EDEXCEL GCSE BUSINESS

UNIT 1

Course Companion

INTRODUCTION TO SMALL BUSINESS

Essential study notes to support your Edexcel GCSE Business Unit 1 Course

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Topic 1.1 Spotting a Business Opportunity

Topic overview

Section	Key Things to Learn
What is a business?	Why do businesses exist? The difference between goods and services The production process
Understanding customer needs	What entrepreneurs need to know when starting a business How to research the market
Market mapping	Spotting a viable gap in the market How to split the market into segments Market mapping as an approach
Analysing the competition	Why understand the competition? What information is required Does competition benefit customers? How can a small business compete effectively?
Adding value	How does a business add value Benefits of adding value
Franchising for start-ups	Understanding the franchise concept Advantages and disadvantages of setting up as a franchise

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What is a Business?

Businesses - goods and services

We are surrounded by businesses. We interact and transact with them every day. But what, exactly, is **a business**?

A business can be defined as

An organisation that provides goods and services to customers who want or need them

What are **goods and services**?

Goods are **tangible** things that are produced, bought or sold, then finally consumed. Look around your home and you will see dozens of examples, from the microwave and the ready-meals in the freezer, to the flat-screen television and Nintendo Wii console.

Services are **activities** that other people or businesses do for you. When you book a holiday, visit the hairdresser or eat in a restaurant you are consuming one or more services. Services are sometimes referred to as **intangible**, in the sense that you can't touch or handle them.

Most businesses provide a service rather than make goods. That is particularly true of the small business sector. Take a flick through the Yellow Pages directory at home to see the many small service businesses operating nearby.

There are some important differences in the skills required to run a business making goods compared with providing services. Here is a brief summary:

Goods	Services
Requires a production location - factory	The location is where the service is provided – either physically (e.g. a builder) or virtually (e.g. telesales or via a website)
The output from production is stock – which can be transported and/or stored for future sale	Service is delivered at a point in time – it cannot be stored! A shop has to be open to sell. A hairdresser has to be there to cut hair
Production costs will include the costs or raw materials and other inputs into the production process	The main cost of a service business is the people involved
Requires close liaison with suppliers	Require high levels of customer satisfaction
Quality can built-in to the product through good design and production processes designed to ensure the right quality is achieved	Quality is measured by the quality of customer service. Harder to manage
Quite costly to set up. The production process needs to be in place and working before goods can be produced.	Relatively easy to start a service business, particularly using franchises, where a business format has already been established

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The Production Process

Businesses provide goods and services. To be able to do this, they need to be able to turn **inputs into outputs.** This is known as the **production process.**

A good way to think about the production process is to imagine a **transformation** that happens to a series of **inputs**, turning them into **outputs**:

Inputs into the production process include:

- **Labour** – employees providing their time, effort and skills
- **Equipment** – machinery, buildings, computers
- **Raw materials** - Physical substances used as inputs (e.g. steel, energy, ingredients)
- **Finance** – cash needed to buy equipment, pay for employees, rent a location and pay for marketing
- **Enterprise** – an input that is often forgotten. Think of enterprise as the **creative energy and force** that gets a business started and drives it forward

Many of the inputs into the production process are provided by suppliers.

Suppliers provide the goods and services that a business needs in order for it operate.

For example, the suppliers to a Chinese restaurant would include:

- Food ingredients - likely to be from a food wholesaler
- Energy - electricity, gas, heat & light)
- Property – the landlord
- Marketing – advertising outlets such as newspapers

The **outputs** from the production process are the finished goods and services.

Outputs are bought by **customers** – the people who pay. Customers are often, but not always the same as consumers.

Consumers are the actual users of the goods or service. For example, a parent might buy a PlayStation 3 console game for a child. The parent is the customer; the child is the likely consumer.

Understanding Customer Needs

What an entrepreneur needs to know

The entrepreneur has come up with what he/she believes is a good business idea. But, how does the entrepreneur check that the business idea actually meets customer needs and has the potential to become a viable business? The answer is to do 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, volume etc)
- How fast the market is growing) & the market growth potential
- Who the existing competitors are and their share of the market
- How the market is divided up into segments ("segments" are the different parts of a larger market – e.g. low price or high quality)
- What kind of customers there are in the market. It is important to known what their preferences are in terms of when and where they buy, and the prices they pay

The main purpose of the market research is to help the entrepreneur find a position in a **niche market** that will enable the business to charge a reasonable **price** and to earn reasonable **profits** once the business has been set-up and established.

A niche market is a smaller part of a large market where customers have quite specific needs and wants.

Here are some examples of how niche and mass markets compare:

Industry	Niche Market	Mass Market
Holidays	Trekking in Nepal	Beach holiday in Ibitha
Motor cars	Porsche 911 Turbo	Fiat Uno
Eating out	Exclusive restaurant	Burger King
Chocolate	Hotel Chocolat	Cadbury's Dairy Milk
Magazines	Snowboard UK magazine	Hello! Magazine

Why should start-ups and small businesses aim for a market niche? Because surviving in high volume or **mass-market** segments is almost impossible. Mass markets are dominated by well-established businesses that enjoy lower costs and can charge lower prices than a smaller business. In other words, a start-up will face stiff competition if it tries to set-up in a mass market.

An entrepreneur needs to be satisfied that there is likely to be a **demand** for the product. However, at the start-up stage, funds are often in short-supply which restricts how much market research can be carried out.

However, don't worry. Effective market research is not about getting hold of lots of statistics or detailed reports. **It is about getting the right information to make good decisions.**

Remember that a small business can learn much about the market by simply trading, talking to customers and suppliers on a day-to-day basis and reading the trade newspapers and magazines.

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 entrepreneur

Secondary data: research data that already exists and which has been collected for a different purpose.

For a start-up, it is most likely that secondary research will be the main source of market research. This is because it cost less and is quicker & easier to obtain. **Gaps in knowledge can be filled with some primary research.**

There are many good sources of secondary data, and the good news for an entrepreneur is that many of them are free! Here are some examples:

Google	A great way of getting quick market research for free
Government departments	Provide detailed insights on the economy and on many industry sectors
Trade associations	Most industries have an industry association - they are a great source of market analysis
Trade press & magazines	Essential reading for an entrepreneur, particularly if he/she has little or no experience of the market
Competitor websites & marketing materials	Valuable information on marketing activities of competitors
Market research reports	Mintel and Keynote produce a wide variety of expensive reports that analyse individual markets

By its nature, secondary research will vary in terms of its usefulness to a start-up – after all, it has been created for a different purpose, it may be out-of-date and it might be biased.

However, secondary research has many advantages to a start-up:

- The information is readily available (particularly online) – so research can be done right now!
- It is generally cheaper than primary research; in many cases it is free
- Good secondary research provides an excellent overview of a target market

In most cases, a start-up will still have gaps in its understanding of a market even after looking at the available secondary data. **Primary research** can help fill these gaps.

It is best to think of primary research as the way that the entrepreneur gets answers to the important commercial questions that need answers before trading begins. For example:

- What do potential customers think of my new product or service?
- How can I obtain supplies of the right goods at the best price?
- What price should I charge?
- What is the best way of reaching potential customers? (e.g. via the Web, retail, direct mail)

The problem with primary research is that it is usually **time-consuming and expensive**. Getting a market research agency to do the primary research is one option, but the costs are high and the entrepreneur must wait for the results. Accordingly, most primary research by a start-up is conducted by the entrepreneur, often informally.

There are various methods of primary research:

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

	“beta” versions for testing by a small group of potential customers. Test marketing can be a good predictor of how a new product or service will be received by the larger market (provided that it can be kept secret from competitors!)

Quantitative and qualitative 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 the two main **approaches** – qualitative and quantitative.

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. However, such data can highlight potential issues which can be explored in 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 is, therefore, more statistically valid. Quantitative research is concerned with data and addresses question such as “how many?”, “how often”, “who?”, “when?” and “where?”

The results of quantitative research will generally be 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

The main methods of obtaining quantitative data are the various forms of surveys – i.e. telephone, postal, face-to-face and online.

Market Mapping

Analysing the customer

A problem that faces any start-up or small business is that customers are not all the same!

Think about how you behave as a customer. The things that you want from your mobile phone or night out are likely to be different from those wanted by someone of a different age, with other interests and so on.

So how does a business address these differences? In short, the challenge for a business is to:

(1) Identify groups of customers who have **similar needs and wants**
(2) Find a way of offering (**positioning**) a product which is attractive to those customer groups

Markets consist of customers with similar needs. For example, consider the wide variety of markets that exist to meet the need to:

- Eat (e.g. restaurants, fast food)
- Drink (e.g. coffee bars, pubs & clubs)
- Travel (for business and leisure, near or far)
- Socialise (as couples, with family, with friends)
- Be educated (as a child, adult, for work or other reasons)

As you can imagine, such markets (if they were not further divided into smaller parts) would be very broad and difficult for a new business to target.

The great news for any new business is that **customers in any broad market are not the same.** For example, within the market to provide meals, customers differ in the:

- Benefits they want (food quality, ambience, dietary health)
- Amount they are able to or willing to pay (budget, expensive)
- Quantities they buy (bulk buy or one-off purchase)
- Time and place that they buy (fast-food, up-market restaurant)

It therefore makes sense for businesses to divide (or **"segment")** the overall market and to target specific segments of a market so that they can design and deliver more relevant products. Let's look at segmentation in some more detail.

Segmenting the market

There are several important reasons why businesses should attempt to segment their markets carefully. These are:

Better matching of customer needs	Customer needs differ. Creating separate products for each segment makes sense and provides customers with a better solution
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-priced product
More effective promotion	By segmenting markets, target customers can be reached more often and at lower cost
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, income and so on. These are described briefly below:

Age	Businesses often target certain age groups. Good examples are toothpaste – look at the variety of toothpaste products for children and adults) and toys (e.g. pre-school, 5-9, 10-12, teen, family)
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
Income	Many companies target rich consumers with luxury goods (e.g. Lexus, Bang & Olufsen). Other businesses focus on products that appeal directly to consumers on low incomes (e.g. Aldi and Lidl (discounted groceries) and fast-fashion retailers such as TK Maxx)
Social class	Many businesses believe that a consumers "perceived" social class influences their preferences for cars, clothes, home furnishings, leisure activities and other products & services

Another approach is known as **"geographic segmentation".** This tries to divide markets using:

- **Regions**: e.g. in the UK these might be England, Scotland, Wales Northern Ireland or (at a more detailed level) counties or major metropolitan areas
- **Countries**: perhaps categorised by size, development or membership of geographic region
- **City / town size**: e.g. population within ranges or above a certain level
- **Population density**: e.g. urban, suburban, rural, semi-rural

It would be nice to think that market segmentation is the answer to an entrepreneur's problems. By spotting a clear niche market using segmentation, the start-up business can focus all its efforts on reaching the target customer base.

Limitations of segmentation

If only business life was that simple. It isn't. Here are some key limitations with market segmentation:

- **Lack of information and data:** some markets are poorly researched with little information about different customer needs and wants
- **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.
- **Hard to reach customer segments once 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

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.

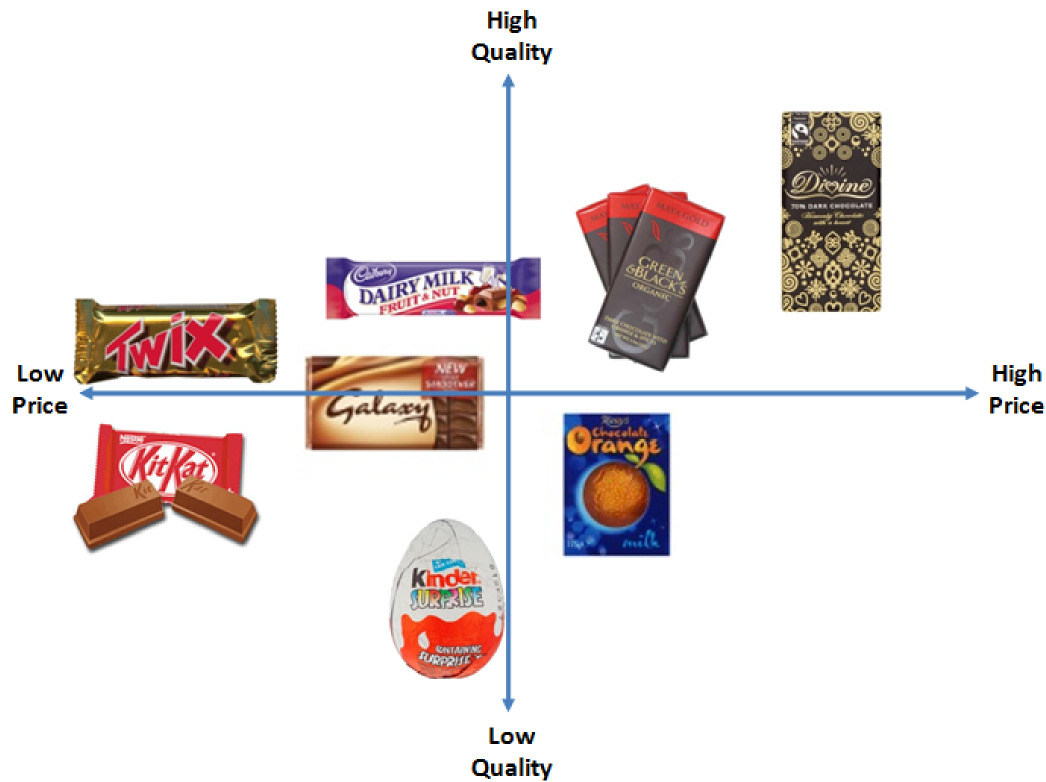
One way to do this is to use a "**market map**" (you might also see this called by its proper name – the "perceptual map").

The market map illustrates the range of "positions" that a product can take in a market based on two dimensions that are important to customers.

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:



How might a market map be used?

One way is to identify where there are “gaps in the market” – where there are customer needs that are not being met.

For example, in the chocolate bar market, Divine Chocolate (a social enterprise) successfully spotted that some consumers were prepared to pay a premium price for very high quality chocolate made from Fairtrade cocoa. 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 (see above) 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.

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Analysing the Competition

Understanding the competition

Almost no business, large or small, operates without any competitors. If there is one thing that gives an entrepreneur sleepless nights, it is the worrying about what competitors are getting up to. Will they copy the good business idea? Will they reduce prices and grab some precious customers? What new products are they planning and how will customers react?

Some businesses think it is best to get on with their own plans and ignore the competition. Others become obsessed with tracking the actions of competitors (often using underhand or illegal methods). Many businesses are happy simply to track the competition, copying their moves and reacting to changes.

There are some good reasons why any business needs to keep a close eye on competitors:

- To help the business understand where they can create an advantage
- To find out about, and respond to, competitor actions
- To see if competitors are investing in new and better products
- To spot changes in the ways that customers buy

There is no excuse for an entrepreneur not to keep an eye on the competition - there is lots of information that is readily available.

Getting this information and putting it together is a bit like doing a jigsaw puzzle. Each individual piece of data does not have much value. The important skill is to collect as many of the pieces as possible and to assemble them into an overall picture of the competitor. This enables the business to identify any missing pieces and to take the necessary steps to collect them.

What do businesses need to know about their competitors? Here are some examples of information that would be very useful – assuming it could be obtained!

- Overall sales and profits, by product and market
- Business costs (usually an estimate)
- Organisation structure
- Methods of promotion and distribution
- Key customers and suppliers
- Product quality and reputation

Does competition benefit customers?

Businesses might prefer to operate with little (if any) competition. However, it is widely accepted that strong competition and rivalry in a market is good news for customers.

The benefits of competition include:

- Greater choice for consumers
- Prices are kept to a sensible level as competitors compete on price to achieve sales

- There is a strong incentive for businesses to invest in new products through innovation and invention
- Successful businesses are those that deliver high product quality and excellent customer service

If competition is a good thing, are there any disadvantages or drawbacks for customers? There are some:

- Businesses can become too focused on short-term success rather than investing for the long-term
- Cutting business costs to remain competitive might mean a business taking short-cuts on important aspects such as health & safety and product quality. Employees working in the business would also suffer from this
- A business might neglect its social obligations (e.g. not taking care of waste disposal or complying with environmental regulations) or behave unethically (e.g. pressurised selling techniques)

Ways in which a business can compete effectively

With all that competition out there, how does a small business compete effectively?

The starting point has to be – by providing a **great product!** In most markets, customers are looking for the best value for money. This means that a product which is better than the competition, and which sells for the same price, will most likely prove to be a winner.

It is often the case that a business needs to have more than one product in order to succeed in a market. Offering a **product range** enables a business to provide customers with more choice and potentially attract customers who buy for different reasons.

For example, a product range might include a "budget" or "best value" product, a mid-range product, and a higher-price premium product. Walk down the aisle of any large supermarket and look at the own-label ranges to see this in action.

Quality is another great way to compete effectively. **A quality product is one that meets customer needs**. Maybe the customer wants something that is 100% reliable, or which uses high quality materials. A successful business can compete by consistently achieving the required quality level.

