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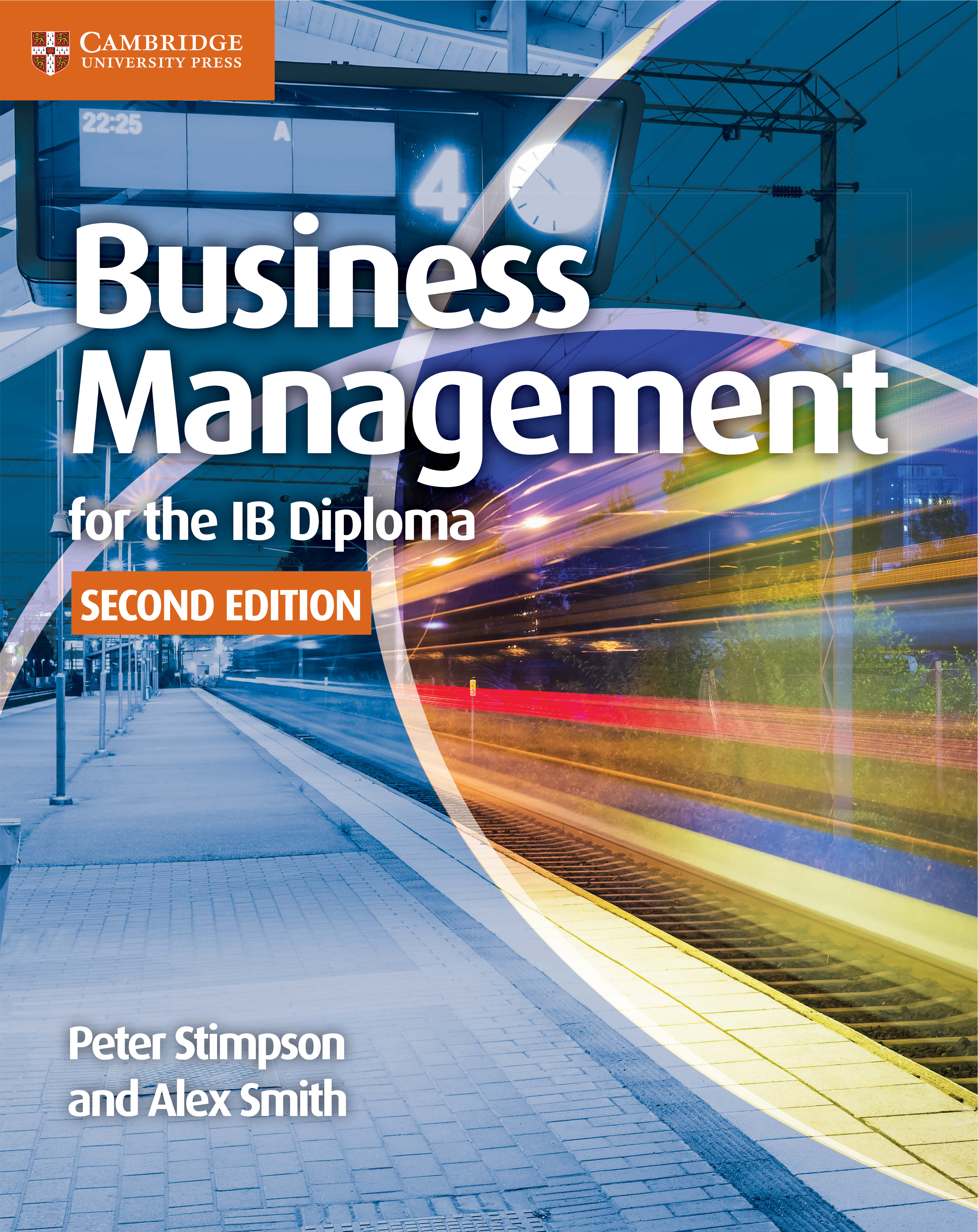
Business Management

for the IB Diploma

SECOND EDITION

Peter Stimpson and Alex Smith



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Cambridge University Press's mission is to advance learning, knowledge and research worldwide.

Our International Baccalaureate Diploma resources aim to:

- encourage learners to explore concepts, ideas and topics that have local and global significance
- help students develop a positive attitude to learning in preparation for higher education
- assist students in approaching complex questions, applying critical-thinking skills and forming reasoned answers.

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Contents

Introduction

Nature of the subject

The International Baccalaureate Diploma Programme Business Management is designed to develop an understanding of essential business theory and the ability to apply business principles, practices and skills. It encourages students to analyse the diverse range of business organisations and activities and the cultural and economic context in which businesses operate. The emphasis is placed on strategic decision-making and the business functions of marketing, production, human resource management and finance. Business Management is the study of both the way in which individuals and groups interact in an organisation and of the transformation of resources. It is, therefore, perfectly placed within the group 3 subject area (individuals and societies) of the IB Diploma Programme hexagon.

Who is this book for?

This book accurately and comprehensively follows the 2014 International Baccalaureate (IB) higher level (HL) and standard level (SL) syllabus for Business Management.

If you are a student preparing for the assessments based on this syllabus, or a teacher preparing students for the assessments, you can be confident that this book provides comprehensive coverage of the course. Other students of business management courses at equivalent levels could also greatly benefit from the subject content, activities and advice that this book contains.

What are the aims of the book?

Apart from providing the appropriate subject content for the IB Business Management course, this book aims to:

- introduce business management as a study of the ways in which individuals and groups interact in an organisation and of how resources are transformed by businesses
- explain that business management is a rigorous and rewarding subject that examines dynamic decision-making processes and assesses how these decisions impact on and are affected by internal and external environments
- help students to develop an understanding of business theory and the ability to apply business principles, practices and skills
- encourage students to consider the activities of business in a global market and appreciate cultural diversity
- evaluate the diverse range of business organisations and activities
- develop in students an awareness of the cultural and economic context in which businesses operate
- encourage the appreciation of ethical issues and the concept of social responsibility in the global business environment

- enable the development of decision-making skills through the use of case studies that enhance students' ability to make informed business decisions
- make a clear distinction between higher-level and standard-level content
- help students improve their performance on the internal and external assessments used in the Business Management syllabus
- show how the Business Management syllabus relates to the Theory of Knowledge part of the IB Programme.

The six key concepts that underpin the Diploma Programme are referred to throughout the book. These concepts are featured in the 'Setting the scene' case studies and a key concept question is included in all of the exam practice questions.

What are the key features of this book?

- **Learning objectives** – identifying the key syllabus-related topics and concepts covered in each chapter.
- **'Setting the scene' case studies** – raising important areas for discussion on business issues through case studies drawn from many different countries. These provide a context to the business applications of the material to be covered in each chapter.
- **Clearly laid-out text** – with easy-to-follow subsections and many tables of data and key advantages and disadvantages.
- **Exam tips** – helping to avoid common errors made by students in examinations.
- **Activities** – based on business case studies, these give practice at applying learning.
- **Revision checklists** – allowing monitoring of understanding of key issues.
- **Revision case studies and exam practice questions** – testing the skills of application, analysis and evaluation, using international business situations.
- **Theory of Knowledge assignments** – these reflect the very close relationship between Theory of Knowledge and Business Management.

