competitive environment is often out of the control of a business, but the decisions that it makes will be very much influenced by competitors and the threat of future competitors. New and small businesses face particular problems as they can be targeted by other businesses that would prefer to dominate profitable markets themselves.

1.3 - Putting a Business Idea Into Practice

Topic overview

In this topic students need to continue to relate the concepts to the contexts in which an enterprise and an entrepreneur will be operating. They must be aware how business implementation can be affected by the local and national business environment and how this might impact on a small business. Students must be aware of this sections relationship with the other areas in this theme and how again, this may impact on business decision-making.

Section	Key things to learn
Business aims and objectives	Defining business aims and business objectives Financial aims for a start-up business Non-financial aims for a start-up business Differences in business aims and objectives between firms
Business revenues, costs and profits	Understanding and calculating business revenue Understanding and calculating business costs Understanding and calculating business profit and loss Interest Break even concept and the margin of safety Interpreting break even diagrams Changes in break-even variables
Cash and cash-flow	The importance of cash in a business Cash versus profit Interpreting cash-flow forecasts
Sources of business finance	Short term finance options for small and start-up businesses Long-term finance options for small and start-up businesses

Business aims and objectives

What motivates someone to become an entrepreneur?

For many people this will be money. The chance to earn significant profits, buy a yacht, take numerous holidays, buy designer goods and send the kids to the best private schools.

Money and personal wealth may well however, not be the real motivation. Evidence suggests that there are many more reasons why someone wants to start a business.

Every business starts small. However, if the entrepreneur takes some calculated risks, shows a lot of determination and has some luck, a start-up business can become very large, profitable and valuable. However, not every entrepreneur wants to build a big business and earn a fortune.

The objectives when starting a business can be broadly split into two categories: **financial** objectives and **non-financial** objectives.

The purpose of business aims and objectives

Aims and objectives provide a direction for any business. Without clear objectives, a business may provide goods and services that are not appropriate to why the business was set up. This may result in the business not being successful. Having objectives just written down however, is not enough to ensure business success. In order for objectives to be effective, they must be implemented and monitored over time. Some of the benefits to a business of having clear objectives are as follows:

Reason	Explanation
Direction	Clear objectives will allow a business to decide on the direction it should take, for example, whether it should expand or not, whether it should change its target market or perhaps increase or decrease its range of goods or services.
Focus for employees	It is important that all employees are aware of the business's objectives and that they are attempting to follow and meet them. If all employees are working together in the same direction, this will increase efficiency.
Allows planning	The overall firm's strategy, what it plans to do in the future, will be in its business plan. Having clear objectives will allow consistent planning for the business as a whole and any departments within the business. The plan will be designed so that the business objectives can be met.
Measurement of success	Having business objectives allows a business to measure its success. In other words, through a business reviewing its objectives, it would be able to see if it had achieved them or not or whether it was on the way to achieving them. This means that the business can then correct or change its business strategy if it is not working. A business might also need to change its business objectives if they are proving impossible to meet or if they are being achieved too easily. The ability to measure success is much easier to carry out for financial objectives, which are easily quantifiable, rather than non-financial objectives, such as "being more ethical" or "increasing customer satisfaction", which are very difficult to measure.

Financial objectives

- **Survival** – over half of new businesses fail within five years and many new businesses do not survive much beyond their launch. Often entrepreneurs discover that their business idea was not as good as they originally thought and therefore the business cannot run profitably or it runs out of cash. Changes in the business environment also may make it harder for a business to be successful. The first priority of a business is therefore always to survive.
- **Profit** – making profit is the main objective for most businesses. This is the reward to the entrepreneur for their hard work and the **risks** undertaken, often with their own money. Ideally, the profit earned is sufficient to provide the entrepreneur with enough income to live on. Profits may also be kept in the business to allow it to expand or develop further. Other objectives businesses may have which are linked to profit maximisation are **increasing revenue**, the amount made from sales, or **decreasing costs.**
- Another financial objective is **financial security** or **personal wealth**. Working for someone else might mean the loss of a securely paid job, which means the entrepreneur would have no

financial security. Some entrepreneurs have a longer term objective. They aim to build a valuable business that can substantially increase their future wealth. They could be aiming to build up the business and sell it, or make it so it will provide a substantial future income for them, with no risk to them of being made redundant!

- **Sales maximisation/market share** – some businesses will be more concerned with increasing their sales and therefore their market share. They may accept lower profits in the short term, in order to increase sales.

Non-financial objectives

Although most businesses will be focussed on financial objectives, there are many other priorities that will exist for new and small businesses. Providing a high quality service will be particularly important for a new business. Looking after its customers and its employees would also be an objective for many small businesses.

In many cases, non-financial objectives will link to or be consistent with financial objectives, but not always as sometimes even for a small business quality might conflict with profit. Therefore when businesses set and use objectives, they will prioritise the areas which are most important to their organisation and the owners.

Here are some of the non-financial motives that are often quoted by entrepreneurs:

- **Social objectives** such as benefiting the environment
- **More control over working life** – want to choose what kind of work is done; the need for greater **independence** is a major motivator
- **A more flexible and convenient work schedule**, including being able to work from or close to home; this motive is an important reason behind the many home-based business start-ups
- **Skills are being wasted** and their potential is not being fulfilled
- **Escaping** an uninteresting job or career
- Pursuing an **interest or hobby** that they enjoy
- **Want to be the boss,** as they are fed up with being told what to do
- Want the feeling of **personal satisfaction** from building up a business
- **Fed up** with working in a business hierarchy or a bureaucratic organisation, where there are lots of rules; people with entrepreneurial characteristics often feel stifled working with and for others!
- **Major change in personal circumstances** for example redundancy, divorce, illness, bereavement

Different aims and objectives

Different businesses will have different aims and objectives. This is particularly the case with small businesses, where every entrepreneur is likely to have different motives for starting up their own business. For example:

Entrepreneur 1: has recently been made redundant from a large building firm. He would like to turn his skills and experience into building maintenance in his local area. He wants varied work and enough money to live off, but does not want to build up the business or travel far.

Entrepreneur 2: has a new business idea for a web application for finding places for a good night out. The idea is proving very popular in the local trials. The entrepreneur wants to develop this application and sell it all over the world in order to make a lot of profit.

Business objectives will also be affected by the external environment which firms operate within. A small low cost hairdresser may have direct competition in one area, indirect competition from an expensive hairdressing national brand in another area and no competition at all in a further area. The objectives of such a small business will be different because of the situation it finds itself in.

Business revenues, costs and profits

In order for a business to calculate its profit (or loss) it needs to work out its total costs and total revenue.

Costs are the spending that a business has to undertake in order to make goods and provide services. Every business has costs, but they vary in terms of their type and amount. For a new business, estimating what the likely costs are going to be is often very difficult.

Successful businesses place great importance on costs. In most cases they want to ensure they are kept as low as possible. There are many reasons for this including:

- Increases in costs reduce the possible profits that the business can make
- They are the **main cause of cash-flow problems** in a small business
- They will change as the output or activity of a business changes

Costs can be divided into two types: **fixed and variable**

Fixed costs

Fixed costs do not change as output varies. In other words, they are fixed even if output moves up or down from period to period.

Examples of fixed costs include:

- Rent and council tax
- Salaries
- Marketing, for example advertising, market research
- Insurance
- Interest repayments
- Leased equipment charges

It is worth remembering that just because a cost is classified as "fixed", it does not mean that the cost will stay the same forever. A fixed cost can change over time. For example, the rent of an office or shop may stay the same for 5 years. However, the rent may change (up or down) when the rental agreement is renegotiated when due. The important point about a cost, like rent, being "fixed" is that it **has to be paid,** whatever the level of sales achieved.

Fixed costs are particularly important when it comes to calculating the **break even output** of a business. The higher the level of fixed costs in a business, the higher the output needed to cover these costs and break even.

Variable costs

Variable costs change when output changes. In other words the higher the output, the higher the variable costs.

Variable costs tend to be those relating directly to the production or sale of a product. Good examples include:

- Raw materials and bought-in stocks and components
- Wages based on hours worked or amount produced
- Marketing costs based on sales
- Agent and other commissions

Total variable costs can be calculated by a simple formula:

Variable cost per unit x output

Total costs

The total costs of a business can be calculated by simply adding together the variable costs, at different levels of output, to the firm's fixed costs. The formula therefore is:

Total costs (TC) = total fixed costs (TFC) + total variable costs (TVC)

Example:

Graham's van repair business is a small business that has the following costs and sales output for March:

Variable costs per job	£75
Garage rent and rates	£500
Salaries	£1,500
Advertising	£100
Other fixed costs	£400
Expected number of jobs for month	100

To calculate the total costs for the business, start with the **variable costs**. These equal £75 per unit x 100 jobs = **£7,500**

Fixed costs = £500 (garage rent and rates) + £1,500 (salaries) + £100 (advertising) + £400 (other fixed costs) = **£2,500**

Therefore the **total costs** for Graham's business equal £7,500 (total variable costs) + £2,500 (total fixed costs) = **£10,000**

As output increases the total costs will not increase as fast. This is because the fixed costs will stay the same. This means that a business may have lower average costs of production as it grows.

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Revenue and Profit

Revenue

Revenue is the money the business receives from its sales. This can be represented simply using the formula:

Revenue = selling price per unit x quantity sold

In practice, most businesses sell more than one different product and have more than one selling price, which makes the calculation more complicated. However, the method remains the same.

In the above example, if Graham charges £100 for each job that he completes, his **revenue** will equal: £100 (selling price per unit) x 100 (quantity sold) = **£10,000**.

Is Graham's business making a profit?

Profit

Having calculated the total costs and the total revenue for a business, it can now work out its profit. Profit is the financial **return** or **reward** that the owners of a business aim to achieve to reward them for the **risk** that they take. It will measure the success of that investment.

Profit is also an important signal to other providers of finance to a business. Banks, suppliers and other lenders are more likely to provide finance to a business that can demonstrate that it makes a profit, or is likely to do so in the near future, and that it can pay debts as they fall due.

Profit is also an important **source of finance** for a business. Profits earned, which are kept in the business and are not distributed to the owners via dividends or other payments, are known as **retained profits**. Retained profits are an important source of finance for any business, but especially start-up or small businesses. The moment a product is sold for more than it cost to produce, then a profit is earned which can be reinvested

Profit can be measured and calculated by the following formula:

PROFIT = TOTAL REVENUE - TOTAL COSTS

Here is an example which illustrates the formula in action:

Sales	Costs	Profit or loss?
£100,000	£75,000	£25,000 profit
£100,000	£125,000	(£25,000) loss Note: negative figures are shown in brackets

- ☑ **Total sales greater than total costs = PROFIT**
- ☒ **Total sales less than total costs = LOSS**
- ➢ **Total sales = total costs = BREAK EVEN**

Whatever the result, profit, loss or breaking even a business will always need to review its performance and look at how it might be improved. Can costs be decreased? How? And by when? Can revenue be increased? Should the price stay the same? Can more be sold? Is there a need for further investment to decrease costs or increase revenue?

Interest

As well as the costs involved in running a business, a business owner may also have to pay interest, if the business needed to borrow money in the form of a loan or mortgage when it was set up. The business may also arrange an overdraft with the bank, which will also involve the payment of interest. Interest will therefore form part of the firm's total costs. The amount needed to be paid may vary if interest rates change. This is however, dependent on the terms of the loan/mortgage/overdraft, which would have been agreed with the bank and the business owner, when the specific source of finance was first taken out.