By focusing on a high quality product, a successful business is often able to develop its **brand** reputation. In many consumer markets, brands are an important source of advantage. Customers trust good brands, are more loyal to them, and are often prepared to pay a higher price too.

Customer service is an important way of beating the competition. Buying the product is one thing – but what about the level of after-sales service? Is that an area where a small business can gain an advantage? The overall selling experience for a customer can be made to be better than the competition – are staff well-informed and friendly?

Price is the other main method of competing. For many businesses, the price charged is a reflection of two factors:

(1) What the other competitors are charging
(2) What the product costs to make or buy

If a business operates efficiently, that gives it a better chance of being able to offer a lower price than competitors and still make a reasonable profit.

Adding Value

What is added value?

Adding value sounds like a bit of business jargon – and it is! However, it also has quite a precise meaning which is important. So it is worth learning this:

Adding value = the difference between the price of the finished product/service and the cost of the inputs involved in making it

Added value is equivalent to the **increase in value** that a business creates by undertaking the production process.

It is quite easy to think of some examples of how a production process can **add value.**

Consider the examples of new cars rolling down the production line being assembled by robots. The final, completed and shiny new car that comes off the production line has a value (price) that is more than the cost of the sum of the parts. Value has been added. Exactly how much is determined by the price that a customer pays.

Alternatively, imagine a celebrity chef preparing a meal at his luxury restaurant. Once the cooking is complete, the meal is being served and sold for a high price, substantially more than the cost of buying the ingredients. Value has been added.

You don't have to use robots or have the culinary skills of Gordon Ramsay to "add value". For example, businesses can add value by:

- **Building a brand** – a reputation for quality, value etc that customers are prepared to pay for. Nike trainers sell for much more than Hi-tec, even though the production costs per pair are probably pretty similar!
- **Delivering excellent service** – high quality, attentive personal service can make the difference between achieving a high price or a medium one
- **Product features and benefits** – for example, additional functionality in different versions of software can enable a software seller to charge higher prices; different models of motor vehicles are designed to achieve the same effect.
- **Offering convenience** – customers will often pay a little more for a product that they can have straightaway, or which saves them time.

A business that successfully adds value should find that it is able to operate profitably. Why? Remember the definition of adding value: where the selling price is greater than the costs of making the product.

By definition, a business that is adding substantial value must also be operating profitably.

Finding ways to add value is a really important activity for a start-up or small business. Quite simply, it can make the difference between survival and failure; between profit and loss.

The **key benefits to a business of adding value** include:

- Charging a **higher price**
- Creating a **point of difference** from the competition

- **Protecting** from competitors trying to steal customers by charging lower prices
- **Focusing** a business more closely on its target market segment

An example of added value

Consider what happens to the ingredients in a packet of Tyrrells Crisps.

Actually, Tyrrells call their crisps "potato chips". According to their website:

> *"We grow our own potatoes and turn them into great tasting, crunchy potato chips. We're in control from 'seed to chip', and that's what makes our chips deliciously unique."*

The main ingredient for a packet of potato chips is, unsurprisingly, potatoes.

So, how much **added value** is created by the production process, turning potatoes into crisps (sorry, chips)?

It is time to do some maths! We'll try to keep it simple!

Potatoes are sold by farmers at around £125 per metric tonne. That's 1,000 kg of potatoes, which equals around 12.5 pence per kilogramme.

What about a packet of Tyrrells crisps? The typical 50g grab bag of Tyrrells costs the retailer around 50 pence to buy (the consumer then pays about £1 per packet).

If there are 50 grams of potato in a bag, then the sales value of 1kg of Tyrrells crisps would be approximately : 50 x 20 x £0.50 = £500

So, for each tonne of potatoes, Tyrrells is turning something that they could sell for £125 into something they sell for £500.

The difference between £500 and £125 is not quite the total added value. Tyrrells has to take account of the other production costs (e.g. labour, energy, and other ingredients).

However, you can see how the production process of turning the humble potato into bags of premium-priced crisps is a good example of a business that is "adding value".

Franchising for Start-ups

The franchise approach

A business idea for a start-up doesn't 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.

That might sound a bit complicated! The trick is to remember that the **franchisor is in charge** - the franchisor is the original owner of the business idea.

Franchises are a significant part of business life in the UK:

- Franchises generated annual sales of £12.4 billion in the UK in 2007
- There are over 800 different franchised business formats in the UK and that number is rising by around 5% each year
- The average sales turnover per franchise outlet is £360,000
- 90% of franchises are reported to be profitable
- A franchise has average borrowings of £70,000, suggesting that banks are happier to make loans to franchise businesses than other start-ups
- The typical franchisee is aged 47. 66% are men and 86% of franchisees are married!
- Franchises are particularly popular in the service sector

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

- Subway
- McDonalds
- Starbucks
- Pizza Hut
- Thorntons
- Molly Maid
- Prontaprint

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 your own business – even if you are sharing the profits with 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 by 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**

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 (e.g. 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. So there is still a need for the entrepreneur to do market research into the franchise

A franchise is a kind of "halfway house" for a budding entrepreneur. It is a lower risk method of market entry 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.

Topic 1.2 Showing Enterprise

Section	Key Things to Learn
What is enterprise?	The meaning of enterprise Initiative and risk-taking What is an entrepreneur?
Thinking creatively	Sources of business ideas What makes a good business idea? Deliberate creativity
Questions an entrepreneur asks	Key questions for the start-up
Invention and innovation	Protecting an invention Success through innovation
Taking calculated risks	The risks of a business start-up Why start-ups fail Taking calculated risks Rewards from enterprise
Important enterprise skills	Skills needed to be an entrepreneur

What is Enterprise?

The meaning of 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…“Simon Cowell’s enterprise” or “Michelle set up her successful enterprise after leaving teaching”.

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

Look again at two key words above – **initiative and risk.**

A person who takes the **initiative** is someone who “**makes things happen**”. He or she tends to be decisive. A business opportunity is identified and the person does something about it. Showing initiative is about taking decisions and being bold – not everyone is like that!

Risk-taking is slightly different. In business there is no such thing as a “sure fire bet”. All business investments carry an element of risk – which is the **chance or probability** that things will go wrong. At the worst, the risk of an enterprise might mean the person making the investment loses all his/her money or becomes personally liable for the debts of the business.

The trick is to take **calculated risks**, and to ensure that the likely **returns** from taking a risk are enough to make the gamble worthwhile.

Someone who shows enterprise is an **“entrepreneur”.** So let’s look at that term next!

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 risk by starting a business

An entrepreneur is someone who is enterprising. In other words he/she:

- Takes the initiative in trying to exploit a business opportunity
- Takes time to understand and calculate the risks involved
- Makes an investment to set up the business
- Goes ahead, despite the risk that the business venture might fail

Thinking Creatively

Sources of business ideas

Where does an entrepreneur come up with the idea for his/her business? In practice there are many ways in which the business opportunity and idea is first spotted. As we shall see, sometimes luck plays a big part; at other times there is a role for approaches which encourage **deliberate creativity**.

Here are some of the main sources of business ideas for start-ups:

Business experience

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

- 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
- Industry contacts, who might then become the first customers of the start-up!

All of the above help the business planning process and you could argue that they reduce the risks of a start-up.

On the other hand, you might argue that "familiarity breeds contempt". In other words, detailed experience of an industry means that the budding entrepreneur doesn't have a fresh perspective. Someone who is new to a market may be able to exploit approaches that have worked in other industries to make an impact with the start-up.

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 products.

Hobbies and interests are also a rich source of business ideas, although you have to be careful to avoid assuming that, just because you have a passion for collecting rare tin 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 generates only a small contribution to household income.

Observation

Simply observing what goes on around you can be a good way of spotting an idea. Often an idea will be launched in another country and has not yet been tried in other, similar economies. When Stephen Waring was in the USA attending a wedding, by luck he 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. It has since become a hugely successful franchise business – Green Thumb.

It is worth looking at some other examples of how successful start-ups got their ideas in order to appreciate the diversity of sources. Here are some good ones:

Business	Entrepreneur	Where the Idea Came From
Glasses Direct	James Murray-Wells	James was fed-up with being charged "rip-off prices" for prescription glasses. He researched the supply chain and found he could offer consumers the same product at substantially cheaper prices by selling direct.
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.
Tyrrell's Crisps	Will Chase	Will needed to find an alternative use for the output from his loss-making potato farm. He added value to the potatoes by turning them into premium-priced crisps.
Superjam	Fraser Doherty	Fraser turned his grandmother's recipe for sugar-free jams into a best-selling grocery brand.
Beautiful Vending	Neil Mackay & Richard Starrett	Neil & Richard spotted the potential for grooming machines whilst working in entertainments industry.
Jo Jingles	Gill Thomas	Gill made a lifestyle choice to move out of the corporate world and set up her own business. She combined her personal interest in teaching music to children with an idea for a franchise format.

What makes a good idea?

Having an idea for a business is the easy bit. It is much harder to work out whether the idea has potential.

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

- They solve a problem
- Offer a cheaper or better way of doing things than existing products 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

Deliberate creativity

An entrepreneur is always on the look out for a business opportunity – the thinking process takes place constantly.

However, it can also be argued that a formal process of creative thinking can also help someone set up a new business. This is often referred to as "**deliberate creativity**".

Here are some of the models or approaches to deliberate creativity which might be used by a start-up:

Blue skies thinking:

This is a kind of brainstorming in which the thinking process allows no limits in what is suggested and no preconceptions about what the answer might be. Blue skies thinking encourages contributors to throw in as many ideas as possible. Only when the flow of ideas has stopped does the process go on to consider which ideas might have commercial potential.

Lateral thinking

Originally created by Edward De Bono, lateral thinking is about reasoning that is not immediately obvious and about ideas that may not be obtainable by using only traditional step-by-step logic. Lateral thinking is sometimes called "thinking outside the box" – it tries to come up with new and unexpected ideas.

Six thinking hats

Another approach to creative thinking from De Bono - this is a thinking tool for group discussion and individual thinking.

The approach identifies six types of styles of thinking which can be used to come up with ideas and focus the group on good ideas:

Neutrality (white Hat)	Considering purely what information is available, what are the facts? Quantitative data on a market (e.g. sales, existing products) would be considered with this hat on.
Feeling (red hat)	Instinctive gut reaction or statements of emotional feeling (but not any justification). Many entrepreneurs rely on their instinctive or gut feel with their business idea.
Negative judgement (black hat)	Logic applied to identifying flaws or barriers, seeking mismatch. The black hat encourages the entrepreneur to think about the things that might go wrong with an idea.
Positive Judgement (yellow hat)	Logic applied to identifying benefits. This is the opposite of the black hat – what are all the positives or upsides from the idea. What is the best that might happen?
Creative thinking (green hat)	Statements of provocation and investigation, seeing where a thought goes. This is the hat which encourages lateral thinking.
Process control (Blue hat)	Thinking about thinking. The blue hat encourages the entrepreneur to consider and evaluate the ideas coming from the other five hats!

Questions an Entrepreneur Asks

Key questions for a start-up

An entrepreneur start-up up a business for the first time is faced by much uncertainty.

It is worthwhile taking a questioning approach to the start-up process so that the key risks are identified and managed.

However, on the other hand, an entrepreneur needs to be wary about taking too long over these questions. It is usually better to be decisive rather than dither over questions which may not be too important.

Amongst the key questions that an entrepreneur should certainly consider are:

- Do I have a clear idea about the vision for the business?
- Am I really determined and committed to making the business work?
- Do I appreciate and accept the personal challenges and sacrifices that I will have to make?
- Can I handle the inevitable feeling of isolation and insecurity that a start-up brings?
- Can I afford to fail? What are the financial implications if the business does not succeed?
- Will customers really buy the product, assuming that I get it right?
- Who already provides this product (or something similar) and can I do it better or cheaper?
- How will I know if the business is succeeding or failing?
- Is my business plan sufficiently realistic, particularly in terms of cash flows and likely start-up losses?
- Can I access the resources (cash, supplies, distribution) that are needed to make the idea work?
- Do I need to obtain legal protection for the idea?

Innovation & Invention

Invention

An invention is something genuinely new – something that has not been done before. It could be a substance, a product, a process etc.

Many of the entrepreneurs who climb the steps leading up to the Dragon's Den believe that not only is their "invention" unique, but that it also has great business potential. Several questions usually follow from the Dragons:

- Is the invention really an original idea?
- Have any already been sold (i.e. is there any evidence of demand?)
- Can it be, or has it been protected by patents to prevent competitors from copying it?

Inventions arise after a period of research – often taking many years. The research process is usually costly, both in terms of cash spent and time taken. So it seems reasonable that a genuine invention should be capable of protection. For an invention, the protection comes from a "**patent".**

A common question asked of applicants on Dragons Den is "have you got patent protection"? However, there are some strict rules that must be applied in order for a patent to be granted. In order for a patent to be granted, the invention must be:

(1) New

(2) Be an innovative step (i.e. not obvious to other people with knowledge of the subject)

(3) Be capable of industrial application (i.e. it can be made and used!)

(4) Not be excluded (certain types of invention don't count - e.g. scientific theories, artistic creations)

If granted, a patent gives the owner the right to take legal action against others who try to take commercial advantage of the invention without getting the permission of the patent owner. A patent can last for up to 20 years.

A key benefit of a patent is the ability of the patent owner to "licence" the right to use the invention. For example, a patent owner could grant a larger manufacturing business the right to use the idea in a product, in return for a royalty.

Innovation

Inventing something new is one thing. But making it commercially viable is quite another. That is where **innovation** comes in. Innovation is about **putting a new idea or approach into action**.

Innovation is commonly described as **'the commercially successful exploitation of ideas'.**

Successful innovation is mainly about creating or **adding value**. It does so either by:

- Improving existing goods, processes or services (**process innovation**), or by
- Developing goods, processes or services of value that have not existed previously (**product innovation)**

However, both kinds of innovation require a business to:

- Challenge the status quo
- Have a deep understanding of customer needs
- Develop imaginative and novel solutions

Innovation can come in many forms:

- Improving or replacing business processes to increase efficiency and productivity, or to enable the business to extend the range or quality of existing products and/or services
- Developing entirely new and improved products and services - often to meet rapidly changing customer or consumer demands or needs
- Adding value to existing products, services or markets to differentiate the business from its competitors and increase the perceived value to the customers and markets

Whatever form it takes, innovation is a **creative process**. The ideas may come from:

Inside the business – e.g. from employees, in-house designers, sales staff

Outside the business, e.g. suppliers, customers, media reports, market research insights or from contacts at local universities or other research organisations

Successful innovation comes from filtering those ideas, identifying those that the business will focus on and applying resources to exploit them.

- The benefits can be significant, including:
- Improved productivity & reduced costs
- Building a brand
- Establishing an advantage over competitors
- Higher sales and profits

Taking Calculated Risks

Risks of a business start-up

What is risk? **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. a "dead-cert") then we'd all do it. The bad news for entrepreneurs is that investing in a start-up 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 savvy start-ups use private limited companies as their form of business organisation).

Another risk is that a failed business will leave the entrepreneur struggling to finance another business or getting a normal job.

And yet another risk is the stigma of failure itself. There is no reason why people should be ashamed of failing in business, but in reality they are.

Taken together, you can see why these risks are often the motivation for an entrepreneur to keep going, even when the business is struggling badly. When you are "risking it all" then you put heart and soul 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 you can learn from and avoid these mistakes, then the new business has a greater chance of survival and success.

Here are the main reasons why new businesses fail:

Poor management	Plain and simple. Poor decisions are taken; costs are not kept under control; management don't understand their market & customers well enough and offer a poor quality product
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. Alternatively the amount is under-estimated. This is a big concern at the start-up stage, where finance is limited. A delayed product launch is often the cause of start-up cost overruns.
Unexpected shocks	These can come in various forms – e.g. the floods in the UK during 2007 or the Swine Flu pandemic in 2009

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, or the customer itself fails, then the business is at risk.
Poor quality	This is linked to poor management. Persistent poor quality products or services will ultimately kill a business.
Overtrading	Sometimes a small business can grow too quickly and, as a result, it runs into serious cash flow problems. A business whose sales grow rapidly might find that customers take too long to pay their debts, whereas stocks build and suppliers demand payment on time. The result can be a business which appears to be successful and profitable, but which runs out of money.

Taking a calculated risk

An entrepreneur cannot avoid risk in a start-up and everyone knows that a large proportion of new businesses eventually fail. The trick is to assess:

- What the main risks are in a new business (e.g. unexpected costs, lower than expected sales, failure to secure distribution)
- The **probability** of the risks happening (this has to be an estimate)
- What would happen if the risks occur – cost, cash etc

The third part of the assessment above is perhaps the most important. For the small business, often starved of cash, even a relatively small event can prove disastrous. The entrepreneur has to assess the potential impact on the business of a risk, but also assess the **upside** (where things turn out to be better than expected).

So, a calculated risk can be defined as follows:

"A risk that has been given thoughtful consideration and for which the potential costs and potential benefits have been weighted and considered"

Entrepreneurs take calculated risks everyday, since they take decisions everyday. Each time they take a decision they are weighing up the significance of the options and (often intuitively) working out whether to go ahead.

Rewards from enterprise

That's enough about the negative side of setting a business up. What about the rewards?