Skills needed by Business Management students

The skills acquired and developed by successful students of Business Management interlink with the IB learner profile. In particular, decision-making, risk-taking and thinking skills are needed to weigh up and make judgements on a wide range of business strategies, and options will be transferable both to other disciplines and to higher-level undergraduate study at university.

The assessments used in the IB Business Management course will test the following skills:

- **Knowledge and understanding** of business terminology, concepts, principles and theories
- **Application** of skills and knowledge learned to hypothetical and real-business situations
- **Analysis and evaluation** of business decisions and business strategies and practices using critical thinking

- **Decision-making** by identifying the issue(s), selecting and interpreting data, applying appropriate tools and techniques, and recommending suitable solutions
- **Synthesise** knowledge in order to develop a framework for business decision-making.

Difference between higher and standard levels

The HL course in Business Management differs from the SL course in a number of important ways. These differences are reflected in this book by the clear distinction made between SL and HL material with several chapters specifically devoted to HL content. The HL material is supported by more evaluative questions and strategic decision-based tasks within the activities and exam practice questions.

IB assessment

The exam practice questions at the end of each chapter are IB-style questions designed to give students practice at answering examination questions.

The final chapter of the book gives clear guidance on the forms of assessment used at both SL and HL. It explains the requirements for the extended essay coursework, internal assessment and examination papers. Written by a senior IB examiner with many years' experience in preparing students for both levels of the IB Diploma, it is essential reading for all those preparing for the assessment in IB Business Management.

Peter Stimpson
Alex Smith
February 2015

Unit
1

BUSINESS ORGANISATION AND ENVIRONMENT

1.1

Introduction to business management

On completing this chapter you should be able to:

Analyse and apply:

- The role of business (AO2)
- The main business functions and their roles (AO2)
- Primary, secondary, tertiary and quaternary sectors (AO2)
- The nature of business activity (AO2)
- Reasons for starting up a business (AO2)
- Common steps in starting a business (AO2)
- Problems that a new business or enterprise faces (AO2)

Evaluate:

- The role of entrepreneurship and intrapreneurship in overall business activity (AO3)

Setting the scene

ENTERPRISE PAYS OFF

Sean Walsh knew that his retail job was at risk during the economic problems of 2009. He wanted to start his own business to give his family more security. Sean is a keen jet skier and power boater but he cannot afford to own these expensive leisure products. When he tried to hire a jet ski at a large lake in the USA he was surprised by the price – $400 a day – and the refusal of the renting company to offer insurance. Sean did not want to take any uninsured risks – he had a young family to think about – so he decided against renting. On the way home he noticed a large number of boats and jet skis lying idle in drives and parking lots and the idea occurred to him that these could be rented out to people who loved the sport but could not afford a boat. He did some market research and discovered what he considered to be a profitable gap in the market. He set up an online agency putting boat and jet ski owners in touch with people who wanted to rent – taking 25% commission when a rental was agreed. He also arranged insurance for both the renter and the boat owner. That was six years ago – he has since set up his own boatyard buying and selling second-hand power boats and jet skis, paid for from profits of the online rental agency.

Points to consider

- Why do you think Sean decided to own and run his own business?
- What resources (or inputs) does Sean need to run his business successfully?
- What problems do you think Sean experienced when starting up his business?

Key concept link

New enterprises need to differentiate themselves from rivals, many of whom will be well established. One way of achieving this is by innovation – providing either a different type of product or a service which is different from those of competitors or which is delivered in a distinct way.

Introduction – what is a business?

A business is any organisation that uses resources to meet the needs of customers by providing a product or service that they demand. There are several stages in the production of finished goods. Business activity at all stages involves adding value to resources such as raw materials and semi-finished goods and making them more desirable to – and thus valued by – the final purchaser. Without business activity we would all still be entirely dependent on the goods that we could make or grow ourselves – as people in some communities still are. Business activity uses the scarce resources of our planet to produce goods and services that allow us to enjoy a much higher standard of living than would be possible if we remained entirely self-sufficient.

The role of businesses

Businesses identify the needs of consumers or other firms. They then purchase resources, which are the inputs of the business, or factors of production, in order to produce output. The 'outputs' of a business are the goods and services that satisfy consumers' needs, usually with the aim of making a profit. Business activity exists to produce goods or services, which can be classified in several ways: **consumer goods**, **consumer services** and **capital goods**.

consumer goods: the physical and tangible goods sold to the general public. They include cars and washing machines, which are referred to as durable consumer goods. Non-durable consumer goods include food, drinks and sweets that can only be used once.

consumer services: non-tangible products that are sold to the general public and include hotel accommodation, insurance services and train journeys

capital goods: physical goods that are used by industry to aid in the production of other goods and services such as machines and commercial vehicles

What are business 'inputs'?

These are the human, physical and financial resources needed by business to produce goods or services. They are also known as factors of production. Firms will use different combinations of inputs, depending on the product being produced and the size of the business. There are four main inputs:

- **Land** – this general term not only includes land itself but all of the renewable and non-renewable resources of nature such as coal, crude oil and timber.
- **Labour** – manual and skilled labour make up the workforce of the business. Some firms are labour-intensive, that is they have a high proportion of labour inputs to other factors of production, e.g. house-cleaning services.
- **Capital** – this consists of the finance needed to set up a business and pay for its continuing operations as well as all of the man-made resources used in production. These include capital goods such as computers, machines, factories, offices and vehicles. Some firms are capital-intensive, that is they have a high proportion of capital to other factors of production, e.g. power stations.
- **Enterprise** – this is the driving force of business, provided by risk-taking individuals, which combines the other factors of production into a unit that is capable of producing goods and services. It provides a managing, decision-making and coordinating role. Without this essential input, even very high-quality land, labour and capital inputs will fail to provide the goods and services that customers need.

Businesses have many other needs before they can successfully produce the goods and services demanded by customers. Figure 1.1.1 shows the wide range of these needs.

