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ANDREW GILLESPIE

ECONOMICS FOR BUSINESS

Economics for Business

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Preface

Welcome to what is essentially the third edition of *Business Economics*. We were delighted with the response to the first two editions, but rather than simply refresh the case studies for this edition we decided to look again at what you really needed. We talked extensively to lecturers about their courses and what students wanted, and it was clear that what was needed was an even greater focus on how economic theory is of value to people in business. Rather than having an economics book adapted for business, you wanted a book written *about* business using relevant economic concepts and theory. The result is that we decided not just to update the second edition but to develop the book significantly so that it can meet your needs more effectively. We have looked at economics through the eyes of someone in business and considered how economic thought might affect business decisions. We have restructured the book and rewritten it significantly so that it is fully tailored to your needs. We think you will find it even more relevant and engaging than the earlier editions.

Two key aims of this book have always been to show why understanding economics is important in business, and to make studying economics accessible. We have continued with this approach and hope that when reading this book you will see why economics is relevant to you, even if you don't want to be an economist, and how economic theory would be important to managers.

A variety of learning features, many of them new to this edition, are supplied in each chapter to help you master the material.

- **Why do I need to know about . . .?**: at the start of every chapter we have created a scenario to help you appreciate why this topic is important in business.
- **Business case**: these cases are real-life business situations that raise a number of issues related to the topic in the chapter. We put the case at the start of the chapter, with some questions so that you can appreciate what it is you are trying to understand in this chapter. As the chapter progresses you gain the knowledge and skills to answer the questions given at the start. We also have extension questions at the end of the chapter to take your understanding of this issue even further, now you have studied it.
- **Management task**: in this feature we give you examples of the decisions that managers might have to make using the theory we have covered, and we ask for your view of what should be done in the given situation. This feature helps you to relate what you are studying to the types of decision you might make in business.
- **Business insight**: this feature includes insights into real business situations and gives you the opportunity to analyse this using the theory you have been learning.
- **Analysing the business data**: provides you with economic data in a variety of forms, such as tables and charts, and allows you to analyse these with the skills you have developed.

- **Key concepts**: the key issues covered in the chapter are clearly defined and flagged for you throughout the chapter.
- **Doing the business maths**: allows you to apply your quantitative skills. Answers to the problems are supplied at the end of the book.
- **Quick check**: questions allow you to review what you have been reading and quickly test your understanding—for example, through multiple choice or true/false questions. The answers are supplied at the end of the book.
- **Read more**: gives you details of sources you might find interesting to take your learning further.
- **Key learning points**: at the end of the chapter summarize what you have learned.
- **Quick questions**: give you an opportunity to review the whole chapter through some short questions.

Contents

Detailed contents

How to use this book

WHY DO I NEED TO KNOW WHAT A BUSINESS IS?

You have been asked to invest in a business. You would become
rent share price is £2.50. You are not sure whether to invest at a
how much to spend. Can you take the risk? Is it worth getting in
Will you able to influence anything anyway?

Why do I need to know about...?

Each chapter opens with a typical scenario you might face in the world of work which demonstrates why this topic is important and relevant to your future career.

BY THE END OF THIS CHAPTER YOU WILL BE ABLE

- explain the role of a manager
- distinguish between different business legal forms
- distinguish between a private limited company (ltd) and a publi

Learning objectives

A bulleted list of the learning outcomes contextualises the chapter's main objectives. This feature can help you plan your revision to ensure you identify and cover all of the key concepts.

BUSINESS CASE

The priorities and targets of a business, and the way that things a
is its culture), can depend on who owns it. Changes in ownership
decisions are made and what managers and employees value. Br
to a business may raise finance, but the objectives and values of

Business case

A topical, real-life business situation which raises a number of key issues relevant to the chapter is included at the beginning of each chapter, with accompanying questions so that you can identify what it is you are trying to understand in the chapter, and see how it applies in practice.

KEY CONCEPTS

The **primary sector** refers to extractive industries, the **secondary**
rials into finished products, and the **tertiary sector** refers to serv

Key concepts

Are flagged and clearly defined where they first appear in the text, providing a practical way for you to check your understanding.