We looked earlier at the motivations for setting up a business. Many of the **intangible rewards** that arise from being in business happen because these motives are achieved.

- A sense of satisfaction
- Building something
- Being in control
- Making that first sale
- Opening a new location

- Employing more people
- Getting an industry award or good publicity
- Getting great feedback from customers

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

However, ultimately, it is the financial rewards that justify the effort and make taking the risk worthwhile.

To illustrate the potential financial rewards, here are some examples:

- Karen Darby sold her business SimplySwitch, a service allowing consumers to compare rates for gas and electricity suppliers among other things, to the Daily Mail for £22million
- Linda Bennett, one of Britain's most successful female entrepreneurs, sold her women's fashion chain, LK Bennett, to two venture capitalists for £70million
- Gerry Pack started up his business Holiday Extras providing airport hotel rooms and parking with just £100. He sold it in 2005 for £43million
- Darren Richards started up his online dating agency (DatingDirect.com) with just £2,500 and sold it eight years later for £30million

You should also remember that there is a strong tradition of entrepreneurs who have built and sold one business for a substantial amount going onto build other successful businesses. They never lose the entrepreneurial buzz. Such people are called "**serial entrepreneurs**".

Important Enterprise Skills

Skills needed to be an entrepreneur

The personal characteristics of successful entrepreneurs are well-described in many books and articles on start-ups. Characteristics such as resilience, determination, persistence and energy are seen as key.

But what about the specific skills that are important to success? Here are some of the main ones:

Planning and thinking:

A thoughtful business plan and taking time to anticipate potential problems and market changes are both examples of good planning and thinking. An entrepreneur is always thinking about whether he/she has “covered the risks” in the existing business and has spotted the new opportunities.

Decision-making:

Indecisiveness in business can be fatal – there is rarely room for an entrepreneur to be a ditherer! If a project or product is losing money and shows no signs of being turned-around, then it should be ditched. Business decisions should be taken on the basis of the best-available information – but the important thing is that decisions are taken!

Making connections:

Using tools like mind-maps and other thinking and planning approaches are good ways to ensure that the entrepreneur has considered all the issues.

Showing leadership:

This is associated with personal characteristics such as persuasiveness, drive and determination. An entrepreneur often needs to show leadership in order to “bring people” with him/her. Staff may need to be persuaded to join a business that looks risky, as do suppliers and finance-providers.

Topic 1.3 Putting a Business Idea into Practice

Section	Key Things to Learn
Objectives of a new business	Financial and non-financial motives for starting a business Social enterprise
Qualities of an entrepreneur	Role of entrepreneurs Key characteristics of successful entrepreneurs
Revenues and demand	Calculating revenue Factors that affect demand Problems with estimating revenues Achieving repeat business
Costs	Types of cost Problems estimating costs
Profit	Meaning and importance of profit Handling a loss
Forecasting cash flows	What is cash flow? Main cash inflows and outflows in a small business Why start-ups suffer from cash flow problems Role and importance of a cash flow forecast Actions to improve cash flow
The business plan	What is a business plan Benefits of business planning What the business plan should include and cover
Obtaining finance	Key choices when raising finance for a start-up Main sources of finance for a small business Why use personal sources to fund the start-up

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Objectives of a New Business

What motivates someone to become an entrepreneur?

Money of course! The chance to earn significant profits, buy a yacht, take numerous holidays, buy designer goods and send the kids to the best private schools.

But, wait a minute! Is money and personal wealth really the main motivation?

Evidence suggests that there are many more reasons why someone wants to start a business.

Every business starts small. But by taking on some calculated risks, a lot of determination and 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 media tend to focus on the financial objectives – so let's deal with these first.

Financial objectives

Most business start-ups begin with one main financial objective – to **survive.**

Why survival? Because a large percentage of new businesses do not survive much beyond their launch. The entrepreneur discovers that the business idea is not viable – the business cannot be run profitably or it runs out of cash. Start-ups have a high **failure rate.**

Survival is about the business living within its means. To survive, the business needs to have enough cash to pay the debts of the business as they arise – suppliers, wages, rent, raw materials and so on. To survive, a business needs to have:

- Sufficient **sources of finance** (e.g. cash, a bank overdraft, share capital)
- A **viable business model** – i.e. one which can make a **profit**

If survival can be assured, then **profit** is the next most important financial objective for a new business. A profit is earned when the **revenue of the business exceeds the total costs.** The entrepreneur can choose to reinvest (aka "retain") the profit in the business, or take it out as a personal payment or dividend.

For many small business owners, profit is the **return** for all the hard work and **risks** taken. Profit is the **reward** for taking a risk and making an investment. Ideally, the profit earned is sufficient to provide the entrepreneur with enough income to live. In many cases it will be more than sufficient, once the business has been trading successfully for a few years

However, it is important to appreciate that, to make a **sustainable** profit, a new business needs to be able to:

- Add value

- Sell into a large enough market

Another financial objective is **personal wealth**. Some entrepreneurs have an objective that goes beyond wanting to earn an adequate income. They aim to build a valuable business that can substantially increase their personal wealth.

Non-financial objectives

Contrary to popular belief, starting a business is not always about financial objectives. Very often a new business is started with other, non-financial objectives in mind.

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

- **More control over working life** – want to choose what kind of work is done. The need for greater **independence** is a major motivator.
- **Need 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
- Feel that **skills are being wasted** and that potential is not being fulfilled
- Want to **escape** an uninteresting job or career
- A desire to pursue an **interest or hobby**
- Fed up with being told what to do – **want to be the boss!**
- Want the feeling of **personal satisfaction** from building a business
- Want a greater **share of the rewards** from the effort being put in – compared with simply being paid by an employer
- **Fed up** with working in a business hierarchy or bureaucratic organisation (people with entrepreneurial characteristics often feel stifled working and having to co-exist with others!
- As a response to a shock or other **major change in personal circumstances** – e.g. redundancy, divorce, illness, bereavement

Social enterprise

One kind of business structure that has grown rapidly in the UK in recent years is the “social enterprise”. Social enterprises are the most common form of “**not-for-profit”** enterprises.

The clue in the phrase “**not-for-profit**” tells you much about the **aims and objectives** of social enterprises. However, it is important to appreciate that a social enterprise is not a charity.

Social enterprises are defined as:

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

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

Social enterprises complete alongside other businesses in the same marketplace, but use business principles to achieve social aims.

A few things all social enterprises have in common are:

- They are directly involved in producing goods or providing services
- They have social aims and ethical values
- They are **self-sustaining**, and do not rely on donations to survive (i.e. they are not charities)

Well known examples of social enterprises include Divine Chocolate, the Eden Project and fair-trade coffee company Cafedirect.

Recent government data suggests that there are more than 55,000 social enterprises in the UK with a combined turnover of £27bn. Social enterprises account for 5% of all businesses with employees, and contribute £8.4billion per year to the UK economy.

Qualities of an Entrepreneur

Introduction

In recent years the media have glamorised 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 they made it", "my first million" etc. Prime-time television shows such as Dragons Den, Risking it All and The Apprentice have proved hugely popular by showcasing the challenges faced in setting up a business. 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.

Entrepreneurs play an important role in society. They make a major contribution to **economic activity**. Imagine how many jobs are created by the thousands of new businesses that are set up every year and by the small businesses that prosper and take on more staff.

Entrepreneurs encourage **innovation** through investment and **risk-taking**. Many of the products and services you use every day have been developed through entrepreneurial activity rather than in the research laboratories or board-rooms of large multinationals.

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

Entrepreneurs take on the **challenge of starting and growing a business**. What characteristics are required to help them succeed?

Not surprisingly, much research has been done to examine the personality and other characteristics of successful entrepreneurs to see if there is a proven method or route to success. You will find many lists of "what is takes to be an entrepreneur", but they tend to say the same things. So here is a summary of the key findings!

Key characteristics of successful entrepreneurs

Successful entrepreneurs tend to have one or more of the following characteristics:

- **Passionate** about their product or service and about getting things right for the customer
- **Visionary** – they have faith in what they are trying to do. They tend to not get too bogged down in the fine detail of day-to-day business
- **Energetic and driven** – prepared to work consistently long hours, especially in the early stages
- **Self-starting and decisive** – they don't wait for others to take decisions. Entrepreneurs tend to take the **initiative,** spotting opportunities early and taking decisions quickly
- **Calculated risk-takers** – not reckless; they are prepared to take a risk in order to maximise the rewards

- **Multitasker** – able to take on more than one role (product development, selling, recruitment)
- **Resilient and determined** – able to handle problems and overcome hurdles. Setting up a business is difficult and time-consuming
- **Focused** – sets clear goals and self-imposed high standards
- **Results-orientated** – take pleasure from achieving targets and setting the bar higher. Entrepreneurs tend to set **clear objectives** for their business which then feed into relevant **business planning**
- **Persuasive –** entrepreneurs are good at bringing other people and businesses "along with the idea"; persuading suppliers to supply a new business, or an employee to leave a current job and join the start-up
- **Leadership –** an entrepreneur leads his or her own business (often working alone in the early stages). As the business develops, the skills of leading others become even more important
- **Lucky –** not to be laughed at! Every business needs some good luck – e.g. being in the right place at the right time. But remember the advice of a well-known golfer – "the harder I practice, the luckier I get"

The important thing to remember about the list above is that an entrepreneur is unlikely to possess all these characteristics!

Anyone who starts a business has strengths and weaknesses. However, the savvy entrepreneur recognises where his/her weaknesses lie and takes steps to address them (e.g. recruit someone with the right skills).

Revenues and Demand

Revenue

A business exists to provide goods and services. Those products are sold to customers. When a customer buys a product, that transaction becomes a sale for the business. That's what businesses do – they make **sales**.

The value of sales made is the **revenue** of the business.

You will come across some different ways of describing sales. Alternative terms for "sales" include:

- Revenue (the official accounting term)
- Income
- Sales turnover
- Takings (often used by retailers)

So we know that sales arise through the **trading activities** of a business. How are sales measured?

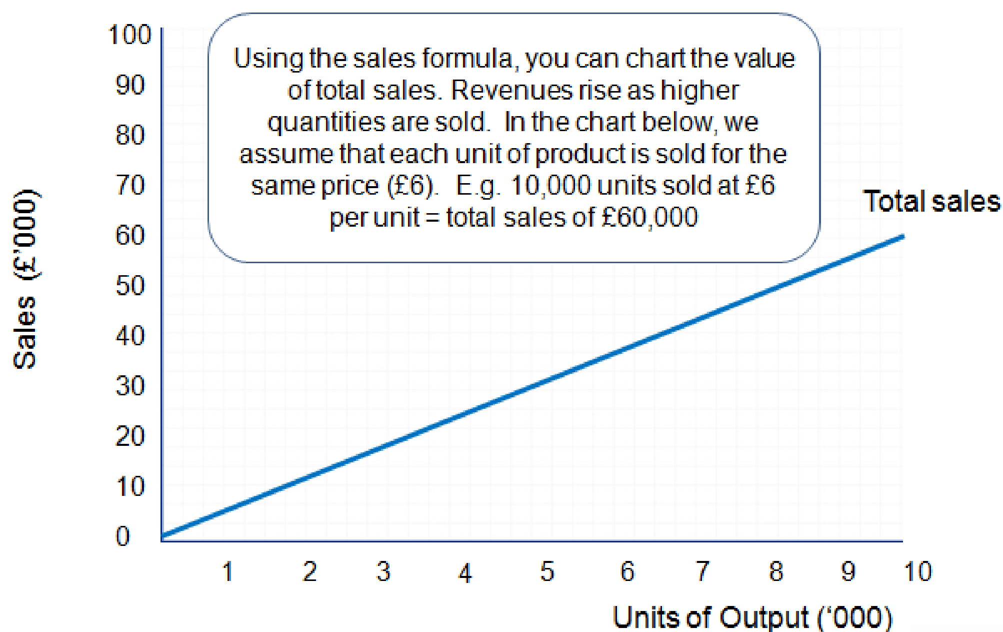
The value of revenue in a given period is a function of the **quantity** of product sold multiplied by the **price** that customers paid. Total revenue can be calculated by this formula:

Total revenue = volume sold x average selling price

A business that wants to increase revenue needs to either:

- Increase the amount or volume sold (higher quantity),
- Achieve a higher selling price,

Or (ideally) both of the above!



Calculating revenue

To see how the revenue formula works, let's look at an example.

Sheila runs a web design business. Her budgeted revenue for next year is as follows:

Quarter	Number of jobs	Average value per Job	Total revenue
Jan-Mar	6	£2,500	£15,000
Apr-Jun	7	£2,500	£17,500
Jul-Sep	5	£3,000	£15,000
Oct-Dec	8	£2,750	£22,000
Total	26	£2,673	£69,500

In the example above, Sheila is budgeting to achieve total revenues of £69,500. These sales come from a total of 26 jobs, with an average selling price per job of £2,673.

How might Sheila do better than her estimated revenue for next year?

Winning more jobs might help, although 26 jobs already looks a lot of work. Sheila may find it hard to handle higher sales volumes, unless she is able to raise capacity by employing extra designing or outsourcing elements of the work.

In Sheila's case, the solution to higher sales can probably be found in the average selling price achieved. By focusing on smaller number of higher-value jobs, Sheila may be able to increase revenues and deliver a better service.

For example, if Sheila did just 20 jobs next year (6 fewer than budget) at an average price of £4,000 per job, then her total revenues would be £80,000 (20 x £4,000), an increase over the existing sales budget of £10,500.

Demand

Demand is defined as:

The amount (quantity) that customers are prepared to buy at a given price

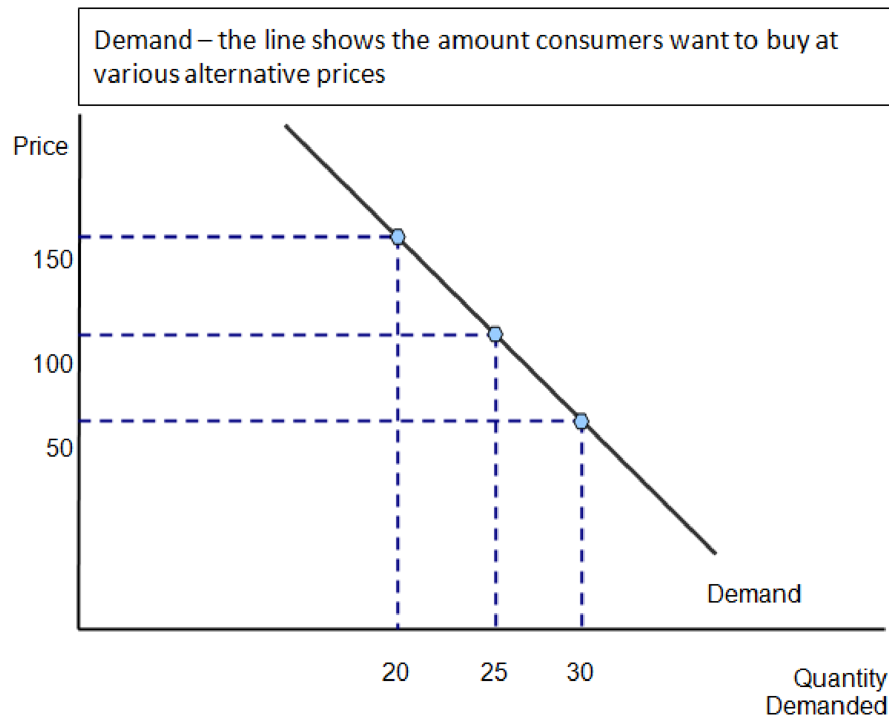
As customers, in an ideal world we would be able to buy whatever we wanted. However, we are restricted by a simple problem – we don't have unlimited money!

So, economists often prefer to talk about "**effective demand**" – which means the quantity that customers **are able to buy.**

Effective demand is all about the **ability and willingness of customers to pay** – or how much they can afford.

Normally, the quantity demanded for a product will increase if the price falls. Conversely, an increase in price will normally lead to a fall in quantity demanded.

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



Factors that affect demand

The demand for a product will be influenced by several factors:

Price	The most important factor that affects demand. Products have different sensitivity to changes in price. For example, demand for necessities such as bread, eggs and butter does not tend to change significantly when prices move up or down
Income levels	When an individual's income goes up, their ability to purchase goods and services increases, and this causes demand to increase. When incomes fall there will be a decrease in the demand for most goods
Consumer tastes and preferences	Can have a significant effect on demand for different products. Persuasive advertising is designed to cause a change in tastes and preferences and thereby create an increase in demand. A good example of this is the surge in sales of smoothies!
Competition	Competitors are always looking to take a bigger share of the market, perhaps by cutting their prices or by introducing a new or better version of a product
Fashions and technology	When a product becomes unfashionable or out-dated, demand can quickly fall away. The rapid decline in sales of Crocs is a great example

Problems with estimating revenues

One of the hardest tasks an entrepreneur faces with a start-up business is coming up with a realistic estimate of revenues. The main problems concern the uncertainties about:

- **The size of the available market** – how much do customers already spend in the market? Not every market is well researched, particularly those which do not involve retailing or which are not covered by official statistics.
- **The price that customers will be prepared to pay for a new product**. A new business will often assume that customers will pay a higher price than they actually will. A new product into a market often has to be offered at a discount (lower price) in order to encourage customers to buy for the first time
- **The timing and source of sales:** where will customers buy and which methods will they use (e.g. from a physical store, marketing leaflet or online store?)
- **The effectiveness of marketing activities** – by definition, new businesses start without an established customer base. Launch marketing activities often do not generate the excitement and customer buzz that is intended!
- **The response of competitors** – how will they respond to a new challenger entering the market? A start-up business cannot expect to enter a market without a challenge from the existing operators.