The following formula can be used to calculate the interest rate on a loan as a percentage:

$$\text{Interest on loans (\%)} = \frac{\text{total repayment} - \text{borrowed amount}}{\text{borrowed amount}} \times 100$$

Example:

If a new business start-up borrowed £50,000 but repaid £60,000 in total, the interest percentage would be:

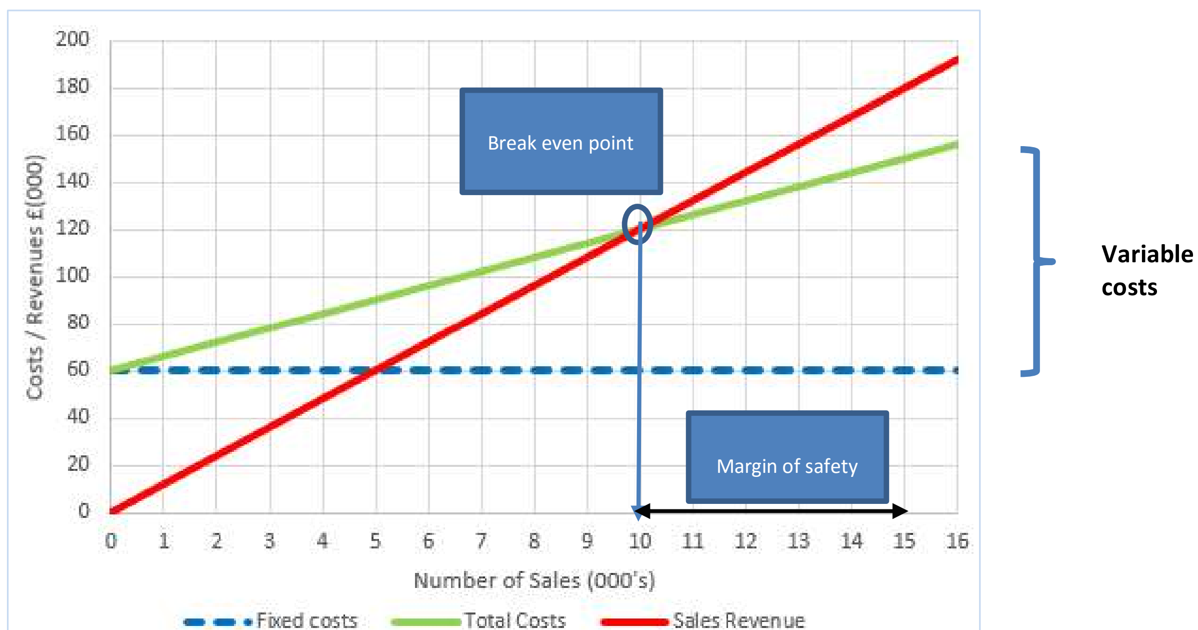
$$\frac{£60{,}000 - £50{,}000}{£50{,}000} \times 100 = \mathbf{20\%}$$

Break even

A business will calculate its break-even point in order for it to have an idea of how much it will need to produce to survive. Break-even is the point where total revenue is equal to total costs, which means the business is not making a profit or a loss. Through calculating break even, a business knows how many units it will need to produce and sell in order to start making a profit.

This information can be represented on a break even diagram or graph and will show the potential profit or loss that could be made at different levels of output, as revenue and costs change.

Break even diagram for Business A:



This break even diagram shows that fixed costs are drawn as a straight line, which is the case because they do not change with output. The total cost line is also shown, instead of the variable cost line on its own, as the total cost line takes into account both fixed and variable costs. The total cost line starts at the same point as fixed costs, as even if the business is making no output, fixed costs still need to be paid. At zero output however, variable costs are zero resulting in fixed costs and total costs being the same value. The revenue line is lastly drawn, which starts at zero and goes up diagonally. This is because as the business makes and sells more, it will gain more revenue.

In this example, Business A's break-even point is 10,000 units, the point where total costs and total revenue cross. This means that if the business manages to produce and sell this amount of output, it will not be making a profit or a loss.

Margin of safety

Business A can also calculate the margin of safety from the break-even diagram. This is the difference between its current level of output/sales and the break-even point. If Business A was currently selling or producing 15,000 units, its margin of safety would be 15,000 (current level of output) – 10,000 (break-even point) = 5,000 units. Business A would want the margin of safety to be as high as possible, as this shows how much output or sales could fall before it hits its break-even point and then after this, the business would be making a loss.

A reminder of the formula for margin of safety is shown here:

Margin of safety = actual or budgeted sales – break even sales

Calculating profit and loss from the break-even chart

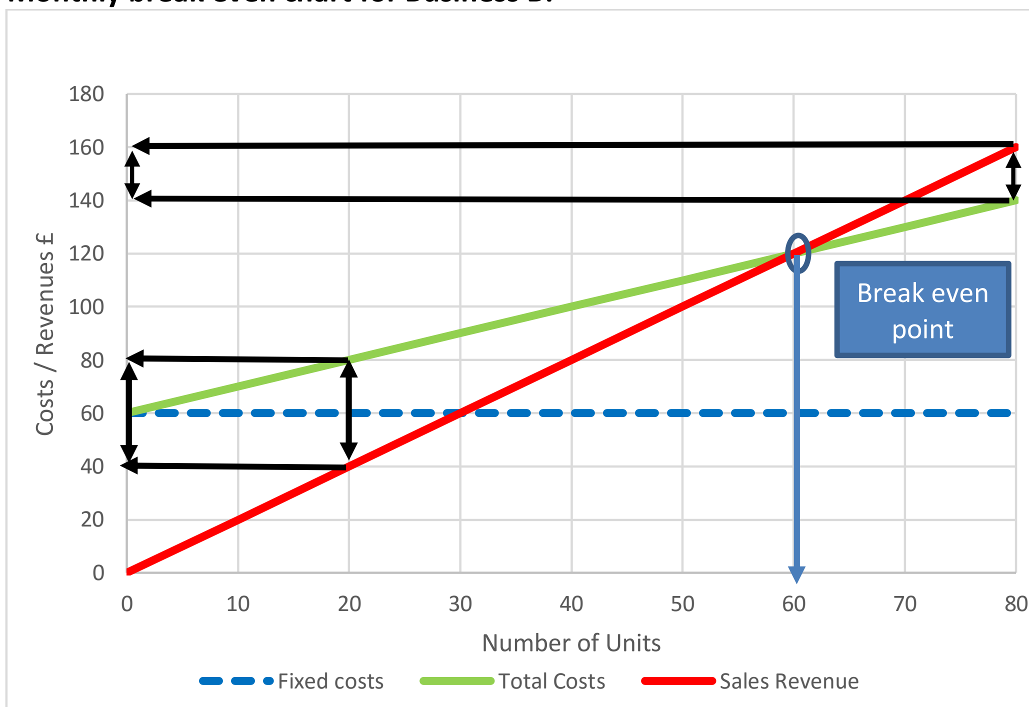
A business can determine the amount of predicted profit or loss level it expects to make at different levels of output from the break-even diagram. As already discussed, profit is calculated by deducting total costs from total revenue. From reviewing the break-even diagram for Business B (on the next page) it can be seen, at an output level of 80 units, the business is making £160 revenue and its total costs equate to £140. If we subtract the total costs from the total revenue the profit at this level of output equals: **£160 - £140 = £20.**

It is clear the business is making a profit at this level of output, as the firm's break-even point is 60 units (the point where total revenue = total costs) and as the business is operating at 80 units, a higher output level than the break-even point, then the business must be making a profit.

However, if the business is operating below the break-even point of 60 units, the business will be making a loss. Looking again at the break even chart for Business B and assuming the business is producing 20 units, the value of total costs at this level of output is £80 and the total revenue figure is £40. Remember that profit = total revenue – total costs, so in this case, the business is making a loss as: £40 - £80 = (£40).

This method of calculating profit/loss for a business can be applied to any level of output for a business that has produced a break even diagram. However, the difficulty is that sometimes values are difficult to read from the diagram and therefore if a business relied on this method only of calculating profit, inaccurate figures may be calculated and therefore used in decision making. For example, looking again at the break even chart for Business B, can the profit or loss be accurately worked out, purely from reading the graph, if the firm was operating at an output level of 55 units?

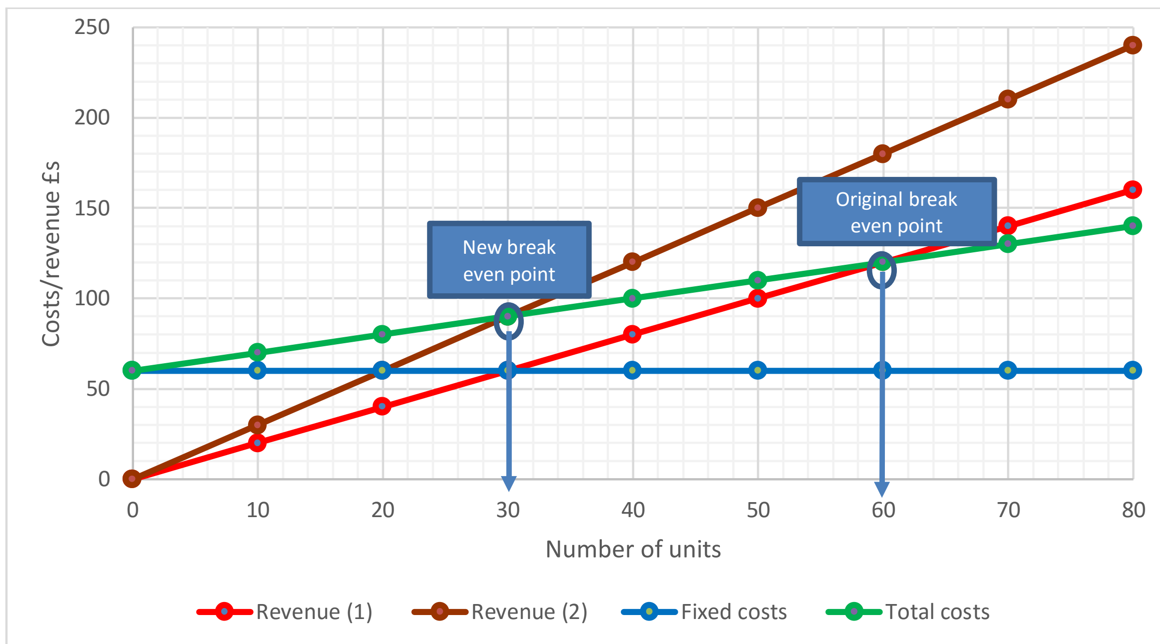
Monthly break even chart for Business B:



The impact of changes in revenue and costs on the break-even point

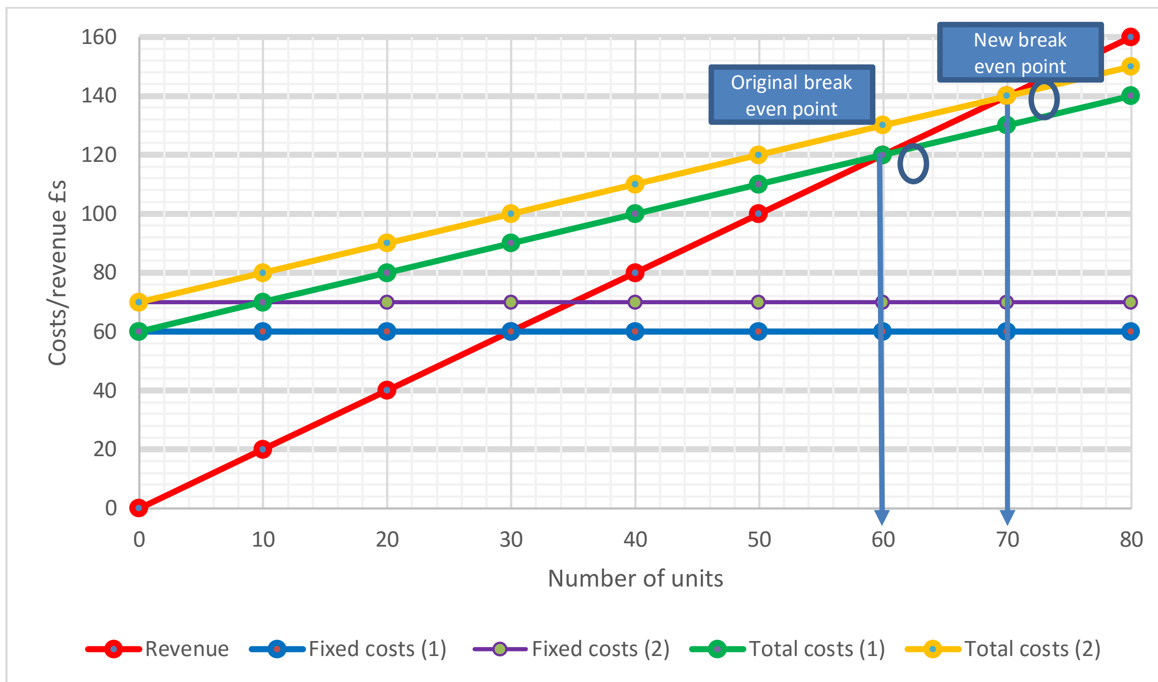
As well as calculating profit and loss and identifying the break-even point, the break-even diagram can also be used to help business owners with decision making and "what if" scenarios. By changing one or more variables in the break-even diagram, business owners, or business decision-makers, can then assess the impact of this change on the break-even point. This will allow worst and best case situations to be prepared for by the business. Some examples are included here to illustrate this further.