2.6 **BUSINESS INSIGHT: SMARTPHONES AND YOUN**

Some of Apple's biggest investors have asked the company to de
how long children can use its smartphones. The demands have
ment groups that hold $2bn (£1.48bn) of Apple shares betwe
represents the pensions of Canadian teachers. These investo

Business insight

Frequent insights into real business situations are included throughout the book to illustrate how theory works in practice. Accompanying questions encourage you to develop your analytical skills.

MANAGEMENT TASK

- You have become the manager of a company that produces co
tors appointed you to improve profits within the next year. W
you can take to boost short-term profits?
- You are the chief executive of a large but still relatively young

Management task

In this feature we give you examples of the decisions that managers might have to make using the theory we have covered, and we ask for your view of what should be done in the given situation. This feature helps you to relate what you are studying to the types of decisions you might make in business.

BUSINESS CASE QUESTIONS: CAN YOU NOW ANS

1. Why do you think Amazon has set an objective of growth?
2. How might this objective affect its decisions within the busin

Business case questions: can you now answer…

As the chapter progresses, you gain the knowledge and skills you need to confidently answer the business case questions included throughout the chapter. These questions refer back to the opening case to consistently reinforce the main concepts.

Year	Return on capita
2017	0.55%
2016	0.67%
2015	−26.13%
2014	7.85%

Analysing the business data

We provide you with the type of data you will come across in your business career, and this supports you in analysing this information with the skills you have developed.

2.2 DOING THE BUSINESS MATHS

To an accountant, the 'costs' incurred by a business means the v
up in a given period. Often this requires assumptions to be made
have been used. These assumptions are stated in the company a
assumptions will affect the profits declared for any given period.

Doing the business maths

Each chapter provides opportunities for you to practice and apply your quantitative skills to common business situations. Answers to the problems are supplied at the end of the book.

READ MORE

Milton Friedman was a very well known writer about the benefit
famously wrote that 'the business of business is business'. You c
benefits of the free market here:

Read more

This feature points you to sources of further information which allow you to take your learning further.

6.4 QUICK CHECK

For each of the following statements, say whether it is true or fal

a. If men get paid more than women this means there must be
b. Labour productivity will affect the demand for labour.

Quick check

These multiple choice and true / false questions allow you to review what you have been reading and quickly test your understanding as you go along.

KEY LEARNING POINTS

- Competitive markets can lead to efficiency and innovation.
- Markets can lead to many failures and imperfections.
- Some products may be over- or under-produced in a free ma
- Governments may intervene in several ways, such as legis

Key learning points

A bulleted list at the end of each chapter enables you to check your progress against the learning outcomes for each chapter.

BUSINESS CASE EXTENSION QUESTIONS

1. Visit the Amazon website, find Amazon's annual report and re
the company's activities by the chief executive. What does sh
issues in the business environment that have influenced Ama

Business case extension questions

Each chapter ends with extension questions to the opening business case; allowing you to take your understanding of the topic even further, now you have studied it.

QUICK QUESTIONS

1. What is meant by a public good?
2. How does a negative production externality affect a market?
3. How does information asymmetry distort a market?
4. How might monopoly power distort a market?

Quick questions

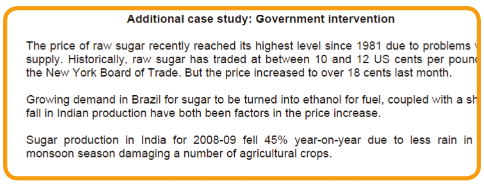
Give you an opportunity to review and quickly assess your understanding of the whole chapter

Online Resources

This book is accompanied by a wealth of online resources, providing students and registered lecturers with ready-to-use teaching and learning resources.
www.oup.com/uk/gillespie-busecon/

For students

Additional short cases



Additional case study: Government intervention

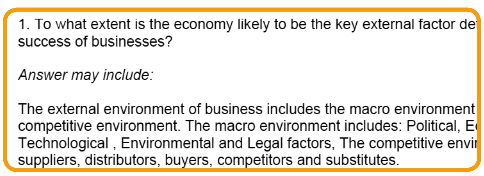
The price of raw sugar recently reached its highest level since 1981 due to problems w supply. Historically, raw sugar has traded at between 10 and 12 US cents per pound the New York Board of Trade. But the price increased to over 18 cents last month.

Growing demand in Brazil for sugar to be turned into ethanol for fuel, coupled with a sh fall in Indian production have both been factors in the price increase.