In general, experience shows that start-ups tend to **overestimate** their expected revenues in the first year or two.

Achieving repeat purchase

A business invests a lot of effort and cash in trying to get a customer to purchase a product for the first time. This is known as **product trial**. Much advertising is aimed at encouraging customers to try a new product, or switch from an existing competitor.

After a new product has been tried once, its success can be measured in how quickly, how often, and in what quantity it is repurchased. **Repeat purchase** refers to the number or percent of customers who purchase a second time, or to how often they buy again.

The problem with advertising is that it is very expensive. A business is unlikely to be successful and profitable if it has to keep advertising heavily in order to generate demand from new customers. It is much better if customers can be encouraged to become loyal to the product – even better, to recommend the product to their friends and family!

Achieving a high level of repeat purchase is good news for a business. So what is required?

Firstly, the product should be of the right quality. A sub-standard or low quality product is sure to disappoint first-time customers. They are unlikely to buy again or recommend the product to others.

Secondly, a business should do all it can to develop an effect relationship with existing customers. This includes activities such as:

- Regular communication (e.g. email newsletters)
- Incentives for loyalty (e.g. promotional discounts)
- Research into customer needs and wants (e.g. through customer surveys)

Costs

What are costs?

Costs are the amounts that a business incurs in order to make goods and provide services. Every business incurs 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. However, researching the likely costs of the business is very important.

In fact, successful entrepreneurs are usually obsessed with costs. In most cases they want to ensure that costs are kept as low as possible. They run a very "tight ship". Entrepreneurs will want to know:

- What it costs to produce the product or service?
- What the cost of marketing the product is?
- How high are the overheads of the business?
- What the potential costs of a business decision are?

Why the obsession with costs? Because costs:

- Are the thing that drains away the profits made by a business
- Are the difference between making a good and a poor **profit margin**
- Are the **main cause of cash flow problems** in a small business
- Change as the output or activity of a business changes – the entrepreneur needs to know how these are likely to change

A good starting point is to consider the difference between the two main types or categories of cost, namely:
Fixed costs – costs which do not vary with output
Variable costs – costs which change as output changes

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 & council tax
- Wages and salaries
- Marketing (advertising, market research)
- Insurance, banking & legal fees
- Software
- Consultant and adviser costs
- Design and development
- Heating, light and other energy costs

- Leased equipment charges

Note – just because a cost is classified as "fixed", that does not mean that the cost will stay the same.

For example, the rental of an office or shop will be paid to the landlord. The rent stays the same for a specific period (e.g. 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. A business needs to generate enough **contribution** (a kind of profit) to cover its fixed costs in order for it to break-even.

The higher the level of fixed costs in a business, the higher must be the achieved output in order to break-even.

As a result, a good strategy for most start-ups is to focus on controlling and minimising fixed costs.

Variable costs

Costs which change when output changes are called **"variable costs"**

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

- Raw materials & bought-in stocks and components
- Wages based on hours worked or amount produced
- Marketing costs based on sales (e.g. % discounts offered on a sales price)
- 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 fixed costs.

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

Let's look at an example: Graham's van repair business has the following costs and sales output for March:

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

What are the total costs for March?

Start with the variable costs, which equal £75 x 100 (i.e. VC per job times the number of jobs) = £7,500

Fixed costs total £2,500 (i.e. £500 + £1,500 + £100 + £400)

So total costs are £10,000 (i.e. VC + FC or £7,500 + £2,500)

Problems estimating costs

A business start-up is faced with the challenge of estimating what the costs of setting up and operating the business will be. It is not always easy.

Some costs are pretty straightforward to estimate – most of them are in the "fixed cost" category.

For example, a business that rents its location (e.g. a shop unit, a room in a shared office complex) will know what the cost will be. It is easy to get a quote from the landlord before signing the lease.

Some basic market research will soon tell the entrepreneur what it will cost to design, print and distribute some marketing leaflets. A call to the newspaper or Yellow Pages will quickly get a quote for the fixed costs of an advertising campaign.

Wages and salaries are also pretty easy to estimate. The entrepreneur knows what he or she is prepared to pay and the actual amount will be agreed in the employment contract. An entrepreneur can control hourly wages by restricting the amount of overtime available.

It is with variable costs that estimation becomes a bit harder. It is easy to get quotes for the price that has to be paid for raw materials and components. However, it might be that the business does not operate efficiently – for example suffering a high degree of waste. That would increase the average cost per unit produced.

Another problem comes when an entrepreneur enters a market in which he/she has little or no experience. For example, the business may discover that there are hidden marketing costs (e.g. commissions) which need to be taken into account. Sometimes the start-up business plan simply misses out a cost category due to inexperience or lack of care in putting the plan together.

Profit

Meaning & importance of profit

Profit is a very important concept for any business – particularly a start-up

Profit is the financial **return** or **reward** that entrepreneurs aim to achieve to reflect the **risk** that they take.

Given that most entrepreneurs **invest** in order to make a return, the profit earned by a business can be used to 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 very 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 (i.e. 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. So here is the formula:

PROFIT = TOTAL SALES less 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)
Total sales greater than total costs Total costs greater than total sales Total sales = total costs		= Profit = Loss = Break-even

How profit is used

Profit arises when total sales exceed total cost for a period.

Once a profit has been made, the owners of the business have a choice:

(1) Take the profit out of the business (e.g. pay a dividend to shareholders)

(2) **Retain** the profit in the business – either in cash or by investing the profit into new assets

Most entrepreneurs reinvested or "retain" profits in a business. Why?

Profit is the most important source of finance for a business. It is defined as being an "internal source" in the sense that it is generated from within the business.

Why is profit important as a source of finance? Because it is entirely within the control of the business – it is not provided by outsiders.

Another reason is that retained profits are relatively cheap. They do have a cost – which is the return that the business owners could obtain by taking the money out of the business. However, the true cost of retained profit is much less than paying interest on a bank loan or overdraft.

What can profit be reinvested in? Essentially to help the business grow: e.g.

- Additional production capacity
- Investment in information technology
- To buy more stocks of raw materials and components

The alternative use for profit is to pay it as a reward or return to the business owners. For shareholders in a company, this method is known as a dividend.

A dividend provides a shareholder with one part of his/her return on investment.

The second part of the return comes when the value of the shares in the company increases.

Handling a loss

A **loss** arises when **total costs are more than total revenues in a period.**

Over time, losses generally result in a **cash outflow** from a business. If the business does not have sufficient sources of finance to fund these losses, then it will not survive.

It is important to remember that losses are fairly common in business – particularly for start-ups or for businesses that are investing in a new product or market.

It is often the case that a business has to incur substantial costs (e.g. research, design, promotion) before it is able to generate revenues for a new business or product.

However, sustained or substantial losses place a business in trouble. A high proportion of start-ups go out of business because they fail to reach profitability. In other words, they do not manage to reach the **break-even** output.

Why might a business experience a loss when the business plan or budget expected a profit? The main reasons are:

- Revenues are lower than expected (the most likely) – entrepreneurs tend to be over-optimistic with their forecasts for revenues

- The business proves to be less productive or efficient than planned – e.g. it suffers from a higher degree of wastage during production, or suffers from too much capacity
- Unexpected costs arise – ether costs that were not planned at all (e.g. a customer or supplier dispute) or where costs turn out to be much higher than expected
- The business suffers from unexpected changes outside its control – e.g. a rise in bank interest rates, a sudden change in consumer confidence, poor weather

The response to a loss should include:

- Reviewing the profit and cash flow forecasts to ensure that the business has sufficient cash to remain viable
- Looking at all major cost categories to see where savings can be made which do not damage revenues
- Renewed marketing activities to boost revenues – particularly in the short-term if cash flow is a problem

Forecasting Cash Flows

Cash flow

Cash flow describes the movements of cash into and out of a business

When you look at the bank statement of any business, you soon realise that cash flow is a dynamic and often unpredictable part of business life.

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:

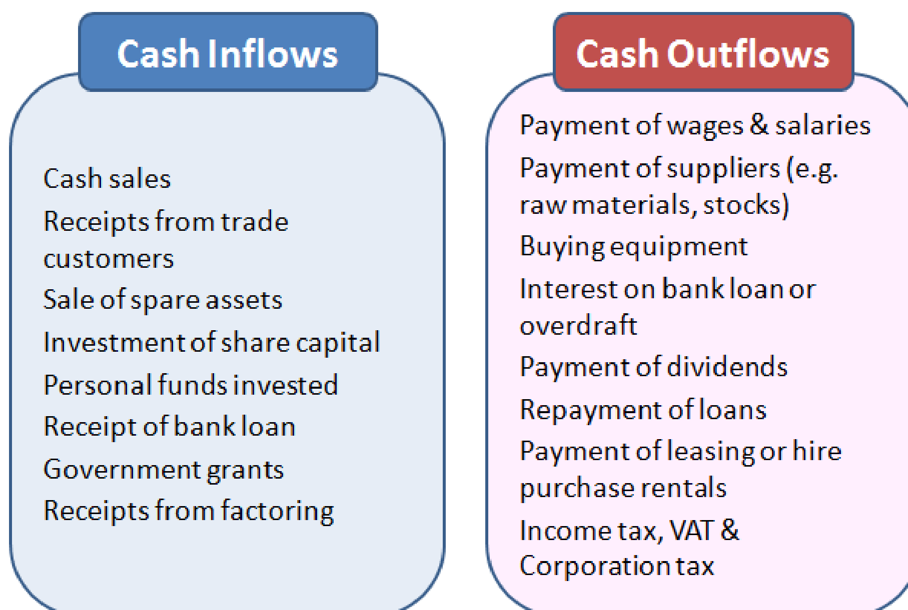
- **Cash inflows:** movements of cash **into** a business
- **Cash outflows:** movements of cash **out of** the business

The difference between the **cash inflows** and **cash outflows** during a specific period (e.g. a week, month) is known as the **"net cash flow".**

The challenge for any business (particularly a start-up) is to ensure that it manages its net cash flow to ensure that it does not run out of money.

Main types of cash inflow and outflow

The main types of cash flow can be summarised as follows:



Why start-ups suffer cash flow problems

Start-ups and small businesses are especially vulnerable to cash flow problems. Here are some of the main reasons:

Firstly, it takes time before the business makes its first sales – the **pre-trading period** often involves incurring costs without getting any revenue in return.

For example, before it can begin to trade, a new shop has to pay for:

- Shop-fitting and merchandise to fill the shelves (stocks)
- The initial rent of the shop (note – it might be possible to negotiate a rent-free period)
- The wages of shop staff to get the store ready for trading

Suppliers may also demand immediate or early payment from the start-up as the business has not developed a track record for paying bills on time.

A new business usually has to spend up-front on expenses such as marketing and product development. The development phase of coming up with a new product may take some time – research, design, testing and similar activities all consume cash without generating any revenues.

Finally, the new business will not have reserves of cash built up from profitable trading – an important source of cash known as "**retained profits**".

During the early months of trading, therefore, a start-up business faces its most significant challenges in managing cash flow. Without careful management and planning of cash, the business may run out of money. You can probably see why cash flow problems are a major cause of business failure amongst start-ups.

The cash flow forecast

The cash flow forecast **predicts** the net cash flows of the business over a **future period.**

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 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	Jan	Feb	Mar	Apr	May	Jun
Cash at start of month	25	20	15	5	10	20
Cash inflows	20	25	20	15	20	25
Cash outflows	25	30	30	10	10	20
Net cash flow	-5	-5	-10	5	10	5
Cash at end of month	20	15	5	10	20	25

A business uses a cash flow forecast to:

- Identify potential shortfalls in cash balances – for example, if the forecast shows a negative cash balance then the business needs to ensure it has a sufficient bank overdraft facility
- See whether the trading performance of the business (revenues, costs and profits) turns into cash.
- Analyse whether the business is achieving the financial objectives set out in the business plan (which will almost certainly include some kind of cash flow budget)

Why the cash flow forecast is so important

If a business runs out of cash and is not able to obtain new finance, it will become **insolvent**. It is no excuse for management to claim that they didn't see a cash flow crisis coming.

So in business, "cash is king". Cash flow is the life-blood of all businesses – particularly start-ups and small enterprises. As a result, it is essential that management forecast (predict) what is going to happen to cash flow to make sure the business has enough to survive.

Here are the key reasons why a cash flow forecast is so important:

- **Identifies 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
- **Makes sure that the business can afford to pay suppliers and employees.** Suppliers who don't get paid will soon stop supplying the business; it is even worse if employees are not paid on time
- **Spot problems with customer payments** – preparing the forecast encourages the business to look at how quickly customers are paying their debts. Note – this is not really a problem for businesses (like retailers) that take most of their sales in cash/credit cards at the point of sale
- **As an important discipline of financial planning** – the cash flow forecast is an important management process, similar to preparing business budgets
- **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 cash flow forecasts at regular intervals

Main causes of a cash flow problems

A **cash flow problem** arises when a business struggles to pay its debts as they become due.

Note that a cash flow problem is not necessarily the same as experiencing a cash outflow. A business often experiences a net cash outflow, for example when making a large payment for raw materials, new equipment or where there is a seasonal drop in demand.

However, 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 production capacity. Factory equipment which is not being used does not generate revenues – so is often a waste of cash
Too much stock	Holding too much stock ties up cash and there is an increased risk that stocks become obsolete (i.e. it can't be sold)
Allowing customers too much credit	Customers who buy on credit are called "trade debtors" Offering credit to customers is a good way to build 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 them

Taking action to improve cash flow

The best way to improve cash flow is to have a reliable and up-to-date cash flow forecast. This provides the information which highlights the main cash flow issues.

In terms of actions which management can take, here are the main options:

Cut costs – by far the most important method of improving cash flow. Every business can identify savings in non-essential costs if it looks hard enough. The recent credit crunch and recession has proved that businesses can take drastic actions to cut overheads and other costs, which immediately reduces cash outflows.

Cut stocks: reduce the amount of cash tied up by buying and holding raw materials or goods for resale. This can be done by (a) ordering less stock from suppliers and/or (b) offering discounts on stocks held to encourage customers to buy (ideally for cash).

Delay payments to suppliers – a dangerous game, but widely used in business. By taking longer to pay bills owed, a business can reduce cash outflows (at the risk of damaging relationships with suppliers though).

Reduce the credit period offered to customers – this is easier said than done. By asking customers to pay for their purchases quicker, a business can accelerate cash inflows. However, there is no guarantee that customers will agree. They may need to be given a financial incentive, such as a prompt-payment discount.

Cut back or delay expansion plans – many of the biggest cash outflows occur when a business is expanding (e.g. opening new offices or shops, adding a production line or factory). By delaying this expansion, cash can be conserved in the short-term.

The Business Plan

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.

Benefits of business planning to a start-up

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

- Provides a focus on the business idea - is it really a good one, and why?
- Producing a document helps clarify thoughts and identify gaps in information
- The plan provides a logical structure to thinking about the business
- It encourages the entrepreneur to focus on what the business is really about and how customers and finance-providers can be convinced
- It helps test the financial viability of the idea - 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 - particular investors and banks

Questions a start-up business plan should answer

A business plan needs to address the issues of interest to the reader and user.

Assuming that the plan is meant to be read by potential finance providers (e.g. a bank, business angel or venture capitalist) then it ought to provide **convincing and realistic** answers to questions such as:

- What is the business idea or opportunity?
- What is the product and how is it different or unique?
- What is the target market segment and who are the potential competitors?
- How large is the target market and is it growing?
- Who are the customers; how much will they buy and at what price?
- What will it cost to produce and sell the product?
- Can the product be made and/or sold profitably?
- At what stage will the business break-even and what are the likely profits?
- What investment is required to launch and establish the business?
- Where will the money come from and what type of finance is required?
- What are the main risks facing the business and how to handle them?

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Information that should be included in a start-up business plan

For a start-up there are usually two kinds of business plan - a simple one and a detailed one. Some businesses need to produce both.