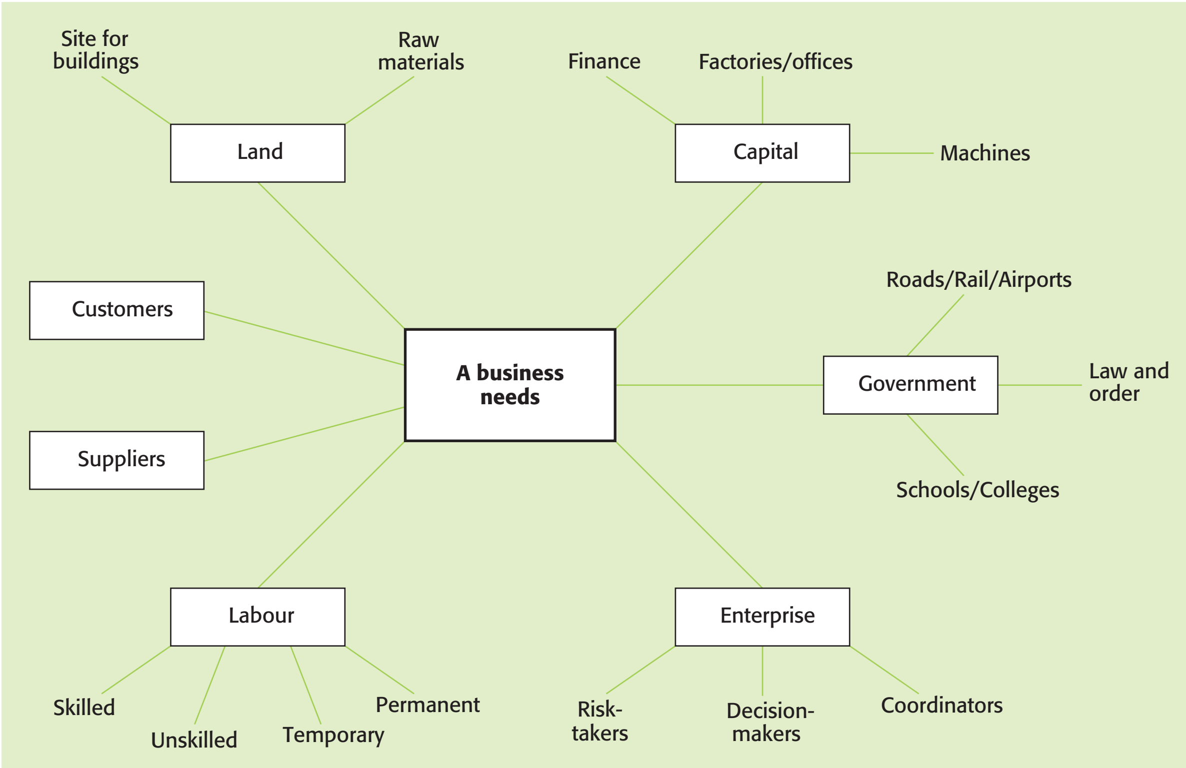


Figure 1.1.1 What businesses need

Business functions

Most businesses have four main functional departments. These will be staffed by people with specific qualifications and experience in the work of the functional areas.

Human resource management

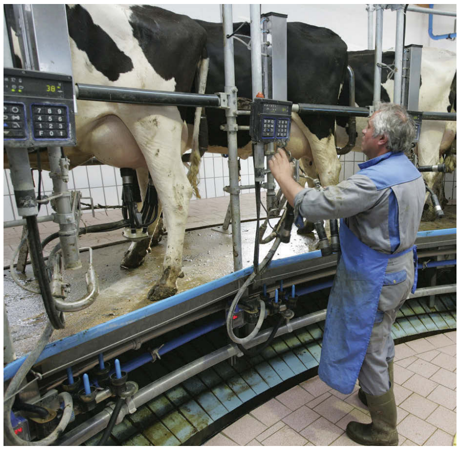
Human resource (HR) management identifies the workforce needs of the business, recruits, selects and trains appropriate employees and provides motivational systems to help retain workers and encourage them to work productively. It also draws up contracts of employment and covers the redundancy or redeployment of employees if these become necessary. The aim of this business function is to manage human resources to help the business achieve its overall objectives.

Finance and accounts

This function has responsibility for monitoring the flow of finance into and out of the business, keeping and analysing accounts and providing financial information to both senior management and other departments. Without adequate finance, no effective decisions can be made within the other functional areas, so finance is a key division of any business.

Marketing

This department is responsible for market research and for analysing the results of such research so that consumer wants can be correctly identified. This information will then be discussed with other departments of the business so that the right product decisions



Primary production – dairy cattle in France

Secondary production – clothing factory in India

Tertiary sector – the breathtaking Burj Al Arab hotel in Dubai

are made. Once a product is available for sale, the marketing function will have to make important decisions concerning its pricing, how and where to promote it and how to sell it and distribute it for sale.

Operations management

Once known simply as the 'production function', operations management has responsibility for ensuring adequate resources are available for production, maintaining production and quality levels and achieving high levels of productive efficiency. This function is important in service industries as well as traditional manufacturing. In service industries, operations management will have the objective of ensuring that the processes for the delivery of the service are well tested, consistent and understood by all employees.

Interrelationship of functions

It should not be assumed that all business decisions taken within these departments are separate and unconnected to the other parts of the business. Nothing could be further from reality! Effective strategic decision-making develops from the functions working closely together. Good communication, cooperation and close interrelationships between functions are essential before major decisions are taken. For example, the decision by BMW to develop and launch its first electric-powered sports car – the i8 – required interaction between:

- marketing – will consumers be prepared to buy this car and at what price?
- finance – do we have the capital needed to develop and produce it?
- HR management – do we need to recruit additional engineers before this project can be turned into a market-ready car?
- operations management – can we produce this product at a cost which allows the marketing department to set a profitable price level? Will quality of the vehicle be up to normal BMW standards?

ACTIVITY 1.1.1

Identify which business function is most likely to undertake the following roles:

Role	Function
Setting prices of new products	
Recruiting a new production manager	
Allocating resources to purchase capital equipment	
Deciding on the appropriate levels of stocks for raw materials	
Finding out if consumers prefer one product design to another	
Determining the level and number of employees the business needs for future operations	

Economic sectors

All production can be classified into four broad types of business activity, or economic sectors. These categories are the three stages involved in turning natural resources, such as oil and timber, into the finished goods and services demanded by consumers plus the 'knowledge-based' support services that businesses require. The four sectors are **primary**, **secondary**, **tertiary** and **quaternary**.

National economic data often makes no distinction between tertiary and quaternary sectors. The balance of the primary, secondary and tertiary sectors in the economy varies substantially from country to country. It depends on the level of industrialisation in each country. The balance between the sectors is often referred to as a country's 'economic structure'. Table 1.1.1 shows the different economic structures of three countries.

Country	Primary	Secondary	Tertiary
United Kingdom	2	17	81
China	42	26	32
Ghana	54	20	26

Table 1.1.1 Employment data 2013 – as percentage of total employment

Changes in economic structure – sectoral change

It is very important to recognise two features of this classification of business activity:

1. The importance of each sector in a country's economic structure changes over time. Industrialisation describes the growing importance of the secondary sector manufacturing industries in developing countries. The relative importance of each sector is measured in terms either of employment levels or output levels as a proportion of the whole economy. In many countries of Africa and Asia, the relative importance of secondary sector activity is increasing. This brings many benefits as well as problems.