Example 1: Break even diagram to show the impact on the break-even point of an increase in selling price



In the above situation, a business's selling price has increased from £2 to £3. This has resulted in the amount needed to be sold to break even (the break-even output) decreasing from 60 units to 30 units. In this case, the business may then conduct some research to see if customers would be willing to pay the increased selling price or whether demand would drop significantly, as even though the break point has lowered, in this case it would take the business a significantly longer time to reach this point due to a drop in demand.

Example 2: Break even diagram to show the impact on the break-even point of an increase in fixed costs



In this case, the fixed costs of the business have increased from £60 to £70. This has increased the total costs which has resulted in the amount needed to be sold to break even (the break-even output) increasing from 60 units to 70 units. In the case, if the business anticipates that its fixed costs are going to rise, which would ultimately make it harder to break even and therefore become profitable, it may look for different ways to become more efficient to lower costs, to overcome this change.

Calculating break even using the formula

Rather than drawing a break even diagram to calculate the break-even point each time, a quicker and more efficient method of calculating break-even is to use the formulae. The break-even formulae are shown in the box:

Break even output = **fixed cost** / **(sales price – variable cost)**

This will give you the number of units the business needs to produce and sell to break even

Break-even point in costs/revenue = break-even point in units x sales price

This formula can be used to calculate the revenue (or costs!) at the breakeven level of output

Break even output using the formula

In order to calculate the break-even output using the formula, three variables are required. These are fixed costs, sales price and variable cost per unit.

In example 2, the original fixed costs of the business were £60.

The current variable cost per unit is £1. Variable costs are not drawn directly onto the break-even chart. However, this value can still be calculated if total costs and fixed costs are known and the formula here is used:

Total variable costs = total costs – total fixed costs

From reviewing the chart, at an easy to read point, i.e. 10 units, the original total costs were £70 and the original total fixed costs were £60. Total variable costs at this level of output therefore = £70 - £60 = £10.

To calculate the variable cost per unit, the number of units just needs to be divided into this amount = £10/10 = £1.

In order to calculate the sales price or the selling price per unit, a similar method can be applied. At an easy to read point i.e. 10 units, the total sales revenue = £20. To calculate the sales price or selling price per unit, the number of units just needs to be divided into this amount = £20/10 = £2.

We now have all the variables required to calculate the break-even output level using the formula as shown:

$$\textbf{Break even output} = \frac{\text{fixed cost}}{\text{(sales price – variable cost)}} = \frac{£60}{£2 - £1} = \textbf{60 units}$$

This being the same answer as obtained from the break-even chart.

Break-even point in costs/revenue using the formula

We will use example 2 again to illustrate how to calculate the break-even point in costs/revenue. A reminder of the formula is:

Break-even point in costs/revenue = break-even point in units x sales price

The original break-even point in units = **60 units x £2 (sales price) = £120**. This again shows the same value on the "y" axis for costs/revenue in £s as the break-even diagram, at the break-even point.

The benefit of using break even analysis to a business

- ☑ Break-even is a very useful business tool, as it can quickly illustrate what happens to a firm's profits at different output levels. This can help a business with decision-making about cost levels and selling prices.

☑ A business could create a series of break-even diagrams to illustrate the impact on the break-even point if one of the variables on the graph changed. This is called "what if" analysis.

Break even does however have limitations:

☒ It assumes that the average price that goods sell at will stay the same.
☒ It gives the impression that just because products are produced that they will be sold at the average price.
☒ It can become very complicated to a business which sells many different products.
☒ It assumes that variable costs are proportional to output, whereas they may get cheaper as output rises or more expensive if workers have to be paid overtime.
☒ It may mean that the business focuses on breaking even rather than making a profit!

Cash and cash-flow

Cash-flow describes the movement of cash into and out of a business. It is **not** the same as profit. Many profitable businesses fail because they do not have enough cash to pay their bills. This is because profit is recorded straight after a sale, whereas cash is recorded when it is either spent or received by the business. If a business offers trade credit to a customer for example, of 30 days, then the sale and therefore profit is documented when the goods are taken by the customer, but the cash will not be recorded until payment i.e. the cash is received 30 days later!

In business, cash is always on the move…

- **Cash-flows into the bank account** when customers pay for their sales, when a loan is received from the bank, interest is received or when assets are sold
- **Cash-flows out of the bank account** when suppliers are paid, employee wages and salaries are paid, interest is paid to the bank and so on…

You need to be able to distinguish between:

- **Cash inflows:** movements of cash **into** a business
- **Cash outflows:** movements of cash **out of** the business

The difference between the **cash inflows** and **cash outflows** during a specific period, for example a week or a month is known as the **"net cash-flow".**

Net cash-flow = cash inflows – cash outflows for a given time period

The challenge for any business, particularly new businesses, is to manage its net cash-flow successfully, so that the business does not run out of money.

Main types of cash inflow and outflow

The main types of cash-flow can be sum**marised as follows:**

Cash inflows	Cash outflows
Cash sales	Payment of overheads, wages and salaries
Receipts from trade customers	Payment of suppliers, for example raw materials, inventories
Sale of spare assets	Buying equipment
Investment of share capital	Interest on bank loan or overdraft
Personal funds invested	Payment of dividends
Receipt of bank loan	Repayment of loans
Government grants	Income tax, VAT and corporation tax

Why businesses suffer cash-flow problems

Start-up and small businesses are especially vulnerable to cash-flow problems. The reasons for this can be divided into two types:

- not enough money coming into the business fast enough
- too much money going out of the business too quickly

In addition, if a business does have cash-flow problems then new businesses or businesses facing financial difficulties will often not have reserves of **retained profits** to see them through until things improve. If a business runs out of cash and is not able to obtain new finance, it will become **insolvent**.

If a business has a positive cash-flow it will build up **cash reserves**. This can be saved in case of future problems or used for future investment.

The cash-flow forecast

The cash-flow forecast **predicts** the net cash-flows of the business over a future period. It can be used to identify likely **cash-flow problems** and help avoid or solve them.

The forecast estimates what the cash inflows into the bank account and outflows out of the bank account will be. The result of the cash-flow forecast is also an estimate of the bank balance at the end of each period covered (normally this is for each month). An example of a simple cash-flow forecast is shown below:

£'000	January	February	March	April	May	June
Cash inflows	200	250	200	150	100	250
Cash outflows	250	300	300	100	250	150
Net cash-flow *(cash inflows – cash outflows)*	(50)	(50)	(100)	50	(150)	100
Opening balance *(same figure as the closing balance for the previous month)*	250	200	150	50	100	(50)
Closing balance *(net cash-flow + opening balance)*	200	150	50	100	(50)	50

As can be seen from the table, the closing balance becomes the opening balance for the next month. This is then added to the net cash-flow for that month, which may be a positive (April) or negative (May), in order to calculate the closing balance for that month. The closing balance each month might be a surplus, which means the business has a positive cash balance at the end of the month, or a deficit, which means that the business has a negative cash balance at the end of the month (often indicated by brackets, as in May).

Looking at this cash-flow forecast a little more carefully, it shows that the business will start the period, i.e. January, with a cash surplus or opening balance of £250,000. During the first three months, the net cash-flow is negative, as it is predicted that there will be more cash outflows than inflows, which will reduce the closing balance surplus to £50,000 in March. In April and June, the cash outflows are estimated to reduce considerably making them less than the cash inflows, resulting in a surplus in the closing balance in those two months. In May again, the outflows are predicted to be higher than the cash inflows. The opening balance, of £100, is not enough to cover this increase and therefore the business is forecasted to go into a deficit of £50,000.

Businesses must carefully monitor when the business is forecast to experience a deficit, as this highlights the business may run out of cash!

To recap the key formulae for cash-flow forecasts are:

Net cash-flow = cash inflows – cash outflows in a given period

Opening balance = closing balance of the previous period

Closing balance = opening balance + net cash-flow

Why the cash-flow forecast is so important

A business uses a cash-flow forecast to:

- **Identify potential shortfalls in cash balances in advance** – think of the cash-flow forecast as an “early warning system”. This is the most important reason for a cash-flow forecast and enables the business to take action, so that it does not experience any cash-flow issues, which can ultimately prevent the business from trading and becoming insolvent

- **Makes sure that the business can afford to pay suppliers and employees** - suppliers which do not get paid will soon stop supplying the business; it is even worse if employees are not paid on time, as in this case there would be no-one to either produce the goods or provide customers with the level of service that they demand
- **Spot problems with customer payments** – preparing the forecast encourages the business to look at how quickly customers are paying their debts. This is only an issue in some businesses and not all. For example, most retailers take most of their sales in cash/credit cards at the point of sale i.e. at the time of purchase
- **Compare actual figures to forecast figures** – this allows management to spot if there are any potential issues and take appropriate action, for example if there are significant differences between the forecasted figures and the actual figures, a business owner would need to arrange appropriate sources of finance to cover any shortfalls in cash
- **External stakeholders, such as banks, may require a regular forecast** - certainly if the business has a bank loan, the bank will want to look at the business cash-flow compared to its forecast at regular intervals, to ensure that the business will continue to make its repayments

Main causes of cash-flow problems

A **cash-flow problem** arises when a business struggles to pay its debts as they become due. When cash-flow is consistently negative and the business uses up its cash balances, then the problem becomes serious. The main causes of cash-flow problems are:

Factor	Why it causes a cash-flow problem…
Low profits or (worse) losses	There is a direct link between low profits or losses and cash-flow problems. Remember, most loss-making businesses eventually run out of cash
Over-investment in capacity	This happens when a business spends too much on machinery, equipment or premises. Factory equipment, which is not being used, does not generate revenue, so is often a waste of cash
Too much stock	Holding too much inventory or stock ties up cash and there is an increased risk that these inventories become obsolete i.e. cannot be sold and therefore cannot generate any cash inflows
Allowing customers too much credit	Offering credit to customers, i.e. buy now and pay later, is a good way to build customer loyalty and long-term revenue, but late payment is a common problem and slow-paying customers put a strain on cash-flow
Overtrading	This occurs where a business expands too quickly, putting pressure on short-term finance. For example, a retail chain might try to open too many stores too quickly, before each starts to generate profits
Seasonal demand	Predictable changes in seasonal demand create cash-flow problems, but because they are expected, a business should be able to handle these in an appropriate way

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Sources of business finance

A start-up or existing small business will need finance. They will need it for various reasons, short term and long term. There are different sources of finance available and the actual source chosen by a business will depend on the amount and reason the finance is required, as well as the circumstances and the type of legal status the business has.

The challenge of raising money

Often the hardest part of starting a business is raising the money to get going.

An entrepreneur might have a great business idea and clear plan for how to exploit a market opportunity. However, unless sufficient finance can be raised, the entrepreneur will struggle to make the most of the opportunity.