The **simple business plan** is rarely shown to outsiders of the business. It is written by the entrepreneur, for the entrepreneur. The simple plan helps summarise the key aims and targets of the business and the actions required to make the business a reality. It is likely to be written in quite an informal way. What would go into the simple plan? Areas such as:

- The idea - a simple description of the proposed business
- Where the idea came from and why it is a good one
- Key targets for the business - sales, profit, growth (gives a sense of direction for the business), ideally for the next 3-4 years
- Finance required - how much from the founder, how much to be loaned over how loan and from who
- Market overview - main segments, market size (value, quantity), growth, market shares of main competitors (if known)
- How the business will operate (location, premises, staff, distribution methods)
- Cash flow forecast (important) + trading forecast

A **detailed business plan** is needed if a more complicated or larger business is planned as a start-up, or if the entrepreneur needs to raise money from business angels or get a substantial loan from a bank. Here is a summary of the key content:

- **Executive summary:** a brief 1-2 page summary of the detail! Should contain nothing new, but highlight the key points
- **Market:** a profile of the target market based on market research
- **Product:** what it is and how it is different from the competition (the "unique selling point")
- **Competition:** an honest description of the competition in the target market - what they do well, their weaknesses and their likely response
- **Protecting the idea:** how the product and business can be protected from competition - e.g. patents, trademarks, distinctive approaches to marketing or distribution that competitors will find hard to replicate
- **Management team:** a crucial area for any investor. Who is involved in the start-up and what will they be doing? What experience and expertise do they bring? Which management roles will need to be filled as the business grows?
- **Marketing:** the key elements of the marketing mix should be explained here. Remember that for a start-up the marketing budget is likely to limited, so the plan should describe a credible approach to promoting the product and include realistic assumptions about how many customers will buy and at what price
- **Production /operations:** this explains what is involved in the production process, what capacity is needed, who will supply the business, where it will be located etc.
- **Financial projections**: a summary of the cash flow and trading forecasts. This section should highlight the key assumptions that have been made and also outline the main

risks and opportunities in the forecasts (i.e. what might go wrong, or where things might prove better than forecast).

- **Sources of finance:** here the figures from the cash flow forecast are taken and used to highlight what funding the business needs, and when.
- **Returns on investment:** another key area for any investor. This is a description of how the entrepreneur expects investors to get a return on their investment. Who might eventually buy the business, when, and for how much?

Obtaining Finance

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 – the start-up 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, medium-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** (e.g. 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 assets that the business needs before it can begin to trade
- **Working capital** (the stocks needed by the business –e.g. raw materials + allowance for amounts that will be owed by customers once sales begin)
- **Growth and development** (e.g. extra investment in capacity)

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, medium-term and short-term finance. The table below summarises the main examples and uses of each category:

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

Share capital

Share capital is the **money invested in a company by the shareholders**. Share capital is a **long-term source of finance**. In return for their investment, shareholders gain a share of the ownership of the company. An illustration of an example company share ownership structure is shown below:

Shareholder	Number of Shares	Shareholding
Angela	300	15%
Nicolas	400	20%
Gordon	600	30%
Barack	700	35%
Total	**2,000**	**100%**

Shareholders benefit from the protection offered by **limited liability** – they are only liable for the amount they invest in share capital rather than the overall debts of the company.

The founding entrepreneur is very likely to invest in the share capital of the start-up. This is a common method of financing a start-up. Ideally the founder will try to provide all the share capital of the company, retaining 100% control over the business.

A key point to note is that the entrepreneur may use a variety of personal sources (e.g. cash, personal investments) to finance the purchase of shares.

Once the investment has been made, it is the company that owns the money provided.

The shareholder obtains a return on this investment through **dividends** (payments out of profits) and/or increases in the value of the company when it is eventually sold.

A start-up company can also raise finance by selling shares to **external investors** – this is typically to a business angel or venture capitalist.

Retained profits

Retained profit is the profit kept in the company rather than paid out to shareholders as a dividend. Retained profit is widely regarded as the most important long-term source of finance for a business.

Retained profits are a very cheap form of finance. They are also very flexible. They can be left in the business as cash in the bank. They can be invested in more fixed assets, extra stocks and so on.

Retained profits are also under the control of the business. It is up to the business owners to decide what to do with them, not the bank manager.

Bank loan

A bank loan is the most common example of **loan capital** for a business.

A bank loan provides medium or long-term finance. The bank sets the **fixed period** over which the loan is provided (e.g. 3, 5 or 10 years), the rate of interest and the timing and amount of repayments.

The bank will usually require that the business provides some security ("collateral) for the loan, although in the case of a start-up this security often comes in the form of personal guarantees provided by the entrepreneur.

Bank loans are good for financing investment in fixed assets (such as plant & machinery, land and buildings). They are generally charged at a lower rate of interest that a bank overdraft. The interest rate can be either fixed (e.g. 8% per year on the amount outstanding) or variable (where the interest rate varies depending on the Bank of England base rate).

However, a bank loan provides less flexibility than a bank overdraft. The business commits to meeting the bank loan repayments and interest – which it needs to do whether or not the cash flow position is good. A failure to meet the terms of the bank loan may lead to the bank putting the business into insolvency.

Bank loans tend not to be offered to start-ups or businesses with a track record of poor profitability and cash flow. Such businesses are perceived as being high-risk by banks that, as a result of the credit crunch, are more cautious about the kind of lending they offer.

Trade credit

When a business buys raw materials, components, services or other goods from another business it will often look to pay for those at a later date. If it is allowed to do so, then that supplier is said to offer "trade credit" to the business. The supplier becomes a trade creditor – someone to whom the business owes money.

Trade credit is a short-term source of finance. It has several important advantages to a business:

- It is flexible – the amount of credit reflects the value of business done with a supplier

- It is low cost – trade creditors don't charge interest on the amount outstanding (unless payment is delayed well beyond the settlement date)
- It matches the purchase of goods and services – e.g. stocks can be bought and held for a period, with the finance provided by trade credit rather than cash

A common complain amongst small businesses is the time it takes for their (larger) customers to settle bills. By delaying payment to a trade creditor, a business holds onto its cash balances for longer. However, by delaying payment, a business has to be careful not to damage its credit reputation.

Bank overdraft

A bank overdraft is flexible **borrowing facility** on a bank current account which is repayable on demand.

A bank overdraft does not actually result in cash flowing into a business. Instead the business is allowed to let its bank account become "overdrawn" – i.e. in the red, up to a maximum amount.

For example, a business may find that it expects to have a cash shortfall of £15,000 during a month as a result of paying wages and suppliers. If the bank allows it, the overdraft facility can be used to temporarily "borrow" the cash from the bank.

A good way to think about a bank overdraft is to imagine a bank current account which can have either a positive (i.e. cash in the bank) or negative (i.e. cash owed to the bank) status.

The maximum amount that the bank account can go into the red is known as the **overdraft facility**.

How much interest does a business pay on a bank overdraft? It depends on what the bank balance is day to day. Interest is calculated daily, usually at a high rate, on the overdrawn balance.

You can see that a bank overdraft is a flexible form of finance. A business only pays interest on the amount of the overdraft facility used.

However it is important to realise that a bank overdraft is essentially a short-term source of finance designed to cover temporary shortages of cash. If a business finds itself using the expensive overdraft month after month, then it ought to consider whether a cheaper, long-term bank loan would be a more suitable source of finance.

Leasing

Leasing is another word for renting assets (e.g. property) over a period of time. Leasing is a way of financing the use of such assets without actually having to buy them outright.

There are two main ways a business can pay for the resources and equipment it needs:

- Buy it outright (often referred to as "capital expenditure")
- Hire purchase or lease

Buying outright is a good option if a business has the funds available, or if it is essential that it owns the equipment. However, paying for resources and equipment means an up-front outflow of cash. This might not be the best option for cash flow.

Paying for goods on hire purchase or leasing equipment allows a business to:

- Use an asset over a fixed period in return for regular payments (i.e. the cash outflow is spread over a longer period)
- Lets the business choose the equipment it needs, with the finance company buying it on behalf of the business

Obtaining finance from outside investors

Should a start-up accept investment from outside investors?

You will have seen entrepreneurs making their pitches on Dragon's Den – this is a good example of how a start-up or small business tries to raise capital by encouraging people other than the entrepreneur to invest in the business idea.

For a start-up, the main source of outside (external) investor in the share capital of a company is **friends and family** of the entrepreneur. Opinions differ on whether friends and family should be encouraged to invest in a start-up company. They may be prepared to invest substantial amounts for a longer period of time; they may not want to get too involved in the day-to-day operation of the business. Both of these are positives for the entrepreneur. However, there are pitfalls. Almost inevitably, tensions develop with family and friends as fellow shareholders.

Business angels are the other main kind of external investor in a start-up company. Business angels are professional investors who typically invest £10k - £750k. They prefer to invest in businesses with high growth prospects. Angels tend to have made their money by setting up and selling their own business – in other words they have proven entrepreneurial expertise. In addition to their money, Angels often make their own skills, experience and contacts available to the company. Getting the backing of an Angel can be a significant advantage to a start-up, although the entrepreneur needs to accept a loss of control over the business.

Using an entrepreneur's personal sources of finance

In practice, most start-ups make use of the **personal financial sources of** the entrepreneur. This can be personal savings in the building society, a bank balance. It can be providing assets for the business (e.g. a car). It can also simply be **working for nothing!** The following notes explain these in a little more detail.

Savings and other "nest-eggs"

An entrepreneur will often invest personal cash balances into a start-up. This is a cheap form of finance and it is readily available. Often the decision to start a business is prompted by a change in the personal circumstances of the entrepreneur – e.g. redundancy or an inheritance. Investing personal savings maximises the **control** the entrepreneur keeps over the business. It is also a strong signal of commitment to other potential investors and banks.

Re-mortgaging is the most popular way of raising loan-related capital for a start-up. The way this works is simple. The entrepreneur takes out a second or larger mortgage on a private property and then invests some or all of this money into the business. The use of mortgaging like this provides access to relatively low-cost finance, although the risk is that, if the business fails, then the property will be lost too. However, the credit crunch falling house prices has made re-mortgaging harder.

Borrowing from friends and family

This is also common. Friends and family who are supportive of the business idea provide money either directly to the entrepreneur or into the business. This can be quicker and cheaper to arrange (certainly compared with a bank loan) and 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.

Credit cards

This is a surprisingly popular way of financing a start-up. In fact, the use of credit cards is the **most common source of finance** amongst small businesses. It works like this. Each month, the entrepreneur pays for various business-related expenses on a credit card. 15 days later the credit card statement is sent in the post and the balance is paid by the business within the credit-free period. The effect is that the business gets access to a free credit period of around 30-45 days!

Working for nothing!

How can this be a source of finance? Simple - by working for nothing, an entrepreneur saves the business cash. By working long hours and multi-tasking, the entrepreneur reduces the need to employ others - and therefore saves cash that would otherwise have to be paid out in wages in salaries. In just about every start-up, the founders look to save cash (i.e. reduce the finance needed) by putting in the "hard yards"

Topic 1.4 Making the Start-up Effective

Section	Key Things to Learn
Customer focus and the marketing mix	Benefits of having a customer focus What goes into the marketing mix An effective marketing mix Basics of product, promotion, price and place
Importance of limited liability	The sole trader Unlimited liability Incorporation and the protection of limited liability Private companies or sole trader?
Start-up legal and tax issues	Basics of setting up a business Main legal issues to consider Taxes paid by start-ups
Recruiting and training staff	Should a start-up recruit staff? The recruitment process Handling job applications Selecting the right person Methods and approaches to training
Motivating employees	What motivates people at work? Benefits of a well-motivated workforce Does money matter? Non-financial ways of motivating people

Customer Focus and the Marketing Mix

Having a "customer focus"

Quite simply, a business that has a "**customer focus**" is one which takes the time and trouble to understand and address **customer needs**.

A **customer** is anyone who buys a product – either a good or a service – from a business. A customer will be **satisfied** with his/her purchase if the product meets the customer's needs. So it is essential that a business has a good understanding of what customers want and need from a product.

If customer **needs** are met, then the customer is generally **satisfied**.

The following ideas are usually considered to be fundamental in achieving customer satisfaction:

- **The product** or **service** must deliver what is promised – i.e. it must be of good **quality**

- **Sales and promotional activities** need to create a positive experience for the customer. For example, the attitudes of staff that make contact with customers should be positive and professional.

- **After-sales service** should also be positive and appropriate (e.g. user training & help lines). Customers often need reassurance after they have bought something that they have made the right choice, or help in using a product properly.

Customer expectations of good **customer service** also play a part in customer satisfaction. These expectations typically include factors such as:

- Safety and security – the product is safe to use!
- Clear and accurate information
- Legal rights are upheld
- Complaints, enquiries and suggestions are dealt with fairly and promptly
- Special needs are catered for (e.g. disability access)

Introducing the "marketing mix"

The **marketing mix** deals with the way in which a business uses four factors - price, product, distribution and promotion - to reach customers.

The marketing mix is often referred to as the **"Four P's**" - since the most important elements of marketing are concerned with:

- **Product** - the product (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

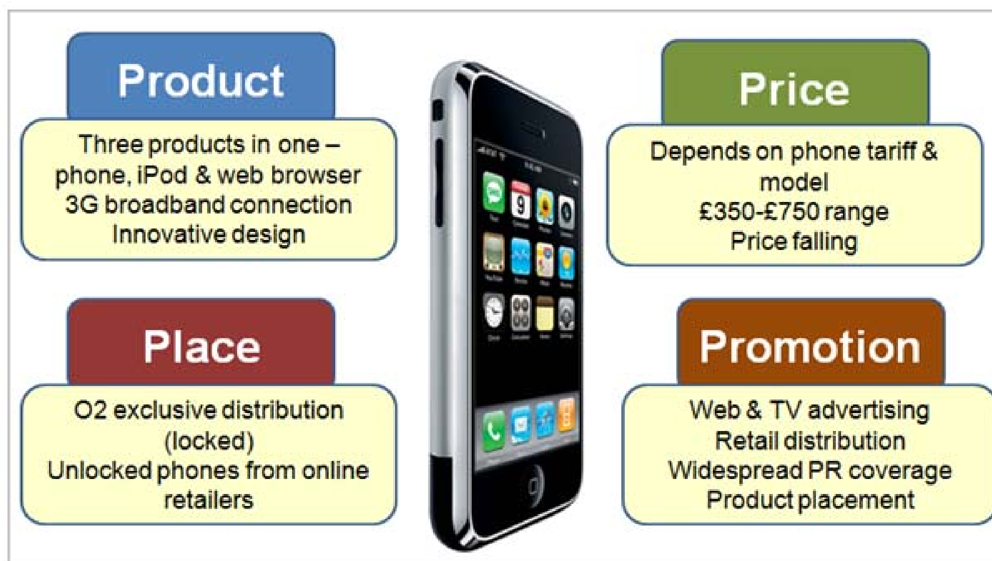
It is known as a "mix" because each ingredient affects the other and the mix must overall be suitable to the target customer.

For example:

- High quality materials used in a **product** can mean that a higher **price** is obtainable
- An advertising campaign carried 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**

The marketing mix is the way in which a marketing strategy is put into action - in other words, the actions arising from the marketing plan.

An example of the marketing mix in action can be seen from this example of the launch of the Apple iPhone back in 2008:



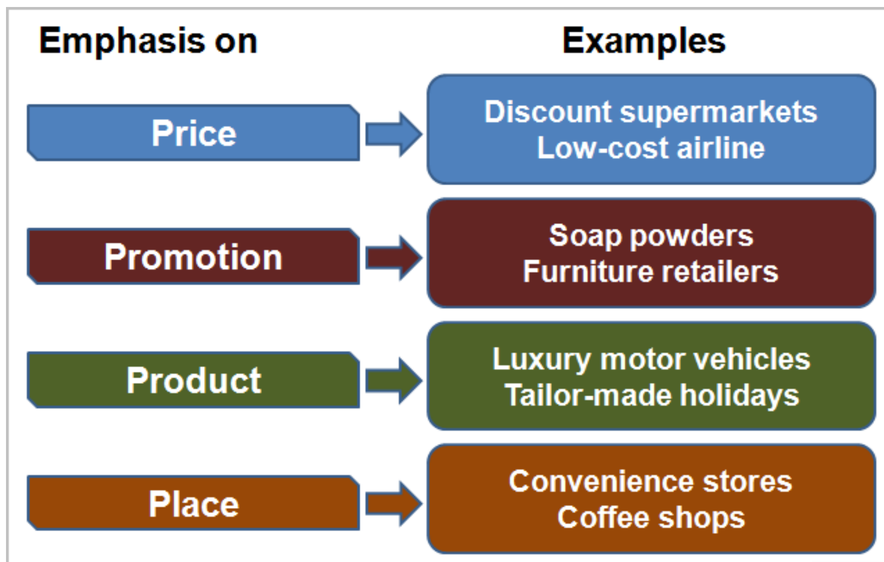
An effective marketing mix

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:



Products

Products are at the heart of the marketing mix. The product needs to exist for the other elements of the mix to happen.

What is a product? A product is:

"Anything that is capable of satisfying customer needs".

This definition therefore includes both:

- **Physical products** – e.g. trainers, games consoles, DVD players, take-away pizzas
- **Services** – e.g. dental treatment, accountancy, insurance, holidays, music downloads

A product is often said to have three main elements:

Core benefits	What the product actually does - the main functions of the product • E.g. washing machine – it cleans clothes • Cinema ticket – it lets you see a film
Tangible or physical element	What the product is made of; what it looks like; dimensions or duration • E.g. 500g of ice-cream • A flat-screen, plasma television which is HDTV compatible
Other product benefits	The extra elements which add to the perceived value of the product in the eyes of the consumer. Other product benefits can be tangible (e.g. materials, weight, extra features) or intangible (e.g. brand name, after-sales service, reputation for reliability)

Promotion

It is a common mistake to believe that promotion by business is all about advertising. It isn't. There are a variety of approaches that a business can take to get their message across to customers, although advertising is certainly an important one.