Sugar production in India for 2008-09 fell 45% year-on-year due to less rain in monsoon season damaging a number of agricultural crops.

Extra case studies help highlight how economic concepts can be applied to real business situations.

Sample essays



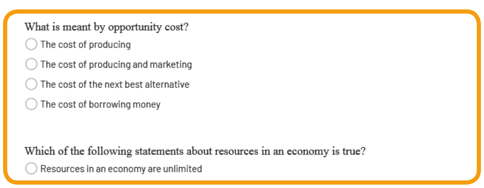
1. To what extent is the economy likely to be the key external factor de success of businesses?

Answer may include:

The external environment of business includes the macro environment competitive environment. The macro environment includes: Political, E Technological , Environmental and Legal factors, The competitive envi suppliers, distributors, buyers, competitors and substitutes.

Essay questions and suggested answers provide you with guidance on how to tackle essay-writing.

Self-test questions



What is meant by opportunity cost?
- The cost of producing
- The cost of producing and marketing
- The cost of the next best alternative
- The cost of borrowing money

Which of the following statements about resources in an economy is true?
- Resources in an economy are unlimited

Provide a quick and easy way to test your understanding, with instant feedback.

Library of video and podcast links

Demand

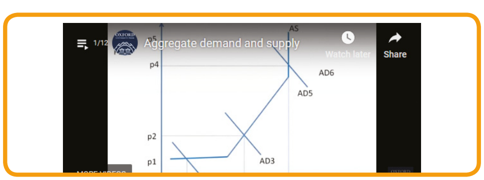
UC Berkeley
http://www.youtube.com/watch?v=ZR2255CEhvk

Deriving demand curves
http://ocw.mit.edu/courses/economics/14-01sc-principles-of-microeconomics-fall-2011/unit-2-consumer-theory/deriving-demand-curves/

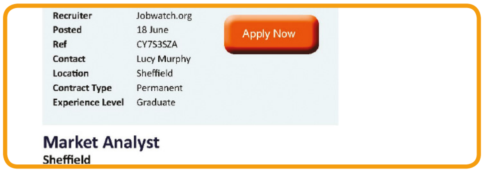
Consumer choice
http://www.youtube.com/watch?v=VNhgKtOWx9U

A curated list of links to topical videos and podcasts from key academics and practitioners.

Visual walkthroughs



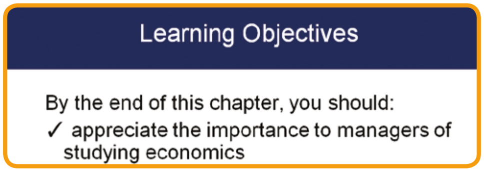
Mini tutorials by Andrew Gillespie on some of the trickier concepts discussed in the book.



Jobwatch

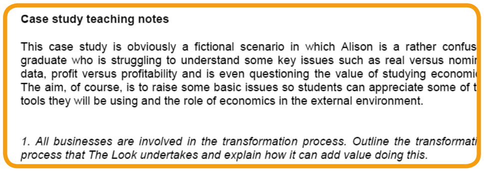
Annotated job adverts which identify the key skills you will require for a particular job, and how to demonstrate them.

For registered lecturers



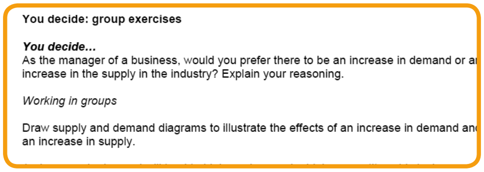
PowerPoint slides

A suite of customizable PowerPoint slides which can be used in lectures or printed as handouts, and can be easily adapted to suit your teaching style.



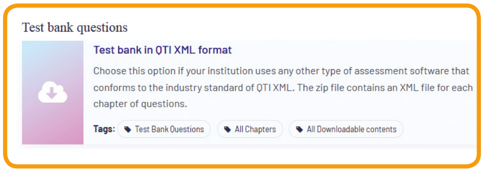
Case study teaching notes

Notes and guide answers for each chapter's opening case.



Group exercises

A range of more detailed, workshop-based activities that students can complete prior to and during tutorials.



Test bank

A wealth of additional multiple choice questions that can be customised to meet your teaching needs.

Acknowledgements

Many thanks to everyone at OUP, especially Kat Rylance and Joe Matthews, and to Lucy Metzger (copy-editor) for all their support, tolerance, and help in developing this latest edition.