Raising finance for a start-up requires careful planning. The entrepreneur needs to decide:

- **How much finance is required**? Raising finance is hard work and expensive – a start-up business should avoid having to go through the process too often!
- **When and for how long the finance is needed?** A useful distinction can be made between long-term and short-term finance
- **What security (if any) can be provided**? This will affect the ability of the business to raise a bank or other loan where the lender requires some security (or "collateral")
- **Whether the entrepreneur is prepared to give up some control** (ownership) of the start-up in return for investment
- **Whether the cost of the finance**, for example the interest charged, is justified

The finance needs of a start-up should also take account of these key areas:

- **Set-up costs**: the costs that are incurred before the business starts to trade
- **Getting ready to produce**: the fixed or long term assets that the business needs before it can begin to trade, such as machinery, equipment, vehicles etc
- **Working capital**: money required for the day to day operation of the business. Money will be needed by the business to buy the stocks required by the business, such as raw materials, and allowance should be made for amounts that will be owed by customers once sales begin, if the business chooses to offer its customers trade credit
- **Growth and development:** in the future the business may wish to grow and expand and therefore will need to invest in extra capacity, for example in extra space to produce more products

Finance to cover different periods

An important consideration when obtaining finance for a business is when and for how long the finance is needed. A useful distinction can be made between long-term and short-term sources of finance. The table summarises the main examples and uses of each category:

Long-term	Short-term
Finances the whole business over many years	Finances day-to-day trading of the business; repayable usually within a year
Examples:	**Examples:**
☑ Personal savings ☑ Retained profits ☑ Share capital ☑ Venture capital ☑ Bank loans ☑ Crowd funding	☑ Bank overdraft ☑ Trade credit

Short-term sources of business finance:

Trade credit

This is used by many businesses as a short-term source of finance. Trade credit essentially means that a firm's suppliers will allow it to have the goods and pay for them at a later date.

- ☑ This can give time for the business to use the goods and sell its products before it pays the suppliers, which will improve its **cash-flow** position.
- ☒ If the bills are not paid on time however, this can lead to the business getting a bad reputation and losing future credit arrangements with the supplier.
- ☒ It can also be particularly difficult for new start-up businesses to negotiate trade credit with suppliers, as there is a risk that the business will fail and suppliers may end up not getting paid!

Bank overdraft

Businesses of all sizes use bank overdrafts as a means of finance. As a business gets bigger, it often finds that its overdraft facility also needs to grow. That is because an overdraft is essentially a short-term source of finance that is available to help fund the day-to-day payments required by a business. It allows the business to withdraw funds from its account that are not there, up to an agreed maximum limit, and is only used when the business requires additional, temporary amounts of money.

- ☑ The big advantage of a bank overdraft is its flexibility. If a business experiences a short-term shortage of cash or an unexpected cost, then it can be paid by using some of the overdraft facility. Interest is only paid on the amount used.
- ☒ The main downside of an overdraft is that it is repayable to the bank at any time. A business may have an overdraft facility of £100,000 i.e. it can owe the bank up to that amount, but the bank may lower or even withdraw that facility at any time. This happened to numerous businesses with bank overdrafts during the credit crunch of 2007-8, many of whom were relying on their overdraft to stay in business.
- ☒ The other drawback of an overdraft is that they usually have high levels of interest attached to them, making them an expensive form of finance when they are used.

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Long-term sources of business finance:

Personal savings

An entrepreneur will often invest personal cash balances into a start-up. This can be personal savings from the bank or building society. This can also be in the form of providing assets for the business, for example using an own car, or it can be as simple as **working for nothing!** By using this source of finance, the entrepreneur is providing a strong signal, to other potential investors and the bank, of his/her commitment to the business venture.

- ☑ This is a cheap form of finance that is readily available.
- ☑ Investing personal savings maximises the **control** the entrepreneur keeps over the business.
- ☑ The amount that is available may be limited, resulting in this being used with other sources of finance to fund the business.

Loans

These might be from friends and family or from financial institutions, such as a bank.

Friends and family:

Friends and family who are supportive of the business idea may be willing to provide money either directly to the entrepreneur or into the business.

- ☑ This can be quick and cheap to arrange (certainly compared with a bank loan).
- ☑ The interest and repayment terms may be more flexible than a bank loan.
- ☒ However, borrowing in this way can add to the stress faced by an entrepreneur, particularly if the business gets into difficulties, as it can cause disagreements.
- ☒ The amount available may be limited, resulting in this being combined with other sources of finance.

Bank loan:

A bank loan is an amount of money borrowed for a set period with an agreed repayment schedule. The repayment amount will depend on the size and duration of the loan and the rate of interest. This is a common source of finance that a small or new business would choose. However, bank loans tend to be more readily available for well-established and growing businesses, rather than start-up businesses. The reason for this is **risk** – banks prefer to loan to successful businesses, which makes them more likely to be able to repay the loan and interest.

If a bank loan can be obtained then there are several advantages for a start-up or an established small business:

- ☑ The business is **guaranteed** the money for a certain period - generally three to ten years (unless it breaks the loan conditions).
- ☑ Loans can be **matched** to the lifetime of the equipment or other assets the loan is being used for
- ☑ While interest must be paid on the loan, there is no need to provide the bank with a share in the business, so **no control is lost.**
- ☑ **Interest rates may be fixed** for the term, making it easier to forecast interest payments and cash-flow.
- ☑ Repayments are made in **instalments**, resulting in the business having access to substantial amounts of cash that does not need to be paid back all in one-go.

There are also some disadvantages of a bank loan:

- ☒ **Time consuming -** a new business would need to produce a detailed business plan to show to the bank in order to secure the loan, which would take up time and resource; however it could be argued in the long-run, that this careful planning would help the business to have a greater chance of success in the future.
- ☒ **Security -** normally has to be given to the bank on some of the assets of the business. The bank will have control over these assets if the business fails.
- ☒ **Lack of flexibility** - a small business might take a loan out for £50,000 but finds it only needed £30,000. That means that interest is being paid on £20,000 of loan that it does not need.
- ☒ **Interest** – interest must be paid on the loan amount, which increases the costs of the business.

Venture capital

Venture capitalists often invest in small businesses. Venture capital can be gained from professional investors or companies who typically invest between £10,000 to £750,000.

Venture capitalists tend to have made their money by setting up and selling their own business – in other words they have proven entrepreneurial expertise. The advantages and disadvantage of this source of finance are:

- ☑ Venture capitalists often make their own skills, experience and contacts available to the firm.
- ☑ They have access to large amounts of funds.
- ☒ The venture capital company or investor will usually want a share of the business and of the profits, which can result in some loss of control over the firm for the entrepreneur, which he/she may not want to give up.

Obtaining venture capital is quite different from raising debt or a loan from a lender, such as a bank. Lenders have a legal right to interest on a loan and repayment of the capital, irrespective of the success or failure of the business. By contrast, venture capital is often invested in exchange for a stake in the company where the **return will be dependent on the growth and profitability of the business.**

Not every business is suitable for investment by a venture capitalist. Such investors prefer to invest in small **entrepreneurial** businesses which are aiming (and have the potential) for sales and profit growth. As a rough guide unless a business can offer the prospect of significant turnover growth within five years, it is unlikely to be of interest to a venture capital firm.

Share capital

Small or new businesses that are set up as a private limited company can raise finance by selling shares in the company. There are many **advantages** to a business of raising finance through share issues:

- ☑ Large sums of money can be raised.
- ☑ Capital does not have to be repaid.
- ☑ There is no interest – dividend payments can be missed if profits are low.

There are however some **disadvantages** including:

- ☒ Possible loss of control if the original owners sell more than 50% of the total shares.
- ☒ Need to satisfy shareholders expectations of dividends and share price growth.

Retained profit

This is a very important source of finance for an existing small business, but is clearly not suitable for a new business, as they are yet to build up reserves of profit!

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The idea is simple. When a business has worked out its profits, the owners or shareholders can decide whether to take the profits for themselves or reinvest the profits back into in the business.

Retained profits have several major advantages:

- ☑ They are cheap, as no interest has to be paid on them.
- ☑ They are very flexible – the business owners have complete control over how they are reinvested and what proportion is kept, rather than paid as dividends.
- ☑ They do not dilute or reduce the ownership of the organisation, so for companies there is no increased risk of a takeover.

There are, however, also some disadvantages:

- ☒ If a business needs some temporary finance because it is facing difficulties, then it is unlikely to have any profits that it can use.
- ☒ Growth may be slow if it is dependent on retained profits, as profits may not be high enough to finance the growth quickly.

Crowdfunding

Crowdfunding is a recent way of small businesses or projects raising money from outside investors, often through the internet or a crowd funding platform such as www.kickstarter.com or www.crowdfunder.co.uk

A proposal is publicised and the aim is that a large number of small investors will be attracted from all over the world. The investors will generally be in sympathy with the aims of the project or the cause for which the funds are being raised.

There are some advantages to a business of using crowdfunding to secure finance:

- ☑ It provides cheap investment when other sources of external finance may not be available.
- ☑ If the project is interesting or newsworthy it might attract good publicity, which will help the business in becoming successful.
- ☑ The business may create a web blog or use social media to keep investors informed, which might provide ongoing finance.
- ☑ Investors may have experience or skills that they can offer the business.

There will however be drawbacks:

- ☒ Investors will need to be offered a return; this might be free use of the good or service produced, or a share in the profits. Some schemes will also provide shares, which therefore dilutes the control of the original owners of the business.
- ☒ There is a risk that there will be a limit to the amount of money investors are willing to use in this way.

1.4 - Making the Business Effective

Topic overview

In this topic students need to continue to relate the concepts to the contexts in which an enterprise and an entrepreneur will be operating. They must be aware of the local and national business environment and how this might impact on a small business. Students must be aware of this topic's relationship with the other topics in this theme and how this might affect business decision-making.

Section	Key things to learn
The options for start-up and small businesses	Limited and unlimited liability Business ownership: sole trader, partnership and private limited company Franchise operations
Business location	Factors effecting business location
The marketing mix	Definition of marketing mix Balancing the marketing mix Impact of change on the marketing mix
Business plans	Content of a business plan Purpose of a business plan

Business organisation

Before the different forms of legal structures of a sole trader, partnership and a private limited company are considered, the very important issues of "unlimited liability" and "limited liability" will be discussed.

Unlimited liability

There is a big risk when operating as a sole trader or a partnership. It occurs because, in the eyes of the law, **there is no difference between the person running the business and the business itself.** When it comes to money owed by a business, the sole trader or partners have to use their own personal funds to pay these debts, if there is not enough money in the business to do so. The sole trader or the partners are, therefore, **liable** for any **debts** that the business incurs. This is called **unlimited liability.**

As the sole trader or partners are personally responsible for any debts run up by the business, this means their homes or other assets owned by the entrepreneur(s) may be at risk if the business runs into trouble. This does happen and each year thousands of people become personally bankrupt, many of them through failed businesses. Some businesses have however, a lower risk of failure, where the owner avoids running up debts through buying and selling in cash, meaning there is no need to borrow large amounts of money.

Limited liability

Shareholders may be individuals or other companies. **They are not responsible for the company's debts**. Shareholders may only lose the money they have invested in the company if a business goes bankrupt, to help pay off any outstanding debts or liabilities. This means that the liability of

shareholders is limited to the value of their investment into the company's shares. This concept is called **limited liability.**

It costs very little to set up a business as a private limited company and it can be set up very quickly. A summary of the benefits to the business of limited liability are:

- ☑ **Investors encouraged** – the owner who normally owns shares, and all other investors who purchase shares, are protected in the way that they can only lose the money they have put into the business, not their personal possessions and property. This should encourage more people to invest in the business, as there is less risk.
- ☑ **Legal separation** – a company has a separate legal identity to the business owners, unlike a sole trader or a partnership where the business is seen as the same as the owners in the eyes of the law. With limited liability any action against the business is taken against the company, not the owners

Remember: LIMITED LIABILITY is only a benefit to private (and public) limited companies. Sole traders and partnerships do not benefit from this. They have UNLIMITED LIABILITY. This is a common area of confusion, which needs revising carefully.

Forms of Business ownership

The vast majority of start-ups and small businesses in the UK choose to operate either as a sole trader or set up as a private limited company. A very small proportion of new businesses set up as a partnership and a small proportion of small businesses grow to become public limited companies.