Promotion is all about communication. Promotion is the way in a business makes its products known to the customers, both current and potential.

The main aim of promotion is to ensure that customers are **aware** of the existence and positioning of products. Promotion is also used to **persuade** customers that the product is better than competing products and to remind customers about why they may want to buy.

It is important to understand that a business will use more than one method of promotion. The variety of promotional methods used is referred to as the **promotional mix.**

Which promotional methods are used depends on several factors:

Stage in the life cycle	E.g. advertising is important at the launch stage
Nature of the product	How much information is required by customers before they buy
Competition	What are rivals doing?
Marketing budget	How much can the firm afford?
Marketing strategy	Other elements of the mix (price, product, place etc)
Target market	Appropriate ways to reach the target market

The main methods of promotion are:

- Advertising
- Public relations & sponsorship
- Personal selling
- Direct marketing
- Sales promotion

A business will use a range of promotional activities for its product, depending on the **marketing strategy** and the **budget** available.

Price

Price is:

- The **money charged for a product or service**
- Everything that a customer has to give up in order to acquire a product or service
- Usually expressed in terms of £

The price a business charges for its product or service is one of the most important business decisions management make. Setting a price that is too high or too low will - at best - limit the business growth. At worst, it could cause serious problems for sales and cash flow.

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So pricing is important. The bad news for entrepreneurs is that pricing is a really tough to get right. There are so many factors to consider, and much uncertainty about whether a price change will have the desired effect.

The law of demand states that, for nearly all products, the higher the price the lower the demand. In other words, sales will fall if prices are put up. However higher prices can also mean higher profits.

There are several factors a business needs to consider in setting the price:

- **Competitors** – a huge impact on pricing decisions. The strength of competitors influences whether a business can set prices independently, or whether it has to follow the lead shown by competitors
- **Costs** – a business cannot ignore the cost of production or buying a product when it comes to setting a selling price. In the long-term, a business will fail if it sells for less than cost, or if its gross profit margin is too low to cover the fixed costs of the business.
- **The state of the market for the product** – if there is a high demand for the product, but a shortage of supply, then the business can put prices up.
- **The state of the economy** – some products are more sensitive to changes in unemployment and workers wages than others. Makers of luxury products will need to drop prices especially when the economy is in a downturn.
- **The bargaining power of customers in the target market** – who are the buyers of the product? Do they have any bargaining power over the price set? An individual consumer has little bargaining power over a supermarket (though they can take their custom elsewhere). However, an industrial customer that buys substantial quantities of a product from a business may be able to negotiate lower or special prices.
- **Other elements of the marketing mix** – it is important to understand that prices cannot be set without reference to other parts of the marketing mix. The distribution channels used will affect price – different prices might be charged for the same product sold direct to consumers or via intermediaries. The price of a product that is old or out-dated cycle will need to be much lower than when it was first launched.

Place (distribution)

Place (or its more common name "distribution") is **about how a business gets its products to the customers**.

It is one thing having a great product, sold at an attractive price. But what if:

- Customers are not near a retailer that is selling the product?
- A competing product is stocked by a much wider range of outlets?
- A competitor is winning because it has a team of trained distributors or sales agents who are out there meeting customers and closing the sale?

Distribution matters for a business of any size – it is a crucial part of the marketing mix.

The objective of distribution is clear. It is to:

To make products available in the right place at the right time in the right quantities

Distribution is achieved by using one or more **distribution channels**, including:

- Retailers
- Distributors / Sales Agents
- Direct (e.g. via e-commerce)
- Wholesalers

Importance of Limited Liability

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 through the Yellow Pages or a local free business listing posted through your letterbox and 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.

Why is the **sole trader** such a popular form of business organisation? The key reason – it is **simple and cheap** to set up and operate in this way.

Being a sole trader is the simplest way to run a business: it does not involve paying any company registration fees; keeping records and accounts are straightforward, and the sole trader gets to keep all the profits.

The sole trader simply registers as being **"self-employed"** with the UK tax authorities.

The profits earned by a sole trader are included in the personal income of the business owner when it comes to calculating and paying income tax and national insurance. Depending on the value of sales achieved, the sole trader may also have to account for VAT.

Don't forget that a sole traders can and do employ other people to work in the business – but most don't.

Unlimited liability

There is a big downside to operating as a sole trader. 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 chasing money owed by a business, a sole trader has to settle up.

The sole trader is, therefore, **liable** for any **debts** that the business incurs.

If the business takes out a loan or buys goods and services on credit, then the sole trader himself/herself is liable to repay the debt. This is known as the important concept of **unlimited liability**.

As a sole trader is personally responsible for any debts run up by the business, this means the home or other assets owned by the entrepreneur may be at risk if the business runs into trouble.

This sounds like bad news, and for some sole traders the nightmare sometimes becomes reality. Thousands of people become personally bankrupt in the UK each year, many of whom have built up trading debts which they find they are not able to repay.

So why would anyone set up as a sole trader given the risks posed by unlimited liability? There are two main reasons:

(1) Setting up as a sole trader is so easy; setting up a company is (wrongly) perceived as being a bit of a hassle. So simple laziness leaves sole traders at risk
(2) Some trades have a low risk of failure – where the sole trader buys and sells in cash and does not need to invest significantly

Incorporation and the protection of limited liability

Incorporation is the creation of a company which then operates as a business. In the vast majority of cases, the type of company created is a **"private limited company".**

Now, here is the really important part.

In the eyes of the law, limited companies exist in their own right.

This means the company's finances are separate from the personal finances of their owners. In the case of a company, the owners are known as **"shareholders**".

Shareholders may be individuals or other companies. They are not responsible for the company's debts unless they have given guarantees (of a bank loan, for example). However, they may lose the money they have invested in the company if it fails.

In nearly all cases, the most a shareholder can lose (personally) is the money that has been invested in the shares of the company. To use some important legal wording, the liability of shareholders is limited. Hence - the concept of "**limited liability".**

You should be able to see that the idea of limited liability offers an important protection to a company shareholder.

Consider a company that goes bankrupt owing money to suppliers, taxes to the Inland Revenue and perhaps an amount outstanding on a bank loan. Who is liable for these debts? Is it the shareholders of the company? No – they are protected by "limited liability". It is the company itself that should have repaid those debts. The company will be liquidated and whatever assets are left will be used to pay off some (not all) the outstanding creditors.

What does it cost to get the protection of limited liability? The answer is – very little. A private limited company can be set up very quickly and the annual administrative costs of a simple company are unlikely to be more than £1,000. That seems a small price to pay for such an important protection offered to the shareholders.

Comparing private limited companies with sole traders

The main differences between private limited companies and sole traders can be summarised as follows:

	Advantages	**Disadvantages**
Sole trader	Quick & easy to set up – the business can always be transferred to a limited company once launched	Full personal liability – "unlimited liability" Harder to raise finance – sole traders often have limited funds of

	Simple to run – owner has complete control over decision-making Owner gets to keep all the profits Minimal paperwork	their own and security against which to raise loans The business is the owner – the business suffers if the owner becomes ill, loses interest etc Pay more tax than a company – profits are taxed as income
Limited company	Limited liability – protects the personal wealth of the shareholders Easier to raise finance – both through the sale of shares and also easier to raise debt Stable form of structure – business continues to exist even when shareholders change Can pay less tax – greater tax incentives and allowances	Shareholders have to agree about how profits are distributed Greater administrative costs Less privacy - public disclosure of company information Directors' legal duties are stricter

Start-up Legal and Tax Issues

The basics of setting up a business in the UK

A checklist of things to do when starting a business can run to many pages. There are many practical issues to address in terms of setting up the administration of the business, obtaining the resources to trade and then, even harder, finding and keeping the first customers! Here is a summary of the main actions that a start-up needs to address:

Register the business:

A sole trader needs to let the Inland Revenue know that a new business has been started so that appropriate income tax and national insurance records can be maintained. A private limited company needs to be registered with Companies House, including the various incorporation documents (formal legal records) which describe how the business will operate and who the shareholders and company officers are. Depending on sales turnover, the business may also need to register to account for value added tax (VAT) on its transactions.

Choose an appropriate business name:

This might sound easy, but it is easy to get a business name wrong! Customers deduce a lot about what a business does and what it can deliver from the name. There are also strict rules about what a private limited company can call itself (e.g. the name cannot include offensive words, suggest the business is of national importance or connected with royalty!) It is also important that the business name does not breach any existing trademarks (most brands are protected by these).

Choose a business location:

Many (in fact most) start-ups begin life at home, operating from the back bedroom, loft conversion or garage. Alternatively, the business may need to rent office or warehouse space, or lease an appropriate retail outlet in order to begin trading. Choosing the right premises is a key business decision. The start-up wants premises that help it operate effectively without excessive costs. At the same time, it is important to avoid being tied to premises that might not suit the business in the future. Different options suit different businesses. Working from home is a good option if all the business needs is a small office space. You can also rent premises or buy a property outright - depending on what start-up finance is available.

Start to keep proper business records immediately:

The importance of this cannot be overstated. It is easy for the start-up entrepreneur to ignore or postpone record-keeping, but this can come back to haunt the business if the tax authorities decide to investigate the business. It is also vital that a start-up has a detailed understanding of the revenues, costs and cash flows of the business. A good solution is for the start-up to set up and use a dedicated business credit or debit card, so that all business expenses are controlled and recorded separately. A simple Excel spreadsheet can be used to maintain monthly summaries of income and expenses, comparing with the start-up financial budget. Hiring a book-keeper for a day or two each month is also money well-spent.

Main legal areas a start-up should address

A start-up soon finds that it needs to consider a variety of legal issues, both before and after it has started to trade. The key legal areas it must cover include:

Legal structure

The main choice is between forming a private limited company and operating as a sole trader with unlimited liability. Some businesses are formed as partnerships – where the partners also have unlimited liability. Generally it is best for a start-up to set-up a limited company, given the important protection provided to shareholders.

Employment

Many start-ups don't employ people at first. However, once someone is employed, even on a part-time or temporary basis, then there are significant legal responsibilities to be complied with. For example:

- An employee has to be provided with a legally-binding employment contract
- Recruitment and selection procedures must comply with laws aimed at preventing discrimination
- Business must maintain proper staff records (vital for tax purposes)
- Working conditions must comply with health & safety requirements
- Employer must check that employees are eligible to work in the UK

Consumer protection

Almost every business that sells goods and services to someone gets customers who are unhappy with some aspect of the transaction. Consumers are well protected by a variety of laws, including the Sale of Goods Act, the Trade Descriptions Act and laws that protect customers who buy online or via distance-selling.

Environmental protection: A business needs to ensure that it complies with:

- Waste disposal regulations (e.g. landfill, packaging, waste water)
- Legislation on carbon emissions

For many smaller businesses these legal issues don't turn out to be too significant.

Taxes

The main taxes that a start-up needs to consider are summarised below:

Value Added Tax (VAT)

VAT is a tax that is charged on most goods and services that VAT-registered businesses provide in the UK. VAT is charged when a VAT-registered business sells to either another business or to a non-business customer such as a customer in a shop. When a VAT-registered business buys goods or services they can generally reclaim the VAT they have paid. Not all businesses charge VAT. However, once annual turnover exceeds a threshold (in 2010 it is £68,000) then VAT needs to be charged. The current rate of VAT in the UK is 15% (due to rise to 17.5% in 2010).

Income tax and National Insurance

Most people who work have to pay income tax (a deduction from gross pay) and national insurance contributions (also based on weekly pay). A business needs to account for these taxes, ensuring that it calculates the correct amount of tax due (from employees) and also making sure that it pays the taxes collected to the Inland Revenue by the due date. A business effectively acts as a tax collector for the government for income-based taxes!

Corporation tax

Corporation tax is a tax based on the profits earned by a company. A sole trader will pay **income tax** on the profits earned by the business, whereas a company's profits are taxed using **corporation tax**.

Companies benefit from a range of "tax reliefs" which reduce the profits on which tax is charged. For example, a company is allowed to offset money spent on capital items like computer systems, plant and machinery. **Small companies also pay a lower rate of corporation tax**, at around 19-20% compared with the normal rate of 30%. Corporation tax is paid around 7 months after a financial year has been completed, so there is plenty of time for a business to calculate what the tax is going to be and ensure that it has enough cash to settle the bill!

Business rates

Rates are another form of business taxation. The difference is that rates are paid to local authorities rather than central government, since they are meant to contribute towards the cost of local services. The amount of business rates payable depends on the kind of business location occupied by the business and also the rates charged by different local authorities.

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Recruiting and Training Employees

Does a start-up or small business need to recruit staff?

Look at the payroll of many start-ups and small businesses and it won't take you long to count the people.

There are over 4.5 million businesses in the UK, and about three-quarters of them don't employ any staff! That is about 3.3 million businesses that have just one employee – the owner, manager and staff all rolled into one person!

Even if they have ambition to grow the business, lots of start-up entrepreneurs initially work for themselves, taking on a variety of jobs, from selling and product development to book-keeping and packaging products.

For an entrepreneur, employing the first few people in a new business is fraught with risk. Make the wrong choices or pay someone too much, and the start-up's overheads soon increase significantly.

On the other hand there is a temptation for a small business owner to want to do everything himself/herself. This can restrict the growth potential of the business. A successful start-up will soon need people with a variety of skills and experience.

Often the entrepreneur takes the easier option and brings in friends and family to work in the business. Sometimes the new staff are "friends of friends", next-door neighbours or acquaintances from a local club or group.

In theory that makes those staff "lower risk" appointments, since the people concerned are known to the entrepreneur. It is also much cheaper – no expensive recruitment agency fees to pay or time-consuming and costly job adverts to run in the local newspaper.

However, are they the right or best people for the jobs and work required? Do they have relevant specialist skills? Could problems arise from mixing business with family or pleasure?

The step-change comes when the small business decides to implement a formal **recruitment process,** looking to attract, select and employ people who are not initially known to the business.

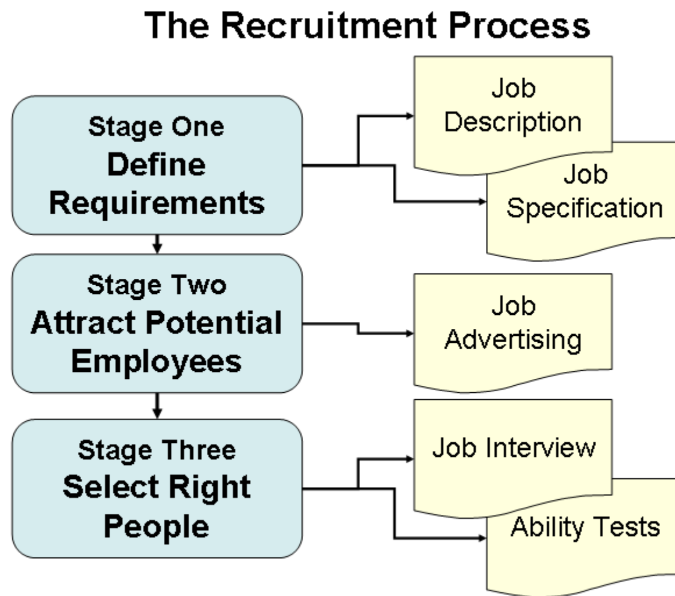
The recruitment process

Recruitment and selection is the process of identifying the **need** for a job, defining the **requirements** of the position and the job holder, **advertising** the position and **choosing** the most appropriate person for the job.

Doing this well is tough, but important for any small business. Indeed, the success of any business depends to a large extent on the quality of its staff.

Recruiting employees with the correct skills can add value to a business and recruiting workers at a wage or salary that the business can afford, will reduce costs. Employees should therefore be carefully selected, managed and retained, just like any other resource.

The process can be summarised like this:



Job descriptions and specifications

The job description and specification are important parts of planning the **workforce needs** of any business. So what are they?

Job description

- A detailed explanation of the **roles and responsibilities** of the post advertised
- Most applicants will ask for this before applying for the job – they want to know what is involved!
- Refers to the post available rather than the person

Job specification

- Sets out the kind of qualifications, skills, experience and personal attributes a successful candidate should possess.
- A vital tool in comparing and assessing the suitability of job applicants
- Refers to the **person** rather than the post

Handling job applications

For many jobs, a business will ask applicants to provide Curriculum Vitae **(CV**). This is a formal document where the job applicant provides details such as:

Personal details	Name, address, date of birth, nationality
Educational history	Including examination results, schools/universities attended,

	professional qualifications
Previous employment history	Names of employers, position held, main achievements, remuneration package, reasons for leaving
Suitability and reasons for applying for the job	A chance for applicants to 'sell themselves'
Names of referees	Often recent employer or people who know applicant well and are ideally independent

In some circumstances however an applicant may be asked to fill in a firm's own **application form**. This is different from a CV in that the employer designs it and sends it to applicants, but it will still ask for much of the same information. It has the benefit over a CV in that a business is able to tailor it to their exact needs and ask specific questions.