Seth, Romily, Clemency. You shine.

Business insight features

What is a business?

CHAPTER 1

WHY DO I NEED TO KNOW WHAT A BUSINESS IS?

You have been asked to invest in a business. You would become a shareholder. The current share price is £2.50. You are not sure whether to invest at all or, if you do go ahead, how much to spend. Can you take the risk? Is it worth getting involved in the first place? Will you able to influence anything anyway?

The company is a social media business. It is only a few years old and is already going public and opening up to outside investors. It has been very high-profile, and some have called it the new Snapchat. This is what caught your eye, plus the fact one of your friends' relations is a manager in the business, although you have no idea what she actually does. You are not quite sure why the company has gone public or what differences it might make—is it a good sign or a bad one?

There are several different forms of business, including public limited companies. These have different forms of legal structure and ownership. In this chapter we examine these different forms and also consider the role of managers within these organizations.

BY THE END OF THIS CHAPTER YOU WILL BE ABLE TO . . .

- explain the role of a manager
- distinguish between different business legal forms
- distinguish between a private limited company (ltd) and a public limited company (plc)

BUSINESS CASE

The priorities and targets of a business, and the way that things are done within it (which is its culture), can depend on who owns it. Changes in ownership can affect the way that decisions are made and what managers and employees value. Bringing outside investors to a business may raise finance, but the objectives and values of these investors may be different from those of the original owners of the business.

Facebook, the social media company, is known for its 'hacker' culture; build things, try them, and if they don't work just start again. One of the company's favourite sayings is 'If you're not breaking things, you're probably not moving fast enough.'

The founder, Mark Zuckerberg, created the company 'to make the world more open and connected'. Its headquarters in Menlo Park, California, looks and feels like a large university campus. On site there you will find small team-based projects, frequent hackathons, open bars, and free food. The idea is to create an environment where employees are more likely to collaborate and come up with innovative ideas.

In 2012 Facebook became a public limited company, bringing in outside investors. Some analysts worried that Facebook would not be able to retain its hacker culture. However, Zuckerberg retained 57 per cent of the votes, which meant he kept a tight control on the development of the business.

BUSINESS CASE QUESTIONS

This chapter will help you answer the following questions.

1. What is the difference between a company and other forms of business?
2. What is the difference between a private and a public limited company?
3. Why would a business want to become a public limited company?
4. How does Facebook create value for its customers?
5. What do you think the managers of Facebook do?

Managing a business

You have just been appointed as the managing director of a business. So, what does your new job actually involve? The answer is that you are managing a collection of individuals that you hope to direct towards a shared goal—the goal you were appointed to achieve. Typically, the overall goal of a business is linked to profit. You want the people who work for you to work together and help the business to achieve this. This means you want the revenue from your business to be greater than the costs. You need to control the employees' efforts and performance to ensure that goal that has been set is achieved. According to Rosemary Stewart, management is about 'getting things done through others'.

READ MORE

Stewart, R. (2012), *The Reality of Management*, Hoboken, NJ: Taylor and Francis.

KEY CONCEPT

Profit is measured by revenue minus costs.

The features of a business are therefore that it involves:

- a group of individuals working together
- shared goals
- managed performance

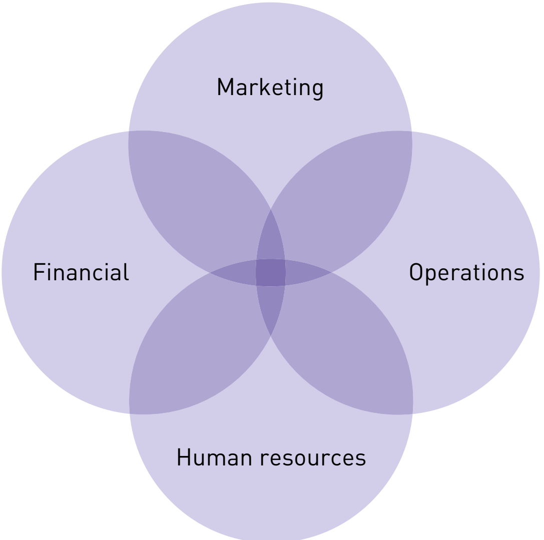
What are your employees busy doing?