Sole traders

Most businesses in the UK are small businesses, owned and operated by one person. In most cases, these businesses operate as a **sole trader**.

Look at Yell.com or Yellow Pages (a local free business listing posted through your letterbox). You will see lots of examples of people operating as a sole trader in your area. Many traders in the service sector e.g. hairdressers, gardeners, plumbers and electricians, use the sole trader option, as do people who run part-time or seasonal businesses.

A **sole trader** is a popular form of business organisation, as it is simple and cheap to set up and operate. Most importantly the sole trader gets to keep all the profits! The sole trader, also takes all the risk and has **unlimited liability**, as already discussed.

Do not forget that a sole trader can and do employ other people to work in their business!

Partnerships

A partnership is formed where a business is **started and owned by more than one person.** Common examples of partnerships are doctors, solicitors or vets.

A legal document called a **Partnership Agreement** is always recommended and sets out how the partnership is run, which covers areas such as:

- How profits are to be shared
- How much each partner has to invest into the business
- How decisions are to be taken
- What happens if a partner wants to leave the partnership or dies

The partners own the business and have **unlimited liability**.

Private limited company (Ltd)

A company is formed when a business is set up to have a **separate legal identity** from its owners. In the vast majority of cases, the type of company created is a **private limited company (ltd).** These are very common and can include small and very large businesses. There are many well-known examples of ltd companies, such as Iceland, Virgin, John Lewis and Clarks shoes.

If a business becomes a private limited company, it can raise funds from investors, such as friends and family, but not from the general public, as its shares are not listed on the stock exchange. Every private limited company must have at least one shareholder. Any money raised from new shares is permanently invested in the business.

In this type of business, the company's finances are separate from the owner's personal finances. The owners are known as **shareholders**, who each own shares in the company. They receive a share of the profits, known as a **dividend**, as a reward for being a shareholder. These are paid in proportion to the number of shares that they own. If the company goes bankrupt, shareholders are protected by **limited liability**.

The business will be run by a Board of Directors, appointed by the shareholders. The shareholders may also act as the directors. The Board of Directors runs the company on a day-to-day basis and makes all the important decisions.

Comparing limited companies with sole traders and partnerships

The main differences between the different types of business ownership can be summarised as follows:

	Advantages	**Disadvantages**
Sole trader	☑ Quick and easy to set up – the business can always be transferred to a limited company once launched ☑ Simple to run – owner has complete control over decision-making ☑ Decision-making is quick, important in changing, fast moving markets with lots of competition ☑ Owner gets to keep all the profits ☑ Minimal paperwork	☒ Full personal liability i.e. "unlimited liability" ☒ Harder to raise finance – sole traders often have limited funds of their own and few assets against which to raise loans ☒ The business is the owner – the business suffers if the owner becomes ill, loses interest etc ☒ Limited life as the business is the owner – lack of continuity ☒ Stressful – long hours, no division of labour, no support with decision-making
Partnership	☑ Quite simple for two or more people to form a business together ☑ Minimal paperwork once Partnership Agreement set up ☑ Partners can provide specialist knowledge and skills ☑ Jobs can be shared, so less	☒ Unlimited liability ☒ Partners have to live with decisions of others; a poor decision by one partner damages the interests of the other partners ☒ Decision-making can take longer, as disagreements can occur ☒ Harder to raise finance than a

	Advantages	Disadvantages
	stressful than operating as a sole trader ☑ Greater potential to raise finance compared to a sole trader, as each partner provides investment ☑ Any losses will be shared	company ☒ Short life, as if one partner leaves or dies the partnership ends ☒ Profits have to be shared
Private Limited company	☑ Limited liability - protects the personal wealth of the shareholders ☑ Easier to raise finance as can sell shares ☑ Stable form of structure – the company continues to exist even when shareholders change ☑ Original owners are likely to retain control	☒ Shareholders have to agree about how profits are distributed ☒ Greater administrative costs than setting up as a sole trader or partnership ☒ Finance limited to "friends and family" ☒ Less privacy - public disclosure of company information, but not as extreme as for a plc ☒ Directors' legal duties are stricter

Choosing the most suitable legal structure for a business

There will be several factors that will influence the type of structure chosen by a business:

- **Size of business** – start-up businesses often start as sole traders, as they are easier and quicker to set up compared to a Ltd. There is less paperwork involved.
- **Type of business** – some business structures relate to the type of good or service provided. If specialist expertise is involved such as doctors, vets or lawyers they are more likely to be partnerships than sole traders. If significant risk is involved, the business is more likely to become a private limited company.
- **Lender requirements** – if a bank loan is needed to start a business, the bank may prefer a small business to be set up a sole trader or partnership, to make sure they can be paid back by the individuals if the business fails.
- **Investment protection** – a private limited company may be chosen, so the investors in a new business or an expanding business can be protected by limited liability.
- **Control** – the owner, as a sole trader or a shareholder, holding the majority of shares in a company, has total control of the business. This is shared in a partnership and at risk in a company with a minority shareholding.

Franchising

A business idea for a start-up does not have to be original. Many new businesses are formed with the intention of offering **an existing business idea.** The use of **franchises** is a great example of that.

The basic idea for a franchise is this. A franchisor grants a licence, the franchise, to another business, the franchisee, to allow it to trade using the brand or business format. There will be restrictions on the franchisee regarding its goods or services and its sources of materials, but it is a low risk and relatively low cost of option that does allow a franchisee to have some independence and freedom.

Remember that the **franchisor** is in charge - the franchisor is the original owner of the business idea.

Franchises are a significant and increasing part of business life in the UK. Based on the BFA/NatWest franchise survey (2015) here are some quick statistics that illustrate this fact:

- Percentage of units profitable (including new businesses): 97%
- Franchises generated annual sales of £15.1 billion in the UK in 2015, selling through 44,200 franchised outlets, employing 621,000 people
- There are over 901 different franchisor brands in the UK, with new franchise ideas becoming available every year
- Average turnover or revenue continues to rise; in 2015 over half had an annual turnover of more than £250,000
- Start-up costs may not be too expensive and can be as little as £10,000 and are typically about £50,000
- In 2015, over 97% of franchises, including new businesses, were profitable
- Franchises are particularly popular in the service (tertiary) sector. Franchises offering property services, for example estate agency, cleaning, gardening, food etc are the most popular

Examples of well-known businesses that use franchising to expand their operations include:

- Subway
- McDonalds
- Starbucks
- Pizza Hut
- Thorntons
- KFC
- Europcar

You might have noticed from the list above that nearly all those businesses provide **services** rather than produce **goods.** Franchising is particularly suitable for service businesses.

Advantages of running a franchise

For a start-up entrepreneur, there are several advantages to investing in a franchise:

- ☑ It is still the franchisee's own business – even if they are paying royalties to the franchisor!
- ☑ The investment should be in a tried and tested format and brand
- ☑ The franchisee gets advice, support and training. The franchisor will also supply key equipment, such as IT systems, which are designed to support the operation of the business
- ☑ It is easier to raise finance - the high street banks have significant experience of providing finance to franchises
- ☑ No industry expertise is required in most cases
- ☑ The franchisee benefits from the buying power of the franchisor
- ☑ It is easier to build a customer base – the franchise brand name will already be established and many potential customers should already be aware of it
- ☑ The franchisee is usually given an exclusive geographical area in which to operate the franchise – which limits the competition, since operators of the same franchise are not in direct competition with each other

Overall, investing in a franchise is a **lower risk method** of starting a business and there is a lower chance of **business failure.**

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Disadvantages of running a franchise

There are several disadvantages for the franchisee:

- ☒ Franchises are not cheap! The franchisee has to pay substantial initial fees and ongoing royalties and commission. He/she may also have to buy goods directly from the franchisor at a mark-up
- ☒ There are restrictions on marketing activities, for example not being allowed to undercut nearby franchises, and on selling the business
- ☒ There is always a risk that the franchisor will go out of business
- ☒ The franchise needs to earn enough profit to satisfy both the franchisee and franchisor - there may not be enough to go round!

There are many good franchise opportunities available for a start-up, but some poor ones too. There is therefore, still a need for the entrepreneur to conduct market research into the franchise before deciding to invest in one.

A franchise is a kind of "halfway house" for a keen entrepreneur. It is a lower risk method of entering a market and it is often easier to raise finance. However, running a franchise does not offer the same kind of long-term financial rewards that owning a business outright can.

Business location

Where to locate is an important decision for all organisations. This is especially true however, for a new business. Should it be based at home or located in a nearby office, shop or industrial unit? How will new technology impact on this decision?

Location is also important for existing or growing businesses. Should they stay where they are? Do they need bigger premises? Would it be an advantage to relocate to somewhere else, either in this country or to a different country? Can the business use modern technology to create a "virtual business," so that its employees are all working from home?

Not every kind of start-up business can be based at home. For a new coffee shop, for example, a strong location is vital to ensure enough customers visit the store.

One of the most important considerations about location for any business will be **cost**. A start-up business is likely to have limited financial resources and therefore will want to minimise its set-up costs, whereas an existing business is likely to have competitors and will want to keep costs low, in order for it to have the opportunity to compete more effectively on price. Having premises will mean that a business will have to pay rent, rates, insurance and many other **ongoing costs,** as well as the **rental deposit or purchase costs**.

Other factors determining location

Whatever the business, there are several general factors, in addition to cost, that influence the choice of location. These are:

Raw materials	The business may depend on supplies of a particular raw material, so costs will be lower if the business is located near the supplier, for example where the raw material is grown or where a distributor is based. This factor tends to be more important for **primary** and **manufacturing** businesses, rather than businesses in the **tertiary** (service) sector.

Labour	When a start-up business needs to hire employees, then access to a reliable supply of skilled staff will be important. Businesses that are labour-intensive often look to locate in areas of traditionally low wages or higher unemployment, although this will depend on the skill level that the business needs and the availability of this type of worker. This factor is important for all businesses, but may be less significant if the business uses a lot of machinery.
Market - customers and population	Businesses may need to be located near particular centres of population. For example, if the product is targeted at a particular type of customer, for example older-aged people, then it is important to be located where they live. This is particularly important for businesses in the tertiary sector, as they provide a service.
Government assistance	This may be available to set up in a particular location. These "assisted areas" are considered to be the poorer parts of the country and may have less wealthy customers. They may however, have cheaper labour available. Assistance may come in the form of grants, loans, reduced tax burdens or use of government owned buildings.
Communications	This includes transport facilities (road, rail, air), as well as information and infrastructure. Transport links are particularly important if the business delivers products, uses a sales force or depends on imports and exports to function. The continued popularity of e-commerce makes transport links increasingly important, to ensure products can be delivered to customers in a timely manner. Information technology is less of an issue these days, as even new businesses can normally have fast and reliable broadband internet connections.
Competition	All businesses need to be aware of where their competitors are based when deciding on their own business location. This is particularly important if the business is providing a service. If a new business sees a "gap in the market" where there is no competitor, this might be a good reason to locate there. However, this might mean that this is not a profitable location for any business. In some cases it may be of benefit to be near a competitor, as customers may come to the competitor, but see another business that is nearby. This can be seen with the popularity of retailers located in retail parks or clothing stores being clustered together in shopping centres.

There is no magic formula which can be applied in deciding the most important factors in choosing a location. Sometimes the convenience of the location for the entrepreneur will be more important than even cost considerations.

The **type of business** (primary, secondary or tertiary) will also be important as primary industries will need to be located where their raw materials are and many tertiary businesses will need to be near their customers for the service to be provided. Manufacturing businesses will be influenced by many different factors such as availability of materials and labour, as well as distribution to their customers.

The **short term and long term objectives** of the business can also be significant, for example, will a business have enough room to expand if it needs to increase output in the future?

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Marketing mix

Introduction to the marketing mix

The marketing mix consists of four elements and represents the way in which a business uses the following four factors to reach customers:

- ☑ **Product** - the good or service that the customer obtains
- ☑ **Price** - how much the customer pays for the product
- ☑ **Place (distribution)** – how the product is distributed to the customer
- ☑ **Promotion** - how the customer is found and persuaded to buy the product

It is known as a "mix" because each ingredient affects the others and the mix must overall be suitable to the target customer.