Benefits

- Total national output (gross domestic product) increases and this raises average standards of living.
- Increasing output of goods can result in lower imports and higher exports of such products.

primary sector business activity: firms engaged in farming, fishing, oil extraction and all other industries that extract natural resources so that they can be used and processed by other firms

secondary sector business activity: firms that manufacture and process products from natural resources, including computers, brewing, baking, clothing and construction

tertiary sector business activity: firms that provide services to consumers and other businesses, such as retailing, transport, insurance, banking, hotels, tourism and telecommunications

quaternary sector business activity: is focused on information technology (IT) businesses and information service providers such as research and development, business consulting and information gathering

- Expanding manufacturing businesses will result in more jobs being created.
- Expanding and profitable firms will pay more tax to the government.
- Value is added to the country's output of raw materials rather than simply exporting these as basic, unprocessed products.

Problems

- The chance of work in manufacturing can encourage a huge movement of people from the countryside to the towns, which leads to housing and social problems. It may also result in depopulation of rural areas and problems for farmers in recruiting enough workers.
- The expansion of manufacturing industries may make it difficult for a business to recruit and retain sufficient staff.
- Imports of raw materials and components are often needed, which can increase the country's import costs. Business import costs will vary with changes in the exchange rate.
- Pollution from factories will add to the country's environmental problems.
- Much of the growth of manufacturing industry is due to the expansion of multinational companies.

In more economically developed economies, the situation is reversed. There is a general decline in the importance of secondary sector activity and an increase in the tertiary sector. This is known as deindustrialisation. In the UK, the proportion of total output accounted for by secondary industry has fallen by 13% to 20% in 25 years. In South Africa, the relative importance of the secondary manufacturing sector fell from 20% to 17% between 1993 and 2012. The reasons for and possible impact of these changes on business include:

- Rising incomes associated with higher living standards have led consumers to spend much of their extra income on services rather than more goods. There has been substantial growth in tourism, hotels and restaurant services, financial services and so on – yet spending on physical goods is rising more slowly.
- As the rest of the world industrialises, so manufacturing businesses in the developed countries face much more competition and these rivals tend to be more efficient and use cheaper labour. Therefore, rising imports of goods are taking market away from the domestic secondary sector firms and many have been forced to close.
- Employment patterns change – manufacturing workers may find it difficult to find employment in other sectors of industry. This is called structural unemployment.

2. The relative importance of each sector varies significantly between different economies. Table 1.1.1 above gives details of the differences that exist between the economies of different countries and the share of total employment accounted for by each sector of industry.

Exam tip: During your IB Business and Management course it is a good idea to read the business section of newspapers regularly – don't forget that these are often available free online. This will help you to apply the work you have done in class to the world outside. What, for example, was the major business story in your country this week?

ACTIVITY 1.1.2

Business	Primary	Secondary	Tertiary	Quaternary	Description of main activities
Coca-Cola					
HSBC					
FAW (China)					
RTZ					
Wyndham Worldwide					
RR plc					
Capco					

1. Copy out this table. Use the internet or other means of research to:
   a. identify these well-known international companies
   b. identify the main sector of industry that they operate in
   c. give details of their main activities.
2. Research **five** businesses that operate in your country and identify which sector of industry they mainly operate in and what their main activities are.

ACTIVITY 1.1.3

BP OPERATES IN THREE ECONOMIC SECTORS

BP is the third-largest oil company in the world. Here are extracts from three recent newspaper articles about the company:

BP announces another huge oil find

BP has just released details of its third major oil reserve discovery in the US Gulf of Mexico. This will enhance BP's position as one of the largest crude oil suppliers in the USA.

BP Castillon refinery

BP's Castillon refinery is the only oil refinery in this region of Spain. It has the capacity to convert 110,000 barrels of crude oil each day into a range of products used by road vehicles, the aviation industry, chemical manufacturers and the plastic industry.

BP now operates 800 petrol stations in China

BP is a familiar petrol and diesel brand to car and truck drivers in China. The company co-owns over 800 petrol station sites – mainly with PetroChina. BP has a leading position in the petrol retail market.

10 marks, 20 minutes

1. Define the term 'economic sector'. [2]
2. Using examples from these articles, explain the statement that 'BP operates in all economic sectors'. [4]
3. Explain why a decision by BP to open new petrol stations in China will involve effective cooperation between all four business functions. [4]

Starting a business

Why start a business?

Reasons for starting a new business include some or all of the following:

- Losing a job encourages many people to set up a business by themselves, either providing their former employer's product or another product, perhaps based on an interest or skill they have.

- Desire for independence – some people do not like the idea of being told what to do! By creating their own business, they have work flexibility and control over their working lives.
- By talking to friends or family, it might become clear that a business opportunity exists that an entrepreneur could take advantage of.
- A wish to make more money than in the current job – many people setting up their own business believe that they will earn a higher income working for themselves.

Role of the entrepreneur

New business ventures started by **entrepreneurs** can be based on a totally new product or customer service idea or a new way of offering a service. People who set up their own new business show skills of 'entrepreneurship'. People who are given responsibility to develop and market a product within a large corporation show skills of 'intrapreneurship'.

entrepreneur: someone who takes the financial risk of starting and managing a new venture

intrapreneur: someone within a large corporation who takes direct responsibility for turning an idea into a profitable finished product through using 'entrepreneurial talents' such as risk-taking and innovation

Entrepreneurs have:

- had an idea for a new business
- invested some of their own savings and capital
- accepted the responsibility of managing the business
- accepted the possible risks of failure.

Intrapreneurs do not risk their own capital and the consequences of failure are accepted by the organisation that they work for. They can drive forward a new product idea and help make the organisation that they work for more innovative and able to cope with change.

THEORY OF KNOWLEDGE

'The Entrepreneurial Instinct profoundly reveals that exceptional success has more to do with thoughtful risk-taking and agility than school pedigree, I.Q. and even decades of experience. Fear keeps us small, but following your instinct with stamina and passion can lead to greatness.'

Ajay Banga, President and CEO, MasterCard Worldwide

What does Ajay Banga's statement tell us about the importance of sense perception when making business decisions?

The personal qualities and skills needed for entrepreneurs or intrapreneurs to make a success of a new business venture are described below.

Innovative

The entrepreneur may not be a 'product inventor', but they must be able to carve a new niche in the market, attract consumers in innovative ways and present their business as being 'different'. This requires original ideas and an ability to do things innovatively.

Commitment and self-motivation

It is never an easy option to set up and run your own business. It is hard work and may take up many hours of each day. A willingness to work hard, a keen ambition to succeed, energy and focus are all essential qualities of a successful entrepreneur.

Multi-skilled

An entrepreneur will have to make the product or provide the service, promote it, sell it and count the money. These different business tasks require a person with many different qualities such as being keen to learn technical skills, an ability to get on with people and being good at handling money and keeping accounting records.

Leadership skills

An entrepreneur has to lead by example and must have a personality that encourages people in the business to follow them and be motivated by them.