Once a business has received all the applications, they need to be analysed and the most appropriate form of selection decided upon. When analysing applications, a business will normally sieve the applications into three categories.

Those to reject	Candidates may be rejected because they may not meet the standards set out in the job specification such as wrong qualifications or insufficient experience or they may not have completed the application form to a satisfactory standard
Those to place on a short list	Often comprises 3-10 of the best candidates who are asked to interview
Those to place on a long list	A business will not normally reject all other candidates immediately but keep some on a long list in case those on the short list drop out or do not appear suitable during interview. The business would not want to incur costs putting them through the selection process, such as interviews, unless they have to

Selecting the right person for the job

An interview is the most common method of selection and it serves a very useful purpose for both employer and job candidate:

For the Employer:

- Information that cannot be obtained on paper from a CV or application form
- Tests conversational ability- often known as "people skills"
- Can quickly get a sense of natural enthusiasm and personality (though interviewees are often good at hiding their true personality!)

- A chance to see how applicant reacts under pressure (though that requires good interviewing skills)
- Queries or extra details missing from CV or application form

For the Candidate

- Helps determine whether the job or business is right for them
- A chance for a brief experience of the culture of the business
- Can confirm the exact details of the job – information beyond the job description

There are though other forms of selection tests that can be used in addition to an interview to help select the best applicant. The basic interview can be unreliable as applicants can perform well at interview but not have the qualities or skills needed for the job.

Other selection tests can increase the chances of choosing the best applicant and so minimise the high costs of recruiting the wrong people. Examples of these tests are aptitude tests, intelligence tests and psychometric tests (to reveal the personality of a candidate). However, for a small business, these methods may be too costly or ineffective.

Often the small business owner will conduct the selection process, relying on guy instinct as well as formal application details to make the selection.

Role and benefits of training

Training is a general term that describes how a business tries to improve the **knowledge, skills and attitudes** of employees to enable them to do their jobs better.

In reality, many small businesses do little, if any, staff training. The costs and disruption of training can be significant in any business, but these are particularly important for a small business. Training takes time and most small businesses are operated with minimal staffing anyway.

However, some employers are prepared to invest in training because they expect (or hope) that their business will benefit from employees' development and progress.

Training can take place at various points and places in a business. Commonly, training is required to:

- Support new employees ("induction training")
- Improve productivity
- Increase marketing effectiveness (e.g. training in telephone selling or customer relationship)
- Support higher standards of customer service and production quality
- Help introduced new technology, systems or other change
- Address changes in legislation (e.g. health & safety, data protection)
- Support employee progression and promotion

It is possible to make quite a strong case for any business investing in training – provided that it turns out to be effective. Training has the potential to provide a range of benefits for a business:

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

Main methods of training

The three main kinds of training are:

Induction training: this is the training that new employees obtain when they first join the business. It covers areas like:

- Learning about the duties of the job
- Meeting new colleagues
- Seeing the layout of the premises
- Learning the values and aims of the business
- Learning about the internal workings and policies of the business

For a small business, induction training is likely to be very informal and brief.

On-the-job training: here employees receive training whilst remaining in the workplace.

The main methods of one-the-job training include:

- **Demonstration / instruction** - showing the trainee how to do the job
- **Coaching** - a more intensive method of training that involves a close working relationship between an experienced employee and the trainee
- **Job rotation** - where the trainee is given several jobs in succession, to gain experience of a wide range of activities

Small businesses make extensive use of on-the-job training, particularly demonstration and instruction. The main benefits from the business perspective are:

- Generally most cost-effective
- Employees are actually doing something – they are productive
- Training alongside real colleagues

Off-the-job training: occurs when employees are **taken away from their place of work** to be trained.

Common methods of off-the-job training include:

- Specific skills-based training courses offered by external training companies (e.g. selling skills, negotiation skills, call-handling)

- Day release (e.g. employee takes time off work to attend a local college)
- Distance learning / evening classes
- Self-study, computer-based training

For the small business, the main disadvantages of off-the-job training are the cost and disruption caused. The perception amongst many small business-owners is that on-the-job training represents much better value for money.

Motivating staff

What is motivation?

Motivation is essentially about **commitment to doing something**. In the context of a business, motivation can be said to be about

"The will to work"

However, motivation is about more than simply working hard or completing tasks. Entrepreneurs and staff can find motivation from a variety of sources.

Motivation can come from the enjoyment of the work itself and/or from the desire to achieve certain goals e.g. earn more money or achieve promotion.

It can also come from the sense of satisfaction gained from completing something, or achieving a successful outcome after a difficult project or problem solved.

Why does motivation matter in business? In short, people's behaviour is determined by what motivates them. The performance of employees is a product of both their abilities (e.g. skills & experience) and motivation. A talented employee who feels de-motivated is unlikely to perform well at work, whereas a motivated employee can often deliver far more than is expected from them!

Benefits of a well-motivated workforce

A well-motivated workforce can provide several advantages:

- **Better productivity** (amount produced per employee). This can lead to lower unit costs of production and so enable a firm to sell its product at a lower price
- **Lower levels of absenteeism** as the employees are content with their working lives
- **Lower levels of staff turnover** (the number of employees leaving the business). This can lead to lower training and recruitment costs
- **Improved industrial relations** with trade unions
- Contented workers give the firm a **good reputation** as an employer so making it easier to recruit the best workers
- Motivated employees are likely to **improve product quality** or the customer service associated with a product

Does money motivate employees?

Though there are many reasons why people work for a living, it is undeniable that money, or other financial rewards, play a key role in motivating people in the workplace.

There is a wide variety of ways in which a business can offer **money** (or **"financial rewards"**) as part of the "pay package", including:

- **Salaries**: fixed amounts per month or year for performing a role; these are common for most managerial positions (e.g. Accountant, Payroll Manager)
- **Benefits in kind ("fringe benefits")** – very common in businesses of all kinds; these include staff discounts, contributions to travel costs, staff uniforms etc
- **Time-rate pay**: pay based on time worked; very common in small businesses where employees are paid per hour.
- **Piece-rate pay:** pay per item produced – becoming less common
- **Commission**: payment based on the value of sales achieved.
- Other **performance-related pay:** e.g. bonuses for achieving targets
- **Shares and options**: less common in small businesses, but popular in businesses whose shares are traded on stock markets
- **Pensions** – becoming less common and generous. Small businesses tend not to offer pension benefits.

In most cases, an employee might expect to have a mixture of the above in a pay package.

How important is money as a motivator? It is widely accepted that poor or low pay acts as a de-motivator. Someone who feels undervalued or under-paid may soon leave to find better-paid employment. However, it is less clear that paying people more results in better motivation. For most people, motivation (the will to work) comes from "within". More money can help us feel better about out work, but it is unlikely to encourage us to work harder or to a higher standard.

Other than through pay, how can managers better motivate their staff?

An entrepreneur or small business owner is in a good position to be able to motivate his/her staff. The business owner is likely to know personally each member of staff and have a close understanding of their skills, abilities and attitude at work.

Here are some ways in which the small business can keep staff motivated:

- **Job enlargement** – give staff a greater variety of tasks to perform (not necessarily more challenging) which should make the work more interesting. This often happens anyway in a small business where staff handle a variety of tasks (e.g. the office manager might also handle the telephone, payroll and customer accounts)
- **Job enrichment** – this involves workers being given a wider range of more complex and challenging tasks surrounding a complete unit of work. This should give a greater sense of achievement.
- **Empowerment** means delegating more power to employees to make their own decisions over areas of their working life. Encouraging contributions and ideas for how to run or develop the business is linked to empowerment too.
- **Communication:** regular and honest communication about what is going on in the business is a key part of keeping employees motivated.

Topic 1.5 Understanding the Economic Context

Section	Key Things to Learn
Demand and supply in commodity markets	What is market demand and supply How are the prices of commodities determined? How changes in commodity prices affect businesses
Interest rates	What is credit – and why do businesses need it? How interest rates operate How businesses are affected by changes in interest rates
Exchange rates	What is an exchange rate? Causes of exchange rate changes Implications for business of exchange rate fluctuations
The business cycle	Business and the economy Stages in the business cycle How businesses are affected by the business cycle
Business decisions and stakeholders	What are stakeholders Main interests of business stakeholders Why stakeholder objectives might come into conflict

Demand and Supply in Commodity Markets

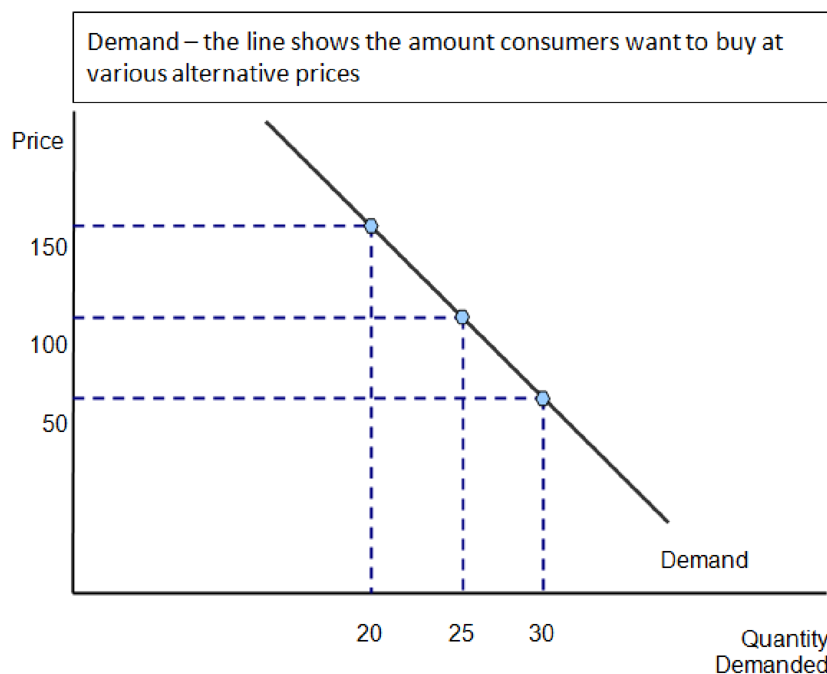
Demand and market demand

Demand

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

Market demand is the **sum of the individual demand for a product from buyers in the market.** If more buyers enter the market and they have the ability to pay for items on sale, then demand at each price level will rise.

In theory, the level of market demand at a range of prices can be shown graphically as a **demand curve**. Here is an example:



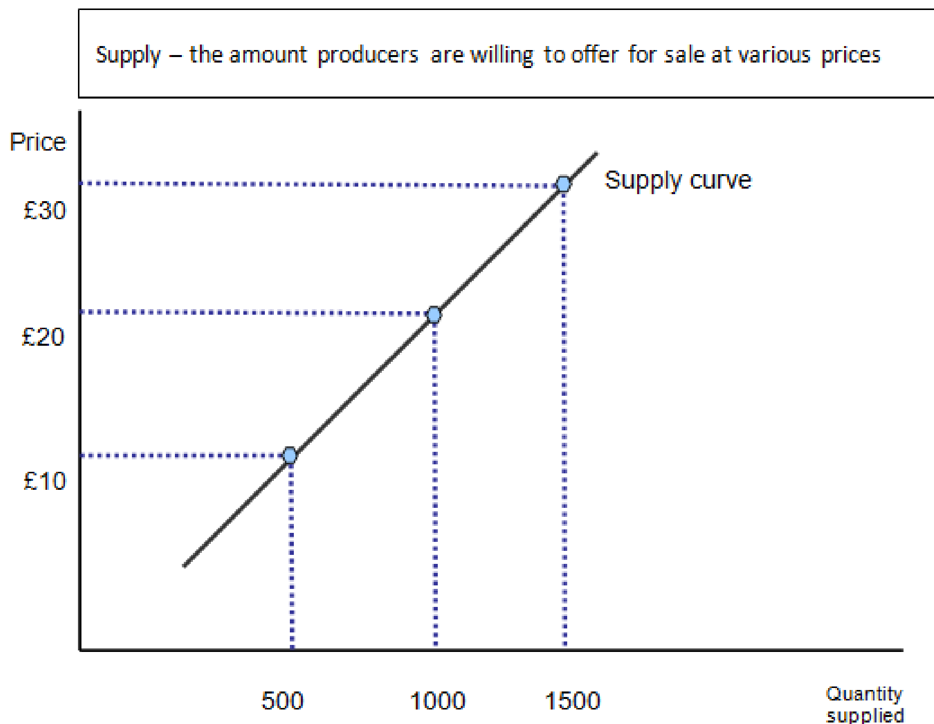
How useful is a demand curve? It is certainly useful for a business to be able to forecast what happens to potential demand from a change in price. However, in reality, a business is restricted in its ability to change prices significantly and often.

Supply and market supply

Supply is defined as the quantity of a product that a producer is **willing and able to supply** onto the market **at a given price in a given time period**.

Market supply is the total quantity that all producers in a market are prepared to supply at each price level.

The basic **law of supply** is that as the price of a product rises, so businesses expand their supply onto the market. A **supply curve** shows a relationship between the price and quantity a firm is willing and able to sell. Here is an example:



Commodities and commodity prices

A commodity is a product for which there is demand and which is supplied without any clear difference in product quality or standard.

An important feature of a commodity is that its price is determined as a function of its market as a whole – by the interaction of market demand and market supply.

Examples of commodities include:

Commodities are widely **traded** on specialist **commodity markets**.

The **suppliers** to those commodity markets are the farmers and other producers who grow, harvest or extract the commodity.

The **demand** for commodities comes from the manufacturers, wholesalers and other businesses that want to use the commodity in their production processes.

Commodity markets are generally seen as very efficient. The markets quickly respond to changes in supply and demand to find an **equilibrium** price and quantity. That is how price is determined – by the interaction of demand and supply.

Commodities are good examples to use as a way to consider the factors that affect the level of demand in a market.

Take the example of **oil**. Oil is one of the most heavily traded commodities in the world. Fluctuating prices have important effects for oil producers/exporters and the many countries and businesses that depend on oil as a key raw material.

What factors affect the demand for oil?

Economic growth

There is a strong link between the demand for oil and the rate of global economic growth because oil is an essential input into many industries. When an economy is expanding, the demand for oil rises. The best recent example of this is the growth of the Chinese economy which led to a surge in demand for crude oil from China.

Similarly, a downturn in economic activity (such as that experienced during 2009) results in lower demand for oil.

Prices of substitutes

Demand for oil is affected by the relative prices of oil substitutes (e.g. the market price of alternatives such as gas or bio-fuels). If, in the longer term, reliable and relatively cheaper substitutes for oil can be developed, then we might expect to see a reduction demand away from oil towards the emerging substitutes.

Changes in climate

It is often said that if the winter in North America is fierce, then the global oil price rises as the USA and Canadian economies raise their demand for oil to fuel household heating systems and workplaces

Market speculation

There is always a **speculative demand** for oil (i.e. investors hoping for a rise in prices on world markets).

How changes in commodity prices affect businesses

A change in commodity prices has too main possible effects on a business:

(1) An effect on sales revenue
(2) A change in raw material and other operating costs

For some businesses, a change in commodity prices directly affects sales revenue. Take the example of a dairy farmer whose revenue is directly linked to the price that he/she can obtain at the farmgate for a litre of milk or a kilogramme of cheese.

The cocoa farmer in Ghana too is concerned with the selling price that can be obtained per tonne of cocoa beans – particularly if the farmer does not benefit from Fairtrade schemes where a **minimum price** is available.

However, for most businesses, the main effect of changes in commodity prices is on their **operating costs**.

For manufacturers, commodity price changes can be particularly significant, since a large proportion of costs will arise from buying raw materials or using energy in the production process. Businesses have relatively little control over the price that they for their raw materials – they are exposed to changes in commodity prices which can often move up or down significantly over a short period.

One important thing to consider is the proportion of total costs that are accounted for by raw materials.

For many service businesses, the main operating costs will by employment-related (e.g. wages & salaries), marketing-related (e.g. advertising, commission) or arising from the choice of business location (e.g. rent, rates). Raw material and energy costs are likely to be relatively insignificant. So changes in commodity prices for these businesses are not likely to be significant.

Another consideration is whether a business is able to pass on increases in its costs to customers. Imagine that a carpenter experiences an increase in the price of his raw material – wood. However, because his service is a specialist (niche) one, the carpenter may find he is able to persuade customers to accept a higher selling price which takes account of higher wood prices. In this example, the change in commodity price does not turn out to be significant.

In most cases, businesses look to absorb small or temporary changes in raw material costs, rather than look to increase the selling price charged to customers. However, if they choose to do this in the medium/long-term, then the result is likely to be lower profit margins.

Interest Rates

Credit and why businesses need it

Some small businesses trade in cash – and nothing else. Customers pay in cash and the expenses and costs of the business are settled in cash. There is no need for credit.

However, most businesses cannot survive simply with the cash they have in the bank. They need to borrow or lend from banks, suppliers and others in order to trade.

So in business, **credit** is about **borrowing** – owing money to others for a period of time.