For example:

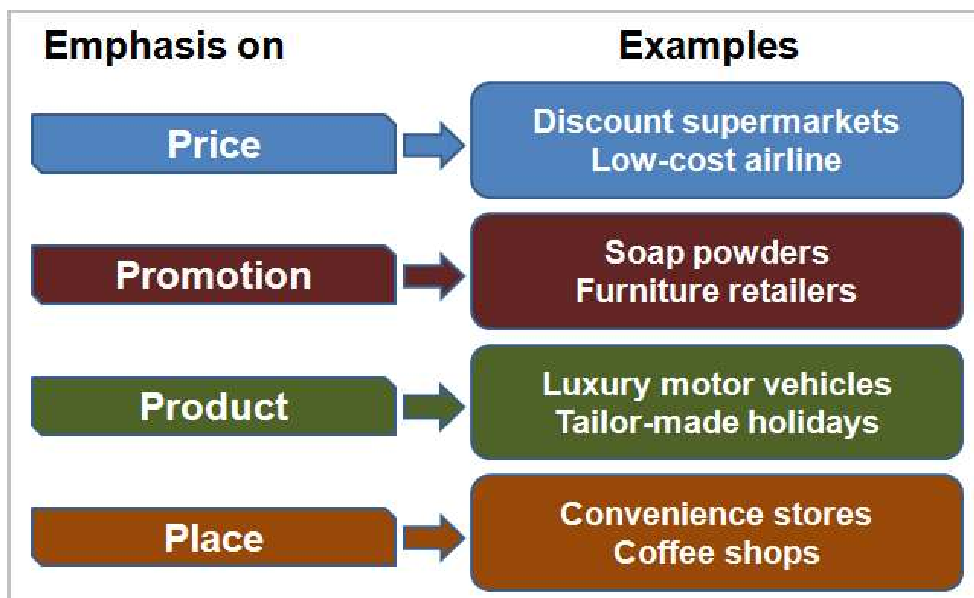
- High quality materials used in a **product** can mean that a higher **price** is obtainable
- An advertising campaign carried out in one area of the country, **promotion**, requires **distribution** of the product to be in place in advance of the campaign to ensure there are no disappointed customers
- **Promotion** is needed to emphasise the new features of a **product**

An effective marketing mix is one which:

- Meets customer needs
- Achieves the marketing objectives
- Is balanced and consistent
- Allows the business to gain an advantage over competitors

The marketing mix for each business and industry will vary; it will also vary over time.

For most businesses, one or two elements of the mix will be seen as relatively more important than the others, as illustrated below:



Changes to the marketing mix

A good example of how changes take place over time is the use of e-commerce. Whereas the retail outlets for electrical goods used to be very important, nowadays price and how quick and conveniently delivery can be arranged is much more critical in getting a sale. Digitial communication has also changed many aspects of promotion, with the extensive use of websites and social media now playing a critical part of even a small business's marketing plans.

The popularity of online and price comparison sites have also made pricing more visible. Consumers are now able to compare very quickly different prices, reviews about the good or service, and then make an informed choice about which product to purchase within a matter of minutes. This means that businesses have to constantly be aware of the information being displayed on their wesbite, as to whether it is up to date and effective.

Customers' needs and wants will always be changing. This can be seen in the "keep fit" market, where new products are constantly being developed, launched and promoted. The Fitbit for example, is priced relatively high and has expensive promotion to support the product and the price. This often makes it difficult for small businesses to compete, which is why they will need to look carefully for a gap in the market or operate in a market niche where there are less competitors.

Business plans

In order to be successful businesses will need to plan. In most cases, this will be through the creation of a **business plan**. A well-used and famous saying is "failing to plan is planning to fail".

What is a business plan?

A business plan is a written document that describes a business, its objectives, its strategies, the market it is in and its financial forecasts. The business plan has many functions, from securing external funding, to measuring success within the business.

Although a start-up business will need a business plan, the existence of such a document will also be important for an existing business. In this case the plan might be for a longer period and will need to be reviewed on a regular basis.

Information that should be included in a business plan

A simple **business plan** is suitable for a start-up business and is written by the entrepreneur. It summarises the key aims and targets of the business and the actions required to achieve them. The plan will include areas such as:

- The idea - a simple description of the proposed business with its location
- Where the idea came from and why it is a good one
- Objectives and key aims for the business - sales, profit, growth (gives a sense of direction for the business) ideally for the next 3-4 years
- Finance required and sources of finance - how much from the owners, how much to be loaned over how long and from whom
- Market overview – results of market research, main segments, target market, market size (value, quantity), growth, market share of main competitors (if known)

- How the business will operate (location, premises, staff, distribution methods)
- Marketing mix – description of these four elements
- Cash-flow forecast (important to ensure the business does not run out of cash)
- Forecast revenue, costs and profits

The purpose of business plans

The main reasons why a **start-up business** should produce a business plan are:

- Provides a focus on the business ideas - is it really a good one and why?
- Produces a document that helps clarify thoughts and identify any gaps in information or research
- It encourages the business entrepreneur to focus on what the business is really about and how customers and finance-providers can be convinced to buy and lend the business money
- It helps test the **financial viability** of the idea by including forecasts of revenue, costs, profits and cash-flow
- A business plan will **minimise the risk** of failure - can the business achieve the required level of profitability and not run out of cash?
- The plan provides something which can be used to **measure** actual performance
- A business plan is essential to **raising finance** from outside providers, such as investors and banks, as it will provide evidence that any loans can be repaid

In addition **existing small businesses** will use this process:

- to review their current performance
- allows business objectives to be modified if required
- allows departments of the business to produce their own plans, for example marketing plan, human resources plan.
- to update their current business strategy or plans for the future, based on their current performance, changes to the business environment, over which they have little control, and revise objectives
- overall it will help the business make informed decisions

1.5 - Understanding External Influences on a Business

Topic overview

In this topic students need to continue to relate the concepts to the contexts in which an enterprise and an entrepreneur will be operating. They must be aware how the local and national business environment might impact on a small business. Students must be aware of this topic's relationship with the other topics in this theme and how this might affect decision-making.

Section	Key things to learn
Business stakeholders	Main business stakeholders and their objectives How stakeholders impact and are impacted by business activity Stakeholder conflict
Technology and business	Different types of technology that businesses use How technology influences business activity
Legislation and business	Purposes and principles of consumer legislation Purposes and principles of employee legislation Impact on businesses of meeting and not meeting legislation requirements
The economy and business	How businesses are affected by the economy and changes to key economic variables
External influences	How businesses are subject to external change and how it influences their business activity

Business stakeholders

A stakeholder is anyone who has an interest in the activities and decision-making of a business.

Stakeholders include:

- Shareholders or business owners
- Managers and employees
- Customers
- Suppliers
- Banks and other finance providers
- Government
- Local community
- Competitors
- Pressure Groups

Various factors affect how many stakeholders a business has and the strength of their interest and influence on the business. These factors include:

The size and scale of the business: for example, a small, sole-trader service business will have relatively few stakeholders. Contrast this with a much larger, complex business like a national supermarket chain,

which has thousands of employees operating in numerous locations and is an important customer to hundreds of suppliers.

The nature of the good or service: some products are more likely to attract the attention of stakeholders. For example, a manufacturing business that has high levels of carbon emissions or waste packaging will be scrutinised much more closely than a simple service business. The local community will have a greater interest in a business that is a major local employer than in a one-man band.

Objectives of business stakeholders

The main objectives of each main stakeholder group will not always be the same as the objectives the business sets for itself. The objectives of the more important stakeholders to a business can be summarised as follows:

Stakeholder	Mainly interested in…
Shareholders/owners	• Good return on their investment • High level of profits and dividends • Success and growth of the business • Proper running of the business (if shareholders are not directly involved in the day-to-day running of the company)
Managers and employees	• Rewards, including maximising basic pay and other financial incentives • Job security and good working conditions • Promotion opportunities • Job satisfaction and status through high levels of motivation, interesting roles and responsibilities • Success of the business
Customers	• Value for money • Product quality that meets their specific needs • Appropriate levels of customer service
Suppliers	• Fair or high prices and prompt payments • Continued profitable trade with the business • Financial stability – can customers pay their bills?
Banks and other finance providers	• Profitability and cash-flow for the bank • Low risk that the business will not be able to repay finance provided • Growth in profits and value of the business
Government	• Prompt and correct collection and payment of taxes, for example VAT, income tax • Creating jobs, for example through businesses succeeding and growing • Compliance with business legislation, for example health and safety, minimum wage/national living wage compliance, consumer protection, fair trading, environmental protection
Local community	• Success of the business – particularly creating and retaining jobs • Compliance with local laws and regulations, for example noise, pollution
Competitors	• Profitability and success for their own business

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Stakeholder	Mainly interested in…
	• An increase in market share
Pressure Groups	• These could include trade unions and environmental groups • Best deal for their members, for example trade unions will push for higher wages, environmental groups will want safeguards to prevent business activity damaging the environment

How stakeholders are affected by business activity

Any activity of a business will affect some, if not all of its stakeholders. The impact will differ dependent on the particular stakeholder group. In many cases, the impact will be positive for some stakeholders and negative for others.

Example: If a business decides to relocate to a location that will be more convenient for customers, this will have different effects on different groups of stakeholders. Customers will benefit, the owners will also benefit, as the profits are likely to increase. Employees might lose their jobs or be forced to relocate, so the effect on them will be negative and one local community will lose, whilst the other local community gains in terms of job and therefore wealth creation.

It should be noted that the effect on stakeholders might be different in the short term and long term. A decrease in wages for workers might be negative in the short term, but might ensure that the business remains competitive and survives, which will mean that the workers' jobs will be preserved in the long term.

Impact of stakeholders on business activity

The behaviour of stakeholders will be influenced by their objectives, as previously described, and in turn, this will impact on the activities of the business.

Example: Employees want higher pay. This means they will negotiate with the managers to get a better deal, possibly threatening strike action if they do not get a pay rise. If they are successful, then this will increase the costs of the business. This may result in the business having to increase its prices to maintain its profit level. However, this might not be possible if there are competitors, so the profits earned by the owners or shareholders will decrease, as prices will need to stay the same in order for the business to remain competitive.

All stakeholders can impact business activity. If suppliers insist on immediate payment, this will make the business's cash-flow more difficult to manage. If the owners want short-term profits, they may prefer a high price strategy rather than a low price, high growth option.

Why might the objectives of stakeholders be in conflict?

Many business objectives are shared by a broad range of stakeholders.

For example, an objective for a business start-up of achieving survival would be supported by nearly all the stakeholders. Other than its competitors, it is unlikely to be in anyone's interest for a business to fail.

However, once a business becomes better established and larger, then potential conflicts begin to arise. Let's look at two examples in a little detail:

Business expansion versus higher short-term profit:

An objective of increasing the size and scale of a business might be supported by managers, employees, suppliers and the local community – largely for the extra jobs and sales that expansion would bring.

However, an expansion is often associated with increased costs in the short-term, for example extra marketing spending, new locations opened, more production capacity added. This might result in lower overall profits in the short-term, which may cause conflict with the business shareholders or owners, who may want high profits and high rewards for being a shareholder in the form of dividend payments now and therefore would not be prepared to wait for rewards.

However in the longer-term, most business owners will be in support of expansion, particularly if it increases the overall value of the business.

Job losses versus keeping jobs

This was a big issue for many businesses during the recent economic downturn. In order to reduce costs and not spend cash, business managers made some staff redundant or introduced other measures like short-time working to reduce wage costs. This will have been supported by business owners and managers.

However, it created a potential conflict with stakeholders such as employees (who were directly affected), the local community (affected by local job losses) and suppliers (which suffered from a reduction in business).