Although the precise shapes and forms of businesses can be very different, as can the precise nature of the work that employees do, there are certain activities that occur within any form of business (see Figure 1.1).

- Marketing activities: the marketing function forms the link between the business and customers. It enables the business to understand the needs and wants of the market, to decide which customers to target, and to develop an offering that is competitive. Marketing will also involve decisions about the communication of information about the product, its pricing, and its distribution.
- Operations activities: these involve managing the actual process of providing the goods and services. For example, operations might involve ordering stock, managing the production process, maintaining quality, and investing in research and development of new products.
- Financial activities: these will be monitoring and recording the value of all transactions. They will be helping managers assess the financial implications of any decision made and decide on which investments to make in the future.
- Human resource activities: these will involve recruiting and training staff, rewarding them appropriately, and managing their role in the operations process.

These different functions may be separate specialist departments in some organizations, or in the case of a one-person business they may all be undertaken by the owner.

Figure 1.1 The functions of a business



KEY CONCEPT

The **functions** of a business are the different activities within it such as marketing, finance, operations, and human resource management.

MANAGEMENT TASK

You have organized your staff into specialist departments. Explain why you think this is a good idea.

One danger of having specialist functions is that they may operate in 'silos'. What do you think this means? What actions would you take to avoid this?

Legal forms of business

There are several different legal forms that a business might have. The principal ones are a sole proprietor, a partnership, and a company.

Sole proprietor

This is where an individual runs a business for themselves. The sole proprietor, also called a sole trader, owns the business and is legally responsible for its activities. This is an attractive form of business in that it does not need to be registered in order to be established and does not require specific legal documents to create the business. As a sole proprietor, you are the owner and the manager.

Partnership

This is where two or more people share ownership and profits of a business; they generally have unlimited liability (although limited liability partnerships do exist). The value of this form of business over a sole trader arrangement is that the partners can share ideas, finance, and workload. In some cases, different partners will specialize in different parts of the business (for example, legal partners who are experts in different areas of the law). The disadvantage is that you are relying on others and are legally responsible for their actions.

Both sole proprietors and standard partnerships have unlimited liability. This means there is no difference in law between your personal assets and those of the business; if used, for example, all your own assets are at risk. By comparison, the owners of a company have limited liability.

Company

A company has its own legal identity. Individuals set up a company and are its shareholders (investors). Typically, there is one vote per share held, but the precise rights and powers attached to each share may be defined in the company's rules. The appeal of setting up a company is that shareholders have limited liability; this means that there is a limit to their risk. If, for example, you invest £100 into a company, this money could be lost but all the rest of your personal assets are safe. The company's funds are at risk, but these are different from the personal assets of the investors. Limited liability is essential to business. It enables businesses to raise funds from selling shares. Investors are willing to put money into a company, even if they are not entirely sure about every aspect of its operations, because they know there is a limit to the risk. To be registered and to operate as company the owners must produce annual accounts that are audited by independent accountants. This, in theory, provides some protection for investors. There are different forms of companies. Some are private, which means that their shares are not traded to the general public. In a public limited company the shares are widely available and bought and sold each day.

Private limited companies in the UK have 'ltd' after their name. Restrictions can be made on who owns these shares and who they are sold to. Family companies, for example, might be private limited companies, and the rules of the company might ensure that shares stay within the family. By comparison, restrictions cannot be placed on the sale of shares of public limited companies. These shares can be advertised and sold easily to others. They are often traded on a stock exchange.

By creating a company it is possible to have specialist managers who run the business, financed by investors who do not necessarily get involved day to day. This allows great managers to raise the finance to run an organization, while those with money who might not be great managers let others control the business on their behalf. This has many benefits—without limited liability investors would not dare to invest because they would be risking all their personal assets, and without limited liability we would need people with money to also be great managers for businesses to be successful. With limited liability people can specialize in the area that plays to their strengths.

However, it may create problems that those running the business are not the same people as the owners. This is known as the principal–agent problem. The principal is the owners and the managers are their agents. The danger arises from the fact that the managers know far more about the day-to-day business than the owners. The managers may therefore keep some information from the owners that they do not want them to know and/or may pursue their own objectives rather than the objectives of the owners. For example, managers may argue that a particular acquisition of a competitor is critical to the business when in fact it is driven by their own ego. Owners must therefore set in place systems to oversee the management of what is their business. The process of managing the managers is known as 'corporate governance'. There are often thousands of investors in a public limited company. They elect the board of directors to represent them (typically 10 or 12 people) and oversee the senior managers. This is part of the process of corporate governance, and the board of directors are responsible for managers' actions.