Belief in oneself

Many business start-ups fail, yet this would not discourage a true entrepreneur who would have such self-belief in their abilities and business idea that they would bounce back from any setbacks.

Risk-taker

Entrepreneurs must be willing to take risks in order to see results. Often the risk they take involves investing their own savings in a new business. Intrapreneurs may also have to take risks but the financial consequences – other than the risk of losing their jobs – are borne by the organisation.

LEARNER PROFILE

Risk-takers

According to Bloomberg, eight out of ten entrepreneurs who start businesses fail within the first 18 months. Predicting the success of a business is an incredibly difficult thing to do. People who start businesses and then see them fail can lose large sums of money and suffer what can be the significant emotional pain associated with business failure.

To what extent do new entrepreneurs have to be risk-takers?

Start-up businesses

New business start-ups can be found in nearly all industries. However, there are some industries and sectors of industry where there is a much greater likelihood of new entrepreneurs becoming established. These include:

- primary sector – fishing, market gardening (producing cash crops to sell at local markets)
- secondary sector – jewellery making, dressmaking, craft manufacture, e.g. batik cloth, building trades
- tertiary/service sector – hairdressing, car repairs, cafés and restaurants, childminding
- quaternary sector – IT support, website design, consultancy.

It would be unusual for entrepreneurs to successfully establish themselves in, say, the steel-making industry or car manufacturing because of the vast amount of capital equipment and financial investment that would be required.

Impact of enterprise (and intrapreneurship) on business activity

All governments around the world are following policies that aim to encourage more people to become entrepreneurs. What are the claimed benefits to the economy and business activity of enterprise?

- **Employment creation** In setting up a new business an entrepreneur is employing not only themselves ('self-employment'), but, very often, will employ other people too. Often these are members of their family or friends, but in creating such employment, the national level of unemployment will fall. If the business survives and expands, then there may be additional jobs created in the businesses that supply them.
- **Economic growth** Any increase in output of goods or services from a start-up business will increase the gross domestic product of the country. This is called economic growth, and if enough small businesses are created, it will lead to increased living standards for the population. In addition, increased output and consumption will also lead to increased tax revenues for the government.
- **Firms' survival and growth** Although a high proportion of new firms fail, some survive and a few expand to become really important businesses. These will employ large numbers of workers, add considerably to economic growth and will take the place of declining businesses that may be forced to close due to changing consumer tastes or technology. So, in Trinidad and Tobago, the relative decline of the sugar industry has been balanced out by the growth of the tourist industry, which has itself been boosted by small guesthouse businesses operating as sole traders.
- **Innovation and technological change** New businesses tend to be innovative and this creativity adds dynamism to an economy. This creativity can 'rub off' on other businesses and help to make the nation's business sector more competitive. Many new business start-ups are in the technology sector, e.g. website design. The increased use of IT by these firms, and the IT services they provide to other businesses, can help a nation's business sector become more advanced in its applications of IT, and therefore more competitive.

Common steps in starting a business or enterprise

Identifying market opportunities

Many people say that they want to work for themselves, but they then do not make the leap into entrepreneurship successfully because they have not been able to identify a market opportunity that will generate sufficient demand for their product or service to enable the business to be profitable. The original idea for most new businesses comes from one of several sources including:

- own skills or hobbies, e.g. dressmaking or car bodywork repairer
- previous employment experience, e.g. learning hairdressing skills with an established business
- franchising conferences and exhibitions offering a wide range of new business start-up ideas, e.g. fast-food restaurants
- small-budget market research – the use of the internet allows any user to browse business directories to see how many businesses there are in the local area offering certain goods or services. This low-cost research might indicate gaps in local markets that could be profitably filled by the entrepreneur.

Sourcing capital (finance)

Once the entrepreneur has decided on the business idea or opportunity, the next task is to raise the necessary capital. This will come from various sources but the business owner/entrepreneur will almost certainly have to use some of their own savings in setting up the business. Friends and family might also be asked for financial support. Banks may provide loan finance or an overdraft facility – but bank officials will want to check the business plan contents very rigorously. Venture capitalists may be prepared to invest if the business idea is novel, can be protected or patented and offers significant profit potential. Government grants might be available – perhaps as part of a policy to reduce unemployment by encouraging people to set up new businesses.

Determining a location

A suitable location is vital if the start-up business intends to sell directly to consumers. This raises the problem of costs. Perhaps the most important consideration when choosing the location for a new business is the need to minimise fixed costs. When finance is limited, it is very important to try to keep the break-even level of output – the output level that earns enough revenue to cover all costs – as low as possible. This will greatly increase the chances of survival. Operating from home is the most common way for entrepreneurs to establish their business. This has the great advantage of keeping costs low, but there are drawbacks:

- It may not be close to the area with the biggest market potential.
- It lacks status – a business with its own prestigious premises tends to generate confidence.
- It may cause family tensions.
- It may be difficult to separate private life from working life.

The cost and position of these locations could have a big impact on the business entrepreneur's chance of success.

New businesses that offer a consumer service need to consider location very carefully. Whereas a website designer could operate from home very effectively, as communication with customers will be by electronic means, a hairdresser may need to consider obtaining premises in an area with the biggest number of potential customers. An alternative is to visit customers in their own homes – this way, the entrepreneur may avoid the costs of buying or renting their own premises altogether.

Building a customer base

To survive, a new firm must establish itself in the market and build up customer numbers as quickly as possible. The long-term strength of the business will depend on encouraging customers to return to purchase products again and again. Many small businesses try to encourage this by offering a better service than their larger and better-funded competitors. This better service might include:

- personal customer service
- knowledgeable pre- and after-sales service
- providing for one-off customer requests that larger firms may be reluctant to provide for.

Problems faced by start-ups

Even if an entrepreneur has all the qualities listed above, success with a new business can never be guaranteed. Many businesses fail during their first year of operation. The most common reasons for this are discussed below.

Competition

This is nearly always a problem for new enterprises unless the business idea is unique. More generally, a newly created business will experience competition from older, established businesses with more resources and market knowledge. The entrepreneur may have to offer better customer service to overcome the cost and pricing advantages of bigger businesses.

Lack of record-keeping

Accurate records are vital to pay taxes and bills and chase up debtors. Many entrepreneurs fail to pay sufficient attention to this as they either believe that it is less important than actually meeting customers' needs or they think they can remember everything, which they could not possibly do after a period of time. For example, how can the owner of a new, busy florist's shop remember:

- when the next delivery of fresh flowers was booked for?
- whether the flowers for last week's big wedding have been paid for?
- if the cheque received from an important customer has been paid into the bank yet?
- how many hours the shop assistant worked last week?

Lack of finance and working capital

In an International Labour Organisation (ILO) survey of new business start-ups, the problem of finance came at the top of the list of replies from entrepreneurs regarding the main difficulty. Why is obtaining finance such a major problem for entrepreneurs?