Here are some other potential causes of conflicts between stakeholders:

- "Short-term" thinking by managers who want to maximise profits today, may discourage important long-term investment in the business which would increase owners profits in the long run
- Investing in new machinery to achieve better efficiency to raise profits for the owners, may result in job losses
- Extending products into mass markets to increase sales and profits for shareholders may result in lower quality standards for consumers

Technology and business

In recent years there has been a revolution in how businesses can benefit from new technology. The invention and widespread use of computers and mobile phones has allowed massive changes to the way businesses operate and how they communicate. It has also redefined markets for many businesses and how they conduct their buying and selling operations. **Digital technology** is an overall term used to include all aspects of computer use and can be applied to most areas of human life from its use in education and health, to its use by government and business.

E-commerce

Businesses have been using computers for over thirty years. Originally computers were used mainly for the storage of data and the production of documents, but as technology has developed, the amount of uses for **information and communication technology** (ICT) has increased to include stock control and production technologies, such as computer aided design (CAD) and computer aided manufacturing (CAM).

The revolution in the use of computers has taken place since the invention of the worldwide web, which has allowed computers to be linked both nationally and internationally. Combined with the use and availability of mobile phones and smart phones, this has created a new digital world where businesses, customers and employees can all benefit from cheap and affordable technologies.

In the last twenty years, the buying and selling of goods through **e-commerce** has grown rapidly. This has included auction sites and internet retailers, as well as high street retailers developing internet sites. There have been many benefits of e-commerce to its users, but one of the most important is it allows access to wider markets.

The table highlights the advantages and disadvantages of e-commerce.

	Advantages	**Disadvantages**
Businesses	☑ Can sell products and services 24 hours a day, 7 days a week ☑ Costs can be reduced, as no need for retail premises ☑ Market can be expanded on a national and international basis ☑ Quality will be improved, as businesses will be under constant scrutiny, as customers can easily compare one business's products to another through reviewing online feedback; only the best value for money goods and services will be chosen resulting in an increase in efficiency ☑ Processing of orders is fast and delivery can be quick and in line with customer expectations; delivery can also be tracked ☑ Data recording and analysis is easily achieved; can help with targeted promotional activity ☑ Pure play or e-tailers can locate in less expensive areas of the country, where land is not of a premium price	☒ No personal contact with customers, so more difficult to influence sales on an individual basis ☒ ICT systems have to be established, maintained and updated which can add to costs and lead to customer frustration if unreliable ☒ Distribution costs can increase rapidly through increased geographical spread of sales ☒ Increased competition, as businesses can make products available on an international basis ☒ Not all customers have internet access; some customers are afraid of fraud and therefore will not trade electronically ☒ Providing a good customer service, including return of products purchased, can be expensive
Customers	☑ Allows customers to shop from the comfort of their own home at a time when it is convenient ☑ Cheaper prices and better quality due to competition ☑ Availability can be checked, which means no wasted journeys to shops ☑ Choice is increased, as products can be selected from anywhere in the world ☑ Product details and reviews are	☒ Customers cannot see or try goods before purchasing them; returning goods can be inconvenient or expensive ☒ Possibility of personal details being used for fraud or for unwanted advertising ☒ Delays in delivery compared to high street shopping, where goods are available immediately

	Advantages	Disadvantages
	available, including from other customers ☑ No hard sell from employees; customers are free to choose and buy products that best suit them	☒ Potential customers, with no internet access, may lose out on choice
Communities	☑ Growth of new job opportunities in providing e-sales centres, distribution outlets and transport networks ☑ Increased sales in associated industries, such as technology and communication ☑ Local and national economic benefits from businesses who are successful; individuals with higher disposable incomes, due to now being in employment, will spend this income in other businesses, creating a multiplier effect	☒ Loss of traditional retailers from high street shopping areas and retail parks, due to an increase in competition ☒ Increase in products from other countries that have cheaper costs, resulting in the loss of direct and indirect jobs from an economy

Social media

Most businesses will now either be using, or at least be aware of, Twitter and Facebook. Social media provides an unrivalled number of direct contacts for communication – said to be 2 to 3 billion potential customers worldwide. It is also not expensive to set up and to operate at a basic level. Most social media sites allow data collection of users.

Marketing and promotion in particular, can be considerably expanded through the use of social media, although small and new businesses may find it hard to establish a following just using a Facebook page. There are an enormous number of similar businesses using similar methods. Social media is often linked to the business website, but provides a more up to date "newsy" type of information or blogs.

Other areas of the business can also benefit, for example the business may well link some recruitment strategies to social media options and sites such as LinkedIn can provide a CV sharing platform.

Digital communication

Digital communication is now in widespread use throughout the world. This includes all devices such as mobile phones, tablets, fax machines and video conferencing equipment. It has enormous applications. Digital communication can also happen through social media platforms.

The use of digital communication and digital technology can be applied to all **stakeholders**. Some specific examples are as follows:

- Customers – ordering, invoicing or sending bills, customer service, advertising
- Suppliers – ordering, payments, product information
- Employees – payslips, job information, booking holidays, checking hours to be worked

- Shareholders – annual reports, dividend information and payments

In addition, e-mail could be used for communication to all stakeholders, to share relevant information that is appropriate to the individual stakeholder needs.

Specific advantages and disadvantages of using digital communication to a business are listed in the table:

Advantages	Disadvantages
☑ Cheap to operate and widely used. Messages and data can be transmitted quickly and is increasingly possible throughout the world	☒ May be unreliable and no guarantee that messages will be received or accessed by the person intended to receive them
☑ Data and messages can be stored electronically, so saves cost of storage. Can be saved digitally and backed up using cloud storage	☒ Can lead to communication overload, as more messages are created and more information is received and sent. Important messages and emails may be lost or delayed
☑ Possible to produce translated versions using online applications	☒ Equipment may not work and not all places will be connected
☑ Teleconferencing and videoconferencing are possible, which can produce considerable time and cost savings	☒ Environmental and health concerns over electronic transmission
☑ High quality advertising and marketing messages are possible through high definition graphic and video images	☒ Lack of leisure time, as employees expected to be available longer hours and when on holiday
	☒ Constant training requirement for staff to understand how to use digital communication efficiently

Payment systems

Technology has been used by businesses for a long time. The paying of staff directly into their individual bank accounts has been used well before the internet was developed. The use of the internet has accelerated the use of e-payments, to such an extent that in many countries it has overtaken the use of cash within the country. This does however, vary considerably between different countries.

One of the first uses of internet payment systems was for businesses to pay suppliers through direct banking payments, either on a one off or regular basis. Similarly businesses can collect payments from customers in a similar way. Methods such as standing orders, direct debits, debit cards and credit cards, now represent the "normal" way for many businesses to collect payments from customers, with contactless pay being the most recent development.

The growth of e-commerce has been linked to the use of electronic payment and firms, such as PayPal, have developed to make this process easier and safer. Mobile payments are also now becoming used on a much wider basis and Apple Pay and Android Pay are examples of a new level of customer friendly applications to set up and make payments.

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There are many advantages to a business of having technology based payment systems. These include:

- ☑ Lower costs
- ☑ Quicker receipt of money
- ☑ Happy customers who find it convenient
- ☑ No need for cash to be kept or used

Electronic payment does however have its critics, normally on the basis of security. There have been well publicised examples of fraudulent use of banking details and this concern is still the main reason why some customers will not use digital payment systems. Disadvantages can therefore be summarised as follows:

- ☒ Cost of buying and using payment systems
- ☒ Customers resistance to use of payment systems
- ☒ Not all customers may have access to required technology
- ☒ Risk of fraud

How businesses are affected by the use of technology

Every business area can make use of digital technology. Ignoring the pace of change is not an option even if in the short run it may be disruptive and expensive, as competitors which do use the technology will become more efficient. Those businesses that continue to use old technology will be left behind and may not survive. For a small business lack of knowledge, awareness or finance in this area can be a real problem.

Some examples of how technology influences and is used in business activity are:

Sales – the use of e-commerce, whilst providing many benefits, has also brought a constant need for businesses to keep up to date with payment methods and consumer preferences. This will be expensive and time consuming to entrepreneurs who are generally very busy.

Costs – financial recording is now predominantly computer based, with various software packages available. Digital applications are also used for electronic billing and payments. Many firms will also use programmes for financial modelling and monitoring linked to **management information systems** which are used to provide this data to managers and owners. Software packages are available that are suitable for small businesses, but they are often expensive.

Marketing mix – Digital technology can be used directly in terms of e-commerce and websites. Marketing also makes other widespread use of computers in terms of product design, advertising, social media and its use of customer databases, which is often linked to market research. Setting up, managing and developing technology based promotion are all possible for a small business. However, there is a need for entrepreneurs to understand its benefits and afford its costs.

There will be other uses of digital technology within even a small business and production, human resources and the organisation of administration will all make considerable use of the opportunities that it provides.

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Legislation and Business

Governments introduce legislation in many areas of the economy. This is done to control businesses that otherwise might put profits before looking after its customers or treating its employees fairly. It also ensures a fair system, as all businesses in the UK have to meet the same requirements.

Consumer Laws

Consumer Rights Act 2015

This law provides consumers with significant protection when it comes to dealing with businesses. All start-up and small businesses, as well as larger businesses, have to ensure that they comply with this legislation. The Consumer Rights Act covers product quality, returning goods, repairs and replacements, digital content and delivery rights.

The main requirements include that:

Goods must fit their description

- E.g. organic wine really must be organic
- Businesses need to take care with descriptions – avoid inaccurate claims

Goods and services must be of satisfactory quality

- The test is whether a “reasonable person” finds them to be satisfactory
- Goods must work and have no significant defects

Goods are fit for the purpose specified

- E.g. a watch should tell the time
- Businesses should take care when explaining what a product can be used for

The Trade Descriptions Act 1968

The Trade Descriptions Act makes it an offence for a trader to make false or misleading statements about goods or services. It carries criminal penalties and is enforced by Trading Standards Officers, making it an offence for a trader to:

- apply a false trade description to any goods
- supply or offer to supply any goods to which a false description has been applied
- make false statements about the provision of any services, facilities or accommodation

The Consumer Rights Act and the Trade Descriptions Act are the two main two acts that exist to protect consumers. However, consumer protection under the law goes much further. For example:

- Businesses may not use **unfair commercial practices**, for example misleading advertising or pressurised selling.
- Customers have a right to return and be provided with a full refund if goods/services do not comply with the law.
- Services must be completed at a reasonable price and by the time stated. The customer can request that unsatisfactory work be repaired or carried out again at no cost.

- Since October 2008, consumers buying from home or at work have the right to a “cooling off period”. This means if a customer orders a product, such as a mobile phone, by phone or online, he/she has 14 days to decide whether he/she wants to keep it or not.

Effects on business

There will be costs that businesses will need to pay, for example in terms of increased quality control, to make sure that they obey consumer law. There will however, be many benefits to a business of ensuring that they do comply with these laws, such as gaining an improved reputation in the marketplace, which could lead to an increase in sales, and avoiding bad publicity.

Breaking any of these laws can lead to a business incurring costs of repair and replacement, increased administration costs, as well as gaining a bad name in the market. It can also lead to very high fines for the business, which can run into millions of pounds.

Employment Law

Equal pay and minimum wage laws

The basic rule for all businesses in the 2010 Equality Act UK is that:

Men and women are entitled to equal pay for work of equal value

… Looking at that rule in a little more detail:

- “Pay” includes everything in the employment contract - bonuses and pension contributions, as well as basic wages or salary
- Workers have the right to ask their employer for information to check equality – using the equal pay questionnaire
- If employees believe their pay is unequal, they can take the employer to an **employment tribunal**

Employees must be paid at least the national minimum wage (NMW) by law. Since April 2016, if staff members are aged 25 or over, they must be paid at least the national living wage (NLW). The NMW and NLW are reviewed and usually changed every year. The rates as at October 2016 and April 2017 are shown in the table:

Current rates

These rates are for the National Living Wage and the National Minimum Wage. The rates change every April.