BUSINESS CASE QUESTIONS: CAN YOU NOW ANSWER . . .

1. What is the difference between a company and other forms of business?
2. What is the difference between a private and a public limited company?
3. Why would a business want to become a public limited company?
4. Why, and how, might the culture of Facebook have changed with more outside investors?

MANAGEMENT TASK

You have been running your own cleaning business from home for the last few years. It has gone well, and you are now about to rent storage units and office space. You want to expand your business. Is now the time to set up a company, do you think?

1.1 QUICK CHECK

For each of the following statements, say whether it is true or false.

a. The owners of a private and a public company have limited liability.
b. A sole trader has unlimited liability.
c. The owners of a company must be the managers.

KEY CONCEPTS

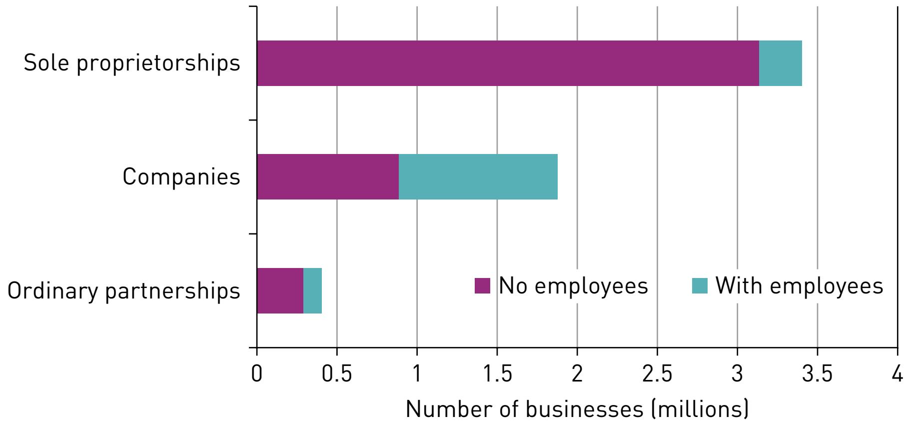
Corporate governance refers to the systems by which companies are directed and controlled. Boards of directors are ultimately responsible for the governance of their companies.

Limited liability means that the risk for investors is limited to the amount invested; their personal assets are separate from the assets of the business.

ANALYSING THE BUSINESS DATA

Sole proprietorships are the most common legal form in the UK. Companies account for around a third of private sector businesses. Figure 1.2 shows the proportions of businesses with and without employees at the start of 2017.

Figure 1.2 Number of businesses in the UK private sector with and without employees, by legal status, start of 2017



Source: www.ons.gov.uk/businessindustryandtrade/business/activitysizeandlocation/bulletins/ukbusinessactivitysizeandlocation/2017.

1. Approximately what proportion of businesses in the UK at the start of 2017 were sole proprietorships?
2. Why do you think such a large proportion of businesses are sole proprietors?

RESEARCH TASK

Research a business that is going public (this is sometimes called an 'initial public offering'—an IPO). Analyse the reasons for this IPO.

MANAGEMENT TASK

You have been running your own management consultancy business as a sole proprietor for the last few years. You are considering creating a private limited company. What factors might you take into account before deciding whether this is the right decision?

Managing the transformation process

As a manager you are overseeing the transformation of inputs into outputs. Your aim is to create value while doing this: that is, to ensure the value of the final products is greater than the value of the inputs used up. The transformation can take many different forms. For example, you may be:

- moving items or people from A to B, e.g. a haulage business or airline
- creating beauty, e.g. a hairdresser or cosmetic surgeon
- producing entertainment, e.g. for TV, a theatre company, or a music label
- helping others do what they do better, e.g. a consultant or financial advisor

If the transformation is in the extractive industries, such as farming and oil extraction, you are operating in the primary sector. If the process produces manufactured items, you are in the secondary sector. If you produce services (intangibles), you are in the tertiary sector. Most of UK business is in the tertiary sector, such as financial services and education.

KEY CONCEPTS

The **primary sector** refers to extractive industries, the **secondary sector** turns raw materials into finished products, and the **tertiary sector** refers to services.