- Lack of sufficient own finance – many entrepreneurs have very limited personal savings, especially if they are setting up their own business because they were previously made redundant.
- Lack of awareness of the financial support and grants available.
- Lack of any trading record to present to banks as evidence of past business success – a trading record would tend to give a bank confidence when deciding whether to lend money for a new venture.
- A poorly produced business plan that fails to convince potential investors of the chances of a business's success. Running short of capital to run day-to-day business affairs is the single most common reason for the failure of new businesses to survive in the first year. Capital is needed for day-to-day cash, for the holding of stocks and to allow the giving of trade credit to customers, who then become debtors. Without sufficient working capital, the business may be unable to buy more stocks or pay suppliers or offer credit to important customers.

Serious working capital shortages can usually be avoided if businesses take several important steps:

- Construct and update a cash flow forecast so that the liquidity and working capital needs of the business can be assessed, month by month.
- Inject sufficient capital into the business at start-up for the first few months of operation when cash flow from customers may be slow to build up.
- Establish good relations with the bank so that short-term problems may be, at least temporarily, overcome with an overdraft.
- Use effective credit control over customers' accounts – do not allow a period of credit which is too long, and quickly chase up late payers.

Poor management skills

Most entrepreneurs have had some form of work experience, but not necessarily at a management level. They may not have gained experience of:

- leadership skills
- cash handling and cash management skills
- planning and coordinating skills

- decision-making skills
- communication skills
- marketing, promotion and selling skills.

Entrepreneurs may be very keen, willing to work hard and with undoubted abilities in their chosen field – for example, a new restaurant owner may be an excellent chef but may be lacking management skills. Some learn these skills very quickly once the business is up and running, but this is a risky strategy. Some entrepreneurs buy in the experience by employing staff with management experience, but this is an expensive option.

It is wrong to think, just because a business is new and small, that enthusiasm, a strong personality and hard work will be sufficient to ensure success. This may prove to be the case, but often it is not. Potential entrepreneurs are encouraged to attend training courses to gain some of these skills before putting their capital at risk or to seek management experience through employment.

Changes in the business environment

Setting up a new business is risky. Not only are there the problems and challenges referred to above but there is also the risk of change, which can make the original business idea much less successful. New businesses may fail if any of the following changes occur, turning the venture from a successful one to a loss-making enterprise:

- new competitors
- legal changes, e.g. outlawing the product altogether
- economic changes that leave customers with much less money to spend
- technological changes that make the methods used by the new business old-fashioned and expensive.

This list of changes could, no doubt, be added to, but even these four factors indicate that the business environment is a dynamic one, and this makes owning and running a business enterprise very risky indeed.

Business plans

business plan: a written document that describes a business, its objectives and its strategies, the market it is in and its financial forecasts

The contents of a typical **business plan** are:

- the executive summary – an overview of the new business and its strategies
- description of the business opportunity – details of the entrepreneur; what is going to be sold, why and to whom
- marketing and sales strategy – details of why the entrepreneur thinks customers will buy what the business plans to sell and how the business aims to sell to them
- management team and personnel – the skills and experience of the entrepreneur and the staff he/she intends to recruit
- operations – premises to be used, production facilities, IT systems
- financial forecasts – the future projections of sales, profit and cash flow, for at least one year ahead.

Table 1.1.2 shows a typical business plan summary for a new business venture.

Name of business	Pizza Piazza Ltd
Type of organisation	Private limited company
Details of business owners	Peter Chun – chef with 15 years' experience Sabrina Singh – deputy manager of restaurant for three years
Business aim	To provide a high-class takeaway pizza service including home delivery
Product	High quality home-cooked pizzas
Price	Average price of $10 with $2 delivery charge
Market aimed for	Young people and families
Market research undertaken and the results	Research in the area conducted using questionnaires Also, research into national trends in takeaway sales and local competitors Results of all research in the appendix to this plan
Human resources plan	Two workers (the business owners) to be the only staff to be employed initially
Production details and business costs	Main suppliers – R and R Wholesalers Fixed costs of business – $70 000 per year Variable costs – approximately $2 per unit sold
Location of business	Site in shopping street (Brindisi Avenue) just away from the town centre. Leasehold site (ten years)
Main equipment required	Second-hand kitchen equipment – $6000 Second-hand motorbike – $2000
Forecast profit	See financial appendix to this plan Summary: In the first year of operations the total costs are forecast to be $55 000 with revenue of $85 000. Predicted profit = $30 000 Level of output to break even – 8750 units per year
Cash flow forecast	See financial appendix to this plan Due to the high set-up and promotion costs there will be negative cash flow in the first year
Finance	$10 000 invested by each of the owners Request to bank for a further $10 000 plus an overdraft arrangement of $5000 per month

Table 1.1.2 Business plan for Pizza Piazza Ltd

Importance of business plans

- Business plans are most important when setting up a new business, but they should be referred to and updated when important strategic choices are being made too. The main purpose of a business plan for a new business is to obtain finance for the start-up. Potential investors or creditors will not provide finance unless clear details about the business proposal have been written down.
- The planning process is very important too. If an entrepreneur went into a new business – even if no external finance was required – without a clear sense of purpose, direction, marketing strategies and what employees to recruit, the chances of success would be much reduced.
- The financial and other forecasts contained in the plan can be used as the targets that the business should aim for.

Users of business plans

Business plans may be of real benefit to the stakeholders of new businesses:

- The plan allows potential investors in the new business – and the bank – to make a judgement about the viability of the idea and the chances of the owners making a success of it. Potential shareholders will not invest without seeing a plan first.
- The financial forecasts in a business plan can act as budgets and control benchmarks for the internal stakeholders such as business managers.
- Updated versions of the plan can be used to apply for additional funding, to attract additional partners or to supply data for the experts if a stock market flotation becomes an option.
- Employees will find that planning helps identify specific objectives and targets and gives focus to their work, which aids motivation.
- Suppliers may be able to tell from the parts of the business plan that are communicated externally whether it is worthwhile establishing a long-term trading relationship with the business.

OVER TO YOU

Revision checklist

1. What is a 'business'?
2. What is a 'business input'?
3. Give **two** examples of primary sector businesses, explaining why they are classified in this sector.
4. Give **two** examples of secondary sector businesses, explaining why they are classified in this sector.
5. Give **two** examples of tertiary sector businesses, explaining why they are classified in this sector.
6. Give **two** examples of quaternary sector businesses, explaining why they are classified in this sector.
7. Allocate each of these decisions into the appropriate business functional department:
   a. deciding on stock levels for an important raw material
   b. deciding between using shops or a website to sell a new range of clothing
   c. deciding whether to promote a manager from within the business or to recruit from another firm
   d. deciding on how to raise $3 million for a factory expansion.
8. Explain why, for a recent major business decision of your choice, it was important for all four business functions to work closely together.
9. Using data from your own country:
   a. How has total output or employment in the secondary sector changed over recent years?
   b. Consider **two** effects of this change on any business in your country.
10. Differentiate between entrepreneur and intrapreneur.
11. Comment on the similar skills needed by both entrepreneurs and intrapreneurs.
12. Explain **two** steps in the process of starting up a business.
13. Explain **two** problems commonly experienced by new business start-ups.
14. Comment on the importance of any two features of a business plan for a start-up enterprise to a potential investor.