Year	25 and over	21 to 24	18 to 20	Under 18	Apprentice
October 2016 (current rate)	£7.20	£6.95	£5.55	£4.00	£3.40
April 2017	£7.50	£7.05	£5.60	£4.05	£3.50

Source: https://www.gov.uk/national-minimum-wage-rates

Effects on business

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The effect of wage legislation on many businesses is often that their wage costs will increase, although some businesses will choose to pay above these levels, to attract a higher calibre of staff. They may also choose to pay higher than the minimum levels to increase staff motivation and reduce labour turnover. This will reduce recruitment costs and increase productivity levels within the business.

Firms which do not pay minimum wages can face significant fines, as well as receiving bad publicity, which will make future recruitment more difficult and may reduce sales.

Discrimination

Discrimination is the **treatment in an unacceptable way of anyone who is termed to be different.** In the UK, it is illegal for an employer to discriminate against an employee on the basis of:

- Sex, including pregnancy and maternity
- Marital/civil partnership status
- A person's disability
- Race
- Age
- Sexual orientation
- Religion/belief
- Trade union membership or non-membership
- Status as a fixed-term or part-time worker

Discrimination laws apply in many areas of employing staff, for example:

- Recruitment
- Employee contract - terms and conditions
- Promotions and transfers
- Providing training
- Deciding which fringe benefits employees receive
- Employee dismissal

Employment rights

An employment right is something to which an employee is entitled, which is protected by law. Laws provide a variety of "rights" for employees, including:

- Reasonable notice before dismissal
- Right to redundancy
- Right to a written employment contract
- Right to request flexible working
- Right to be paid the national minimum or living wage
- Right to take time off for parenting

Health and Safety

The **Health and Safety at Work Act (1974)** gives employers the duty to ensure, as far as it is possible, the **health, safety and welfare** at work of all their employees.

The act requires for example:

- safe operation and maintenance of the working environment, plant and systems

- maintenance of safe access to and around the workplace
- safe use, handling and storage of dangerous substances
- adequate training of staff to ensure health and safety
- adequate welfare provisions for staff at work

In terms of health and safety, management must remember that it is not just concerned about protecting staff – health and safety applies to any person who comes into contact with the business. That means that proper health and safety needs to be provided to:

- Employees working at the business premises, from home, or at another site
- Visitors to the premises, such as customers or subcontractors
- Employees working at other premises where their business is working, such as on a construction site
- Members of the public - even if they are outside the business premises
- Anyone affected by the products the business designs, produces or supplies

For most start-up or small businesses, complying with health and safety does not pose too many problems, although the business will incur additional costs to ensure that it complies with the law properly. For example, there could be staff training costs on relevant health and safety matters, providing appropriate equipment and clothing to staff and lost management time spent checking that the business is obeying all aspects of the law. In some industries however, health and safety is really important, for example:

- Food processing (hygiene)
- Hotels (guest safety, hygiene)
- Chemical production (dangerous processes, waste disposal)
- Air travel (passenger safety)
- Tour operators (holidaymaker safety)

Effects on business of Health and Safety Law

Many businesses will often say that meeting health and safety requirements can be expensive and make them uncompetitive, especially if they face competition from firms in other countries where there are less health and safety requirements. However, failure to meet health and safety requirements can result in unlimited fines and imprisonment.

Businesses will also benefit from **a safe working environment,** as staff will stay working for the business and will be happy and more motivated in what they are doing. This will increase productivity levels. Businesses will also find it is easier to recruit new employees, if a vacancy arises.

The economy and business

Governments will all have well established economic policies designed to influence and control how the economy operates in their country. They will have aims such as low inflation, high employment, increased production and a balance in international trade. The policies used to achieve these objectives, which include **interest rates** and **taxation**, will all affect businesses both directly and indirectly through their effects on consumers and employees.

Level of employment and unemployment

Governments will be aiming to have high employment (and low unemployment) in their economy, so there will be less people reliant on benefit payments. There are, however, advantages and disadvantages to businesses of high levels of employment. These are summarised in the table:

Advantages	Disadvantages
☑ Incomes will be higher, so spending on goods and services will increase, particularly on non-essential items ☑ Workers will be more motivated, as they have more job security, increasing productivity levels and efficiency	☒ Fewer workers will be available, resulting in new job vacancies being difficult to fill ☒ Wages and salaries are likely to increase, as fewer workers are available; new and existing workers can demand higher pay ☒ Increased staff turnover, as it easy for workers to move jobs, increasing recruitment and training costs

High unemployment will result in the reverse of the above points and may also cause workers' skills to be lost, particularly in industries using technology.

There will also be considerable regional variation within a country in terms of employment levels. This may encourage businesses to relocate to take advantage of the opportunities that this provides, directly through an increase in the amount of available labour or indirectly through government relocation grants and subsidies. Some businesses will benefit more than others, depending on whether their goods or services are targeted at consumers with high or low incomes.

Growth and consumer spending

An increase or decrease in consumer incomes will affect how much money consumers spend and what they spend their money on.

An **increase** in spending will mean that consumers will **purchase more goods and services**. Although this is an opportunity for local, domestic businesses, they will need to produce more or consumers will buy from other countries that may be quicker to expand production and fulfil customer needs more efficiently. If production cannot increase to meet customer demand, there is a possibility that increased consumer spending might lead to prices rising and inflation taking place. When a decrease in consumer spending occurs, the above effects are reversed.

When an increase or decrease in income levels happens, consumers will **purchase different goods and services**. For example, when there is an **increase** in income levels, businesses that produce luxury goods and services will do very well. Businesses that produce more basic products might see a decrease in demand, even though overall customer spending is increasing. This is because customers may switch from buying lower priced products, such as Tesco value beans to buying a branded product, such as Heinz beans. Demand for some products however, will remain near enough constant, despite changes in income levels. Examples of these products include bread, milk and eggs, as they are seen as necessity items.

Inflation

Inflation is a prolonged period of rising prices in an economy. The UK economy has had very low inflation for many years. If inflation were to increase this would mean that the prices of goods and services would increase and there would normally be corresponding increases in wage rates, so that consumers could afford the higher prices.

The effect of inflation on business can therefore be seen in two parts: costs and demand.

Increased costs – wage costs and the cost of materials will rise. This can prove difficult for businesses, as they will always want costs to reduce. It can lead to pay disputes with workers or a decrease in quality of materials purchased in order to save money.

Increased prices – the increased costs will be passed onto the customers. This may reduce **demand** as consumers find cheaper products from goods imported into the country. Some consumers will also not have an increase in their wages. The increased prices might also cause a fall in demand if they sell their products to other countries, which have lower or no inflation.

As well as the additional work involved in managing inflation, there is always the risk of a **wage – price spiral** where wage increases lead to price increases which lead to further wage increases and so on. The inflation rising out of control will damage most businesses in an economy.

Taxation

Taxation will affect businesses directly and indirectly. Firstly businesses will be taxed on their profits. This is known as income tax for a sole trader or partnership. A company pays corporation tax which affects all business with revenue of over £300,000 a year. The rate at which businesses are taxed has been reduced in recent years to encourage businesses to stay in the UK rather than moving to other countries, which may tax profits at lower rates.

Businesses will also be affected by taxes on consumer income and expenditure. Direct taxes on consumers include income tax. If this increases then consumers will have less money to spend, so businesses will suffer (see **consumer spending**). There are also indirect taxes that consumers pay on their spending, VAT being the most important. 20% is currently added to the price of most goods and services. Changes to VAT are used by the government to encourage or discourage consumer spending.

Interest rates

In recent years, interest rates have been very low in the UK. Any change overall or in the direction of interest rates, can influence consumer and business behaviour considerably. An increase in interest rates may cause the following to happen:

Direct effects:

- Business loans will be more expensive. This will discourage investment and may mean businesses become less competitive or are reluctant to expand
- Costs may increase, as the cost of existing loans/overdrafts may be higher, dependent on the terms of the borrowing
- Businesses may choose to save money to earn the higher interest, rather than spend it

Indirect effects:

- Consumers will spend less, as it is more expensive for them to borrow money to fund expenditure
- Consumers will also spend less, as they will be more inclined to save more if interest rates are increasing
- Consumers may also spend less, as their costs on existing debts, such as loans and mortgages, may increase, meaning they have less disposable income to spend on other purchases, particularly non-essential goods and services, such as going to the cinema. Certain businesses will therefore see a drop in sales, revenue and therefore profit

- The exchange rate may increase, making the costs of goods sold by businesses to other countries more expensive

Exchange rates

Where businesses trade with other customers and suppliers in other countries, they will need to take into account the value of that country's currency. This **exchange rate** and changes to this exchange rate will affect the prices that have to be paid and the amount that can be earned from overseas trade.

Imports are goods and services that are purchased from other countries. These might be raw materials or finished products or services purchased by consumers. **Exports** are goods and services sold to businesses and consumers in other countries.

If the exchange rate changes so that the **currency appreciates,** then it will be worth more. This means that it will cost more for businesses located outside of the UK to buy the UK currency or pound sterling. It will also be cheaper for businesses located in the UK to buy another country's currency. This means that imports into the UK will be cheaper and exports will become more expensive.

As a result if a country's currency is appreciating then it is:

- bad for a business that exports, as its goods will become more expensive in the countries that it sells its goods in, so sales will decrease
- good for consumers, as prices of imports will decrease and they can get different and cheaper goods and services
- good if a business imports raw materials, as the business will be able to buy more of these raw materials for the same UK converted price. This will reduce business costs, which would give it more flexibility with pricing. This is very important if the business operates in a competitive market, as a reduction in prices could result in an increase in sales, which if costs are controlled could lead to an increase in profits
- bad for a local business that may not be able to compete against the cheap imports

If a **currency depreciates** than it will be worth less (devaluation) and be cheaper for other countries and businesses to buy. This is often seen as a disadvantage to a country, but in reality there are some businesses which will gain from this situation and others that will lose, which can be described as follows:

- good for a business that exports, as its goods will be cheaper so sales might increase
- bad for consumers, as prices of imports will increase, so they will have to spend more to get the same imported goods and services
- bad if a business imports raw materials, as it may increase its costs which might cancel out the benefits of cheaper export prices
- good for local businesses, as they will be able to compete better against cheaper imports

Fluctuations in exchange rates cause **uncertainty** in business and will impact on business decision-making. Since Brexit, the pound sterling has fallen in value, which has resulted in exports becoming cheaper, but imports becoming more experience. Changes in the exchange rate such as this, might discourage businesses from trading internationally, as it will impact on the profits that a business makes.

These effects are often summarised using the word SPICED:

S	trong
P	ound
I	mports
C	heaper
E	xports
D	earer

The importance of external influences

External influences are very important for all businesses, but this is particularly so for a small or new business, as these influences, and changes to them, are outside the control of a business. Businesses will however, be affected by these factors and have to react to them. A good business will also be looking to the future and anticipating any changes and how they best should prepare for them. These changes can be local, national or international. For example, how will a business be affected if interest rates rise? Or if the large factory nearby closes? Or the minimum wage is increased significantly? Successful businesses are those businesses that are prepared and have a plan in place for these changes.

In order to summarise the way external influences can result in changes of business strategy and planning we can consider a few examples on a small independent hotel business:

External change	Impact on business	Reaction of business
Increase in income tax rates	☒ Business costs increase and consumer income decreases ☒ Reduced demand for goods and services, dependent on the nature of the product, for example there would be less demand for luxury goods In the example set, the business may see a drop in demand from wealthier customers, as they can no longer spend their income on short breaks, but must spend their income on their mortgage	• Short term price reductions to fill hotel • Some staff reductions to save costs • Advertisements in other countries as possible new markets
New anti-pollution law	All businesses need to recycle higher percentage of waste materials. ☒ Costs increased and profits decrease	• Room prices to customers increased, dependent on rivals • Other cost savings made in reducing staffing, less marketing and less training

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External change	Impact on business	Reaction of business
Increase in e-shopping using mobile phones	☒ Drop in sales booked through reception and loss of sales to other hotels that were quick to adopt online bookings through mobile phones	• Investment in e-sales and a website which is compatible with smart phones • Daytime hotel reception staff made redundant • Price reductions for online bookings

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