For example, credit arises when:

- A business makes use of a **bank overdraft facility** – e.g. the bank account goes £50,000 "into the red" or overdrawn
- A business takes out a **bank loan** – e.g. £100,000 loaned over five years
- A business buys goods or services from a supplier and agrees to pay for them in 30 days – this is known as **trade credit**

The amount of credit that a business can raise will depend on several factors such as:

- Whether the business is profitable and is likely to remain so in the future
- The ability of the business to generate a positive cash flow to allow it to repay credit
- The strength of the relationship between the business and its creditors
- The industry or market in which the business operates

You may have heard about the **"credit crunch"** during 2008 and 2009. The credit crunch was about a reduction in the availability of credit for businesses. As lenders struggled to stay in business, they lost confidence in the ability of businesses to repay credit. So many businesses found themselves in financial trouble due to:

- Banks withdrawing or lowering overdraft facilities
- Banks refusing to provide bank loans, or making the repayments and interest charges worse
- Suppliers insisting on earlier payment of invoices
- Customers taking longer to pay their bills

The effects of the credit crunch – notably an increase in failed businesses – show just how important credit is to the business community.

Interest rates

An interest rate is the **cost of borrowing money** or the **return for investing money**.

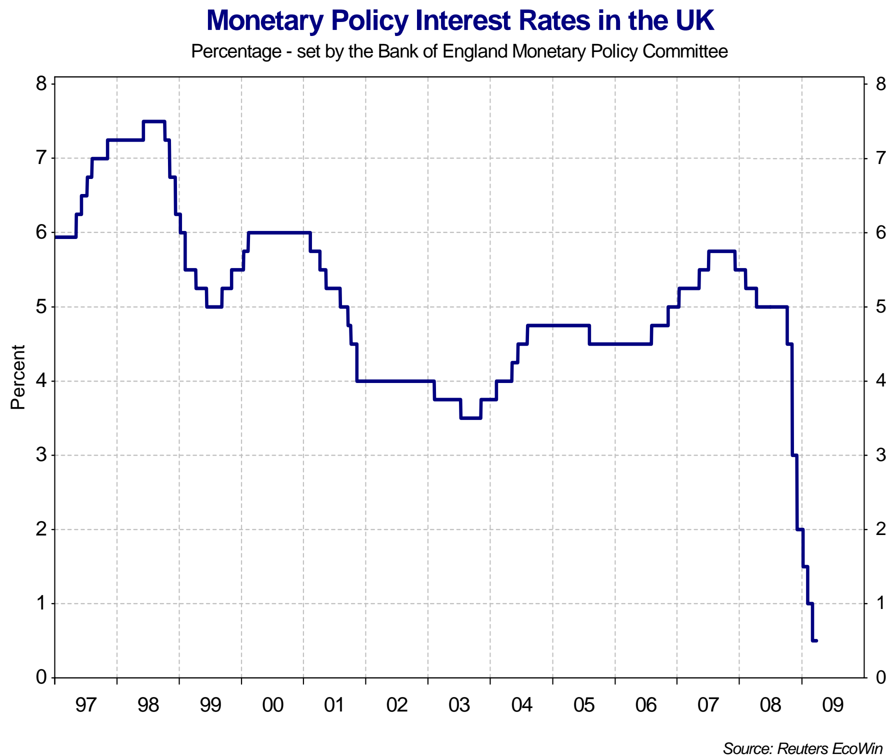
For example, a bank charges interest on amounts loaned out or on the balance of an overdrawn bank account.

A bank will also pay interest to the owner of an account with a positive balance.

Interest rates vary depending on the type and provider of borrowing.

The **base interest rate** in the UK economy is set by the Bank of England. Each month, the Monetary Policy Committee of the Bank of England to decide what the base rate should be.

During the credit crunch, the base interest rate has fallen sharply to as low as 0.5%, as shown in the chart below:



The base interest rate set by the Bank of England affects other interest rates in the economy because it is the rate at which banks can themselves lend from the Bank of England.

In theory, a lower base rate will lead to lower interest rates on borrowings paid by businesses – but not necessarily.

The effect of a change in interest rate will be affected by whether borrowing is at a **variable** or **fixed** rate:

With a variable rate, the interest charged varies in relation to the base rate. So a fall in the base rate to 0.5% in early 2009 should mean that businesses with variable-rate overdrafts pay lower interest.

A fixed interest rate means that the interest cost is calculated at a fixed rate – which doesn't change over the period of the credit, whatever happens to the base rate.

How businesses are affected by changes in interest rates

The effect of a change in interest rates will depend on several factors, such as:

- The amount that a business has borrowed and on what terms
- The cash balances that a business holds
- Whether the business operates in markets that depend on consumer spending

Let's look at the third factor listed above to examine the implications a little more closely.

Consider the example of households and consumers who like to pay for their goods and services using borrowing such as credit cards or a bank overdraft or loan. Also think about households who have substantial balances outstanding on a mortgage used to finance a house purchase.

An increase in interest rates will mean that the cost of borrowing rises.

In theory, a higher bank base rate will mean that credit card companies such as Visa and MasterCard will also raise the rate they charge borrowers on amounts that are outstanding.

A higher interest rate will also mean an increase in the monthly mortgage payments that are made by home-owners who have mortgages which are charged at a variable rate.

In both cases, the disposable income of consumers and households will fall.

The monthly mortgage payment might rise from say £500 to £550, which means that the household has £50 less disposable income available to spend or save.

If consumers and households think that the rise in interest rates is temporary or short-term, they may simply continue to spend as before. In this case, there will be little effect on demand. However, it might also prompt them to cut back on spending, which would result in lower demand.

Some businesses operate in markets which are very sensitive to changes in interest rates. These markets often involve goods and services where the purchase is financed by debt and where the price paid is relatively significant compared with the customer's income. For example:

- Housing (mortgages)
- Motor vehicles
- Holidays
- Major purchases of consumer goods – e.g. new kitchen equipment, audio-visual systems

Exchange Rates

What is an exchange rate?

An exchange rate is the **price of one currency expressed in terms of another currency.**

The exchange rate determines how much of one currency has to be given up in order to buy a specific amount of another currency.

For example, look at the exchange rates in the following table:

£1 buys	May	September
US Dollars ($)	$1.60	$1.45
Euros (€)	€1.15	€1.05

In the table above, you can see that in May, £1 would buy $1.60, if you wanted to convert some pounds into US dollars. Alternatively, £1 would buy €1.15 euro.

Exchange rates change constantly as currencies are bought and sold (traded) on the global currency markets. Let any commodity, a currency has a value or price expressed in terms of what it could buy – that is the exchange rate.

Look at the table and see what happened to the exchange rate for the pound between May and September.

The value of £1 fell against both the US dollar and the Euro. For example, by September, £1 would only buy you $1.45, a fall of $0.15 from May.

That means that the pound **weakened** against the dollar (and the euro).

Putting it another way, the value of the US dollar **strengthened** against the pound. If you were holding dollars, you would need less of them to convert into £1.

Causes of movements in exchange rates

An exchange rate is a price of a currency. The price is determined by the **forces of demand and supply** in the currency markets.

Just like the commodity markets for wheat, oil and coffee, the price of a currency will reflect the amount of the currency that consumers and businesses want to buy (demand) and sell (supply).

Currencies are traded on in international currency markets 24 hours a day. Many billions of pounds and other currencies are traded every hour, to service the needs of governments, businesses and millions of individuals.

For example, here are some reasons why there is demand for a currency:

- Businesses need to pay for invoices from overseas suppliers (e.g. a US supplier sending goods to the UK and pricing the invoice in dollars)
- Businesses needing to convert payments they have received from customers in one currency into another (e.g. a customer in Italy pays a UK business in Euros – which it wants to convert into pounds before putting it in the bank)
- Consumers and business people buying currency before taking a trip or holiday overseas.
- Businesses sending back profits (cash) from their overseas operations to the base currency

Currency markets are also affected by speculative demand and supply. Currency traders bet on which way they think exchange rates will move. If they think that there will be excess demand for a currency and that it will strengthen, then they may buy that currency and then look to sell the currency when the exchange rate has risen (making a profit)

A currency is also affected by interest rates. For example if interest rates in the UK rise, then holders of other currencies may swap them into pounds in order to gain access to a higher interest rate.

Implications for UK businesses if the pound strengthens

A good way to look at what happens if a currency strengthens (an increase in the exchange rate) is to work through an example.

£1 buys	January	June
US Dollars ($)	$1.40	$1.60

Brandon Ltd imports electronic goods from the US for sale via a UK website. These goods are invoiced in US$ - and that is the currency that Brandon must use to settle the invoices. Each month they pay their American suppliers approximately $100,000 for goods imported into the UK.

What is the effect of the strengthening pound in the table above on Brandon Ltd?

Let's convert the monthly US dollar payment to suppliers ($100,000) into pounds to see how much Brandon has to pay:

£1 buys	January	June
US Dollars ($)	$1.40	$1.60
$100,000 converted into £	£71,428	£62,500

In June, Brandon Ltd needs to spend £62,500 to pay for their $100,000 of imported goods from the US. This is £8,928 **less** than in January. That means, for Brandon ltd, the cost of imports has gone down. A strengthened pound has led to cheaper imported goods – that's good news for Brandon Ltd (they should be able to make a better profit margin on those imported electrical goods).

If a strengthened exchange rate is good news for an importer like Brandon, what about a business that sells from the UK to the USA – an **exporter**?

Take the example of Huntington Plastics Ltd. Huntington exports moulded plastic components to customers in the US, invoicing in US dollars. What would the effect of a strengthened exchange rate be for Huntington?

£1 buys	January	June
US Dollars ($)	$1.40	$1.60
$100,000 converted into £	£71,428	£62,500

If Huntington received $100,000 in sales in January, they could be converted into £71,428.

But in June, the same $100,000 of sales would only be worth £62,500. That's bad news for Huntington. A strengthened pound has resulted in lower sales.

If Huntington were to invoice their exports in pounds rather than dollars, then they might not be directly affected by the changed exchange rate – since there are no foreign currency receipts to convert back into pounds. However, the business might still suffer, since the price of Huntington products would be more expensive for US customers, who might then buy less (perhaps buying from a cheaper domestic supplier).

Let's summarise:

A stronger pound leads to:

Imports being cheaper

Exports dearer (more expensive)

Here is an acronym that can help you remember that: SPICED

S - Stronger
P - Pounds
I - Imports
C - Cheaper
E - Exports
D - Dearer

What happens if the pound weakens (i.e. falls in value against other exchange rates)?

The answer is – the opposite of a stronger pound.

Imports become more expensive for UK importers

Exports become cheaper in overseas markets.

Simple!

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The Business Cycle

Business and the economy

All businesses operate within a **competitive environment** – the nature of competition varies from industry to industry, though.

All businesses also operate in the **economic environment**. It is something they can do nothing about but they must understand and respond to changes in the economic conditions.

A key part of the economic environment is the strength of the macro-economy. Macroeconomics is mainly concerned with:

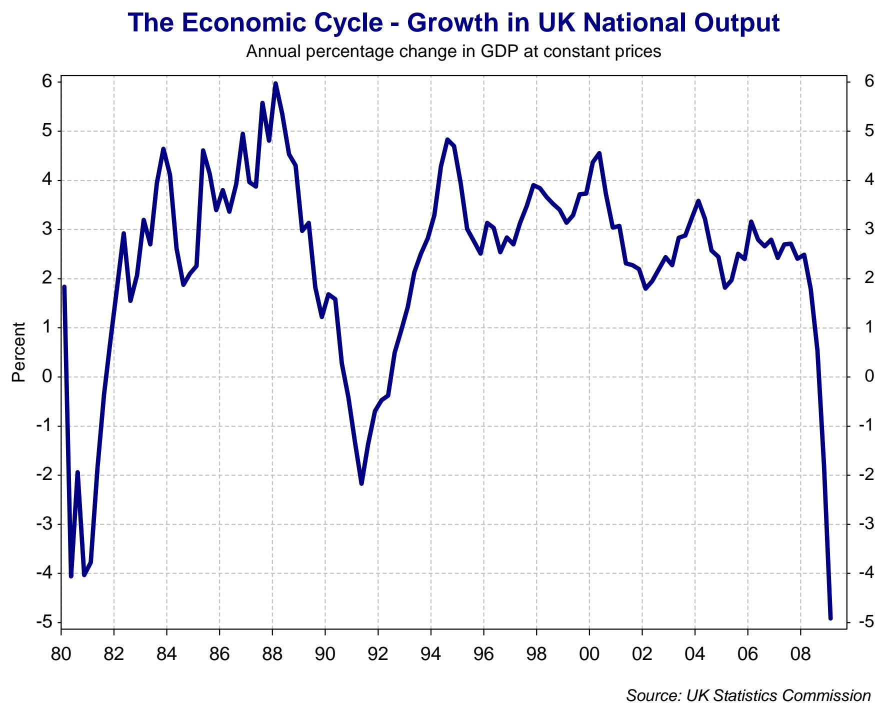
- The total level of spending (or demand) in the economy
- Levels of employment and unemployment
- The general level of prices
- The rate of interest and exchange rates

The strength of the economy is always changing, although broad movements take time to occur. The level of activity in an economy can be measured in several ways, but the most common way is to look at the value of gross domestic product (shortened to "GDP") (the main measure of economic activity) in each period.

Economies go through a regular pattern of ups and downs in the value of GDP. This is known as the **"business cycle"** (sometimes you also see it referred to as the "economic cycle").

The business cycle is characterised by four main phases:

- **Boom:** high levels of consumer spending, business confidence, profits and investment. Prices and costs also tend to rise faster. Unemployment tends to be low
- **Recession:** falling levels of consumer spending and confidence mean lower profits for businesses – which start to cut back on investment. Spare capacity increases + rising unemployment
- **Slump / depression:** very weak consumer spending and business investment; many business failures; rapidly rising unemployment; prices may start falling
- **Recovery:** things start to get better; consumers begin to increase spending; businesses feel a little more confident and start to invest again; but it takes time for unemployment to stop growing



How businesses are affected by the business cycle

Every business is affected by the stage of the business cycle, but some businesses are more vulnerable to changes in the business cycle than others.

For example, a business that relies on consumer spending for its revenues will find that demand is closely related to movements in GDP. During a boom, such businesses should enjoy strong demand for their products, assuming that the products are actually what customers want! But during a slump, the business has to "ride out the storm" – suffering a sharp drop in demand.

You can see lots of examples of this in the UK economy currently.

During the housing-market inspired boom of the early 2000's, many retail and consumer goods businesses took advantage of the boom. Consumers were prepared to take on significant personal debt in order to finance their purchases. However, the sharp economic downturn during 2008 and 2009 has seen many businesses suffer sales falls of between 10-30%. Some have not survived.

Some businesses benefit from an economic downturn. If their products are perceived by customers as representing good value for money, or a cheaper alternative than more expensive products, then consumers are likely to switch.

Business Decisions and Stakeholders

Stakeholders

A stakeholder is anyone who has a **vested interest in the activities and decision making of a business**. Stakeholders include:

- Shareholders or business owners
- Managers & employees
- Customers
- Suppliers
- Banks and other finance providers
- Government
- Local community
- Other external groups (e.g. pressure groups)
- Competitors
- The media

Various factors affect how many stakeholders a business has and the strength of their interest and influence. 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 like Asda which has thousands of employees, operates in numerous locations and is an important customer to hundreds of suppliers.

The nature of the product 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 closer 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.

Main interests of business stakeholders

The main interests of each main stakeholder group can be summarised as follows:

Stakeholder	Mainly interested in…
Shareholders / Owners	Return on investment Profits and dividends Success and growth of the business Proper running of the business (if shareholders are not directly involved in running the company)
Managers & Employees	Rewards, including basic pay and other financial incentives Job security & working conditions (e.g. holidays) Promotion opportunities Job satisfaction & status – motivation, roles and responsibilities Success of the business
Customers	Value for money Product quality – something that meets their needs Customer service
Suppliers	Continued, profitable trade with the business Financial stability – can the business pay its bills?
Banks & other finance providers	Risk that the business will not be able to repay finance provided (banks and other lenders) Profitability and cash flows of the business Growth in profits and value of the business (investors in the shares of the company – e.g. business angels)
Government	The correct collection and payment of taxes (e.g. VAT, Income Tax) Helping the business to grow – creating jobs Compliance with business legislation – e.g. health & safety, consumer protection, fair trading, environmental protection
Local community	Success of the business – particularly creating and retaining jobs Compliance with local laws and regulations (e.g. noise, pollution)

Why might the objectives of stakeholders be in conflict?

Many business objectives complement each other and are acceptable to 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. It is in no-one'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 (e.g. 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. In the longer-term, however, most business owners would be pleased to support an expansion if it increases the overall value of the business.

Job losses versus keeping jobs

This has been a big issue for many businesses during the economic downturn in 2008-2010. In order to reduce costs and conserve cash, business managers have often made redundancies amongst the workforce or introduced other measures like short-time working to reduce wage costs. This will have been supported by business owners and managers.

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

Here are some other potential causes of conflicts between stakeholders:

- "Short-term" thinking by managers may discourage important long-term investment in the business
- New developments in the business such as a major product launch or new factory may require extra finance to be raised, which reduces the control of existing investors
- Investing in new machinery to achieve better efficiency may result in job losses
- Extending products into mass markets may result in lower quality standards