Exam practice question

RECESSION SPARKS NEW BUSINESS IDEAS

Disney, McDonald's, Burger King, Procter & Gamble, Johnson & Johnson, Microsoft – what do they all have in common? They all started during a recession or depression.

The message, delivered to around 40 would-be entrepreneurs at a workshop in Stratford, East London, is clear: don't let bad economic headlines put you off. Most of the people at this session are not aiming to create new multinational corporations. But during the coffee break, they seem pretty confident that their ideas can prosper even in the current climate. 'I'm here to find out about starting up a business providing CVs to school leavers,' says Jessica Lyons, wearing a lapel badge with My First CV, the name of the future business, written on it. 'For my particular business idea I think this is the ideal time, because there are more people than ever out there looking for work.'

The recession is causing a spike in interest in setting up small businesses. Another interesting example was from a gym instructor who wants to take his equipment to companies around London, giving people a lunchtime workout without their having to leave their offices. Most of the would-be entrepreneurs in Stratford are looking at potential opportunities in the tertiary sector which don't require large amounts of start-up finance to purchase capital equipment and which rely more on their own skills and interests.

20 marks, 40 minutes

1. Define the term 'tertiary sector'. [2]
2. Outline the factors of production needed to set up the business providing CVs to school leavers. [4]
3. Explain **two** reasons why new businesses might start up in the tertiary sector. [4]
4. Discuss the advantages and disadvantages of setting up a business in a recession. [10]

Key concept question

20 marks, 40 minutes

With reference to one or two organisation(s) that you have studied, evaluate the importance of innovation in starting a new business. [20]

1.2

Types of organisations

On completing this chapter you should be able to:

Analyse and apply:

- The distinction between the private sector and public sector (AO2)

Evaluate:

- The main features of the following types of for-profit (commercial) organisations: sole traders, partnerships and companies/corporations (AO3)
- The main features of the following types of for-profit social enterprises: cooperatives, microfinance providers, public–private partnerships (PPP) (AO3)
- The main features of the following types of non-profit social enterprises: non-governmental organisations, charities (AO3)

Setting the scene

FRENCH TxCELL GOING PUBLIC

TxCell, a French private limited company that specialises in cell immunology, has taken the first steps to converting to a public limited company. Based in Valbonne, France, this company has 105 patents already and has developed a new generation of cell therapy for the treatment of inflammatory diseases. The finance raised from the Initial Public Offering (IPO) of shares to the general public will be used to continue the development and marketing of this important new product.

The first stage for planning of the IPO has already been completed. TxCell has announced the registration of its '*document de base*' (full analysis of the company's activities and finances) with the French *Autorité des marchés financiers* (AMF). Converting to a public limited company will not only allow access to additional capital but will increase the status and prestige of the business, may make it easier to attract the best employees and will allow the original owners to sell some of their share in the business to make money from their initial investments.

Source: Adapted from www.european-biotechnology-news.com

Points to consider

- Why are the owners of TxCell planning to sell shares to the public for the first time?
- Why is it important for potential investors to have a full 'analysis of the company's activities and finances'?
- Would the ownership by TxCell of 105 patents make potential investors more likely to buy shares in the company?

Key concept link

Is the culture of a business organisation partly dependent on its legal form of ownership? It could be the culture of a small sole-trader business is likely to be different from that of a large public limited company, owned by thousands – perhaps millions – of shareholders. The cultural difference could be even greater between 'for-profit' organisations and 'non-profit' social enterprises. The values, atittudes and beliefs of senior management and other employees of a social enterprise will not be the same as those of managers and employees in a profit-centred organisation.

Introduction

The first chapter looked at the classification of business into different economic sectors. This chapter further classifies business activity into:

- the **private sector** and **public sector**
- profit-based and non-profit-based organisations.

Profit-based or for-profit businesses in the private sector can take different legal forms and the advantages and disadvantages of these are very important. The growing importance of non-profit-based and non-governmental organisations is also analysed in this chapter.

public sector: comprises organisations accountable to and controlled by central or local government (the state)

private sector: comprises businesses owned and controlled by individuals or groups of individuals

Private sector and public sector organisations

Industry may be classified by sector: either public or private, and by type of legal organisation. These two types of classification are interlinked as some types of legal structure are only found in the private sector.

The relative importance of the private sector compared to the public sector is not the same in all **mixed economies**. Those economies that are closest to **free-market** systems have very small public sectors. Those countries with central planning **command economies** will have very few businesses in the private sector.

mixed economy: economic resources are owned and controlled by both private and public sectors

free-market economy: economic resources are owned largely by the private sector with very little state intervention

command economy: economic resources are owned, planned and controlled by the state

Distinctions between the sectors

In most mixed economies, certain important goods and services are provided by state-run organisations – they are in the public sector. It is argued that they are too significant to be left to private sector businesses. They include health and education services, defence and law and order (police force). In some countries, important 'strategic' industries are also state-owned and -controlled, such as energy, telecommunications and public transport. These public sector organisations therefore provide essential goods and services for individual citizens and organisations in the private sector, and they often have objectives other than profit – for example:

- ensuring supplies of essential goods and services – perhaps free of charge to the user, e.g. health and education services in some countries
- preventing private monopolies – single firms that dominate an industry – from controlling supply
- maintaining employment
- maintaining environmental standards.

In recent years, there has been a trend towards selling some public sector organisations to the private sector – **privatisation** – and this means that they put profit-making as one of their main objectives.

privatisation: the sale of public sector organisations to the private sector

Private sector organisations are owned and operated by individuals or groups of people. These organisations are usually operated for a profit but not all are. For example, charities are non-profit-making organisations in the private sector; they are not owned and controlled by the government or state.

Public sector enterprises

public corporation: a business enterprise owned and controlled by the state – also known as nationalised industry or public sector enterprise

The term 'public' is used by business organisations in two different ways, and this often causes confusion. We have already identified public limited companies as being owned by shareholders in the private sector of the economy. Thus, public limited companies are in the private sector. However, in every country there will be some enterprises that are owned by the state – usually central or local government. These organisations are therefore in the public sector and they are referred to as **public corporations**.

Exam tip: Public limited companies are in the private sector of industry – but public corporations are not.

Public sector organisations do not often have profit as a major objective. In many countries the publicly owned TV channels have as their main priority the quality of public service programmes. State-owned airlines have safety as a priority. Selling off public corporations to the private sector, known as privatisation, often results in changing objectives from socially orientated ones to profit-driven goals. A summary of the potential advantages and disadvantages of public corporations is given in Table 1.2.1.