Managing the transformation process involves management of the supply chain as well as the actual process.

- Controlling the supply chain means, for example, choosing whether to produce items yourself or buy them in, where to source supplies from, which suppliers to use, and what terms and conditions to negotiate for payment. These types of decisions will determine whether you get the supplies you need when you need them.
- Managing the process itself means, for example, deciding where to produce, what systems and processes to use, and how to organize what is done when.

MANAGEMENT TASK

You are the chancellor of a university. You are being interviewed tomorrow and have to justify your government funding.

a. Explain how your organization creates value and how you might measure this.

b. Explain the benefits your university brings to the economy.

BUSINESS CASE QUESTIONS: CAN YOU NOW ANSWER . . .

How does Facebook create value for its customers?

What do managers do?

The role of a manager has many aspects to it, summed up in Figure 1.3. She should be scanning the environment now and, more importantly, anticipating possible future changes, in order to plan what is to be done next. Planning is key to provide a focus for people on what they should be doing. Getting the right plan is vital to the success of the business. Turn left when you should have turned right and you have a problem. This is particularly true with major decisions, because they can be difficult to reverse once implemented.

Figure 1.3 What does a manager do?

Part of this scanning should cover the business environment. This can be divided into two components.

- The micro or immediate environment includes individuals and organizations that a business has direct and regular interaction with, such as rivals, suppliers, and distributors.
- The macro environment includes factors which affect a business but which it cannot easily influence, such as government legislation, social changes, and developments in technology. One important set of factors in the macro environment is economic. Economic factors that influence the success of a business include the value of the country's currency (exchange rate), the cost of borrowing money (interest rate), and the average income of citizens in the country. Changes in these economic factors will influence the costs and availability of resources, the likely target markets and the prices that can be charged.

Managers must analyse the business environment to determine the strategy or direction the organization is heading in and how it would best compete.

As well as setting the overall direction, business managers need to organize the resources required such as the staff, physical space, equipment, and supplies. This process is not necessarily sequential, in that the resources available will clearly influence the plan in the first place.

Once the resources are organized—such as the right people employed and trained, the right equipment and systems in place—managers need to coordinate the implementation of the plan.

As work continues, managers need to review the progress of the plan. They will have set key indicators of performance and will need to assess whether everything is on target, and what actions to take next. They will review whether what has happened was what was intended, and what targets to set next time around. Future plans will be affected by past experiences.

1.2 QUICK CHECK

Which of the following would you say are in the micro environment of a business, and which in the macro environment?

a. Suppliers
b. Demographic factors
c. Customers
d. New legislation
e. Changes in the exchange rate
f. Competitors

The precise activities of a manager will depend on which area of the business they are focused on and the level they are at. For example, junior managers may concentrate on supervising and controlling subordinates and getting a job done; more senior managers may be more concerned with strategic planning.

The economy and the transformation process

As a business, you are one part of the economy as a whole. The chances are that you are a global business buying materials from abroad and trading overseas; this means you are a small part of the global economy. The decisions you make will have a ripple effect—throughout your local economy, the national economy, and the global economy. For example, your decision to use one supplier rather than another will affect the supplier's business, the staff who work for them, and the businesses who in turn supply them. Your decisions to locate in one area rather than another will affect the regions involved, their economies, and the businesses linked to them. At the same time you will be affected by the decisions of other businesses. Their decisions will affect the demand in your markets, the costs of your resources, and the availability of supplies. You will also be affected by decisions of the government, which will influence factors such as the ease of trade, the conditions of trade, and market conditions.

As a manager you need to understand the economy because it will affect the market for your inputs and the market for your outputs. The economy may be analysed in terms of what is happening locally, nationally, and globally.

- Locally—for example, in your city or region—there may be specific issues such as labour shortages or high land prices.
- Nationally, there are factors that affect the UK as a whole, such as the government's policy on taxation.

- Globally, there are factors affecting the world economy, such as trading agreements between countries.

YOU, THE MANAGER

You have scheduled a meeting with your senior managers later this week to discuss the position of your business and the opportunities and threats it faces. Explain the three key issues that businesses are facing at the moment in (a) the local economy, (b) the UK economy, and (c) the global economy.