Advantages	Disadvantages
• Managed with social objectives rather than solely with profit objectives • Loss-making services might still be kept operating if the social benefit is great enough • Finance raised mainly from the government so not subject to limitations from banks or shareholders	• Tendency towards inefficiency due to lack of strict profit targets • Subsidies from government can encourage inefficiencies • Government may interfere in business decisions for political reasons, e.g. by opening a new branch in a certain area to gain popularity

Table 1.2.1 Public sector organisations – advantages and disadvantages

For-profit organisations

Figure 1.2.1 shows the main types of private sector businesses that are operated for profit.

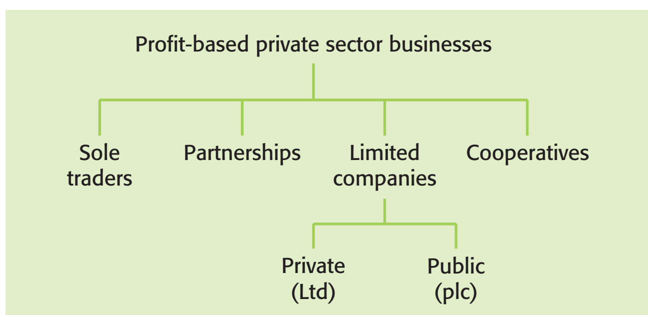


Figure 1.2.1 Private sector businesses

THEORY OF KNOWLEDGE

The personal loan market in many economies has seen the emergence of a huge number of so-called 'payday' lenders. These organisations provide very short-term loans (up to 30/40 days) to borrowers who urgently need cash to cover their living costs or a particular expense until, in theory, they get paid.

One of the most well-known payday lenders is a company called Wonga which started in the UK but is expanding internationally. You can, for example, borrow £111 from Wonga for 33 days and you will be charged interest and fees of £43.95, which means you will end up paying back £154.95. This has a headline interest rate of 5853%!

Payday lenders are for-profit organisations.

Discuss these questions in your class:

- What sort of people take out payday loans?
- What are the aims of payday loan organisations?
- What does this tell us about the 'values' of people who run payday loan organisations?

Sole trader

This is the most common form of business organisation. Although there is a single owner in this business organisation, there may be employees but the firm is likely to remain very small. Although they are great in number, **sole traders** account for only a small proportion of total business turnover. All sole traders have unlimited liability. This means that the owner's personal possessions and property can be taken to pay off the debts of the business should it fail. This can discourage some potential entrepreneurs from starting their own businesses.

sole trader: a business in which one person provides the permanent finance and, in return, has full control of the business and is able to keep all of the profits

Another problem faced by sole traders involves finance for expansion. Many sole traders remain small because the owner wishes to remain in control of their own business, but another reason is the limitations that they have in raising additional capital. As soon as partners or shareholders are sought in order to raise finance, then the sole trader becomes another form of organisation altogether. In order to remain a sole trader the owner is dependent on their own savings, profits made and loans for injections of capital.

This type of business organisation is most commonly established in construction, retailing, hairdressing, car servicing and catering. The advantages and disadvantages of sole traders are summarised in Table 1.2.2.

Advantages	Disadvantages
• Easy to set up – no legal formalities • Owner has complete control – not answerable to anyone else • Owner keeps all profits • Able to choose times and patterns of working • Able to establish close personal relationships with staff (if any are employed) and customers • The business can be based on the interests or skills of the owner – rather than working as an employee for a larger firm	• Unlimited liability – all of owner's assets are potentially at risk • Often faces intense competition from bigger firms, e.g. food retailing • Owner is unable to specialise in areas of the business that are most interesting – is responsible for all aspects of management • Difficult to raise additional capital • Long hours often necessary to make business pay • Lack of continuity – as the business does not have separate legal status, when the owner dies the business ends too

Table 1.2.2 Sole traders – advantages and disadvantages

Partnership

A **partnership** agreement does not create a separate legal unit; a partnership is just a grouping of individuals. Partnerships are formed in order to overcome some of the drawbacks of being a sole trader. When planning to go into partnership it is important to choose business partners carefully – the errors and poor decisions of any one partner are considered to be the responsibility of them all. This also applies to business debts incurred by one partner; in most countries there is unlimited liability for all partners should the business venture fail. It is usual, although not a legal requirement, to draw up a formal 'Deed of Partnership' between all partners. This would provide agreement

partnership: a business formed by two or more people to carry on a business together, with shared capital investment and, usually, shared responsibilities on issues such as voting rights, the distribution of profits, the management role of each partner and who has authority to sign contracts.

Partnerships are the most common form of business organisation in some professions, such as law and accountancy. Small building firms are often partnerships too. Many other owners of businesses prefer the company form of organisation and this is considered next. The advantages and disadvantages of partnerships are summarised in Table 1.2.3.

Advantages	Disadvantages
• Partners may specialise in different areas of business management • Shared decision-making • Additional capital injected by each partner • Business losses shared between partners • Greater privacy and fewer legal formalities than corporate organisations (companies)	• Unlimited liability for all partners (with some exceptions) • Profits are shared • As with sole traders, no continuity and the partnership will have to be reformed in the event of the death of one of the partners • All partners bound by the decisions of any one of them • Not possible to raise capital from selling shares • A sole trader, taking on partners, will lose independence of decision-making

Table 1.2.3 Partnerships – advantages and disadvantages

ACTIVITY 1.2.1

Helene owns a computer repair business – ITfix. She employs three skilled workers. The business operates from rented premises. It owns some machines but leases testing equipment. ITfix is very busy but there is no room for further employees in the small workshop. Helene is proud of her success in starting up and expanding such a profitable business. Despite its success, ITfix has insufficient finance to buy its own premises – Helene believes that this would be a wise investment for the future.

10 marks, 20 minutes

1. Define the term 'sole trader'. [2]
2. Explain **one** advantage and **one** disadvantage for Helene of being a sole trader. [4]
3. Analyse **two** benefits the introduction of a partner would bring to Helene's business. [4]

Limited company

There are three important differences between companies – private limited and public limited companies – and sole traders and partnerships: **limited liability**, legal personality and continuity.

limited liability: the only liability – or potential loss – a shareholder has if the company fails is the amount invested in the company, not the total wealth of the shareholder

share: a certificate confirming part ownership of a company and entitling the shareholder to dividends and certain shareholder rights

shareholders: individuals or institutions that buy/own shares in a limited company

Limited liability

The ownership of companies is divided into small units called **shares**. People can buy these and become '**shareholders**' – they are part-owners of the business. It is possible to buy just one share, but usually these are owned in blocks, and it is possible for one person or organisation to have complete control by owning more than 50% of the shares. Individuals with large blocks of shares often become directors of the business. All shareholders benefit from the advantage of limited liability.

Nobody can make any further claim against shareholders should the company fail. This has two important effects:

- People are prepared to provide finance to enable companies to expand.