1.1 BUSINESS INSIGHT: LOCATING IN FRANKFURT

Political and economic conditions will affect business decisions. For example, in recent years the UK has been negotiating to leave the European Union (EU). Trade between the UK and EU member countries could become more difficult as a result. This possibility has led to some businesses considering where they want to be based. A number of firms have moved offices, or are threatening to move from the UK, to be based in countries that are staying in the EU.

Frankfurt has been home to around 1 million citizens for many years, but the number is now growing as several UK banks have announced they are relocating there from the City of London. These banks, concerned about what would happen if the UK left the EU, decided they needed to plan for an unfavourable outcome and relocate some of their operations to within the EU.

According to a BBC report from August 2017:

> Morgan Stanley, Citigroup and Standard Chartered are among those who have chosen Frankfurt as their new European base, while others such as Goldman Sachs and UBS have promised to move thousands of jobs to the German hub.
>
> Predictions for the number of bankers set to descend on Frankfurt vary wildly, from tens of thousands, up to 100,000.

This has led to significant building of office space in Frankfurt, with plans to build 20 more skyscrapers.

Frankfurt is appealing for many reasons. It has a large English-speaking population. It has good transport connections and is a safe and attractive city for those looking to move. Its time zone is favourable to bankers, allowing contact with Asian markets in the morning and the US in the evening. And the appeal also lies in the price. Office space in Frankfurt costs about 38.50 euros (£35) per square metre per month, roughly half the cost of London office space. A final factor is convenience—many banks already have a presence in Frankfurt and can simply expand.

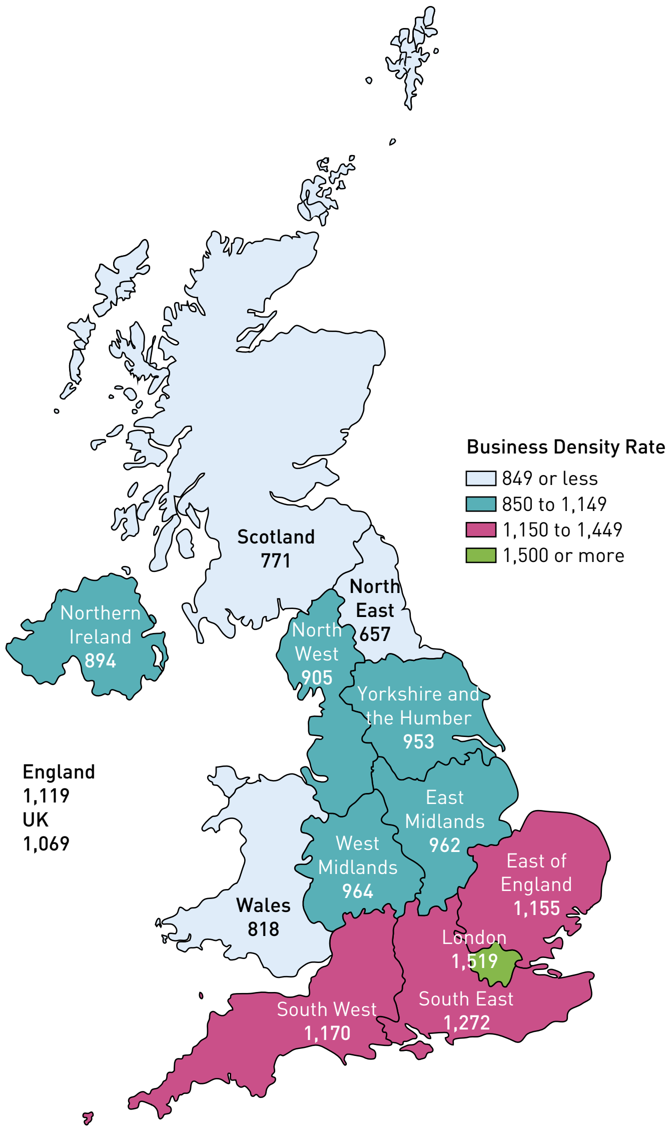
Source: www.bbc.co.uk/news/business-41026575

Question

What factors do you think might prevent businesses from relocating from London to Frankfurt?

ANALYSING THE BUSINESS DATA

Figure 1.4 Number of businesses in the UK private sector per 10,000 adults, UK region and country, start of 2017



Source: Business Population Estimates www.gov.uk/government/uploads/system/uploads/attachment_data/file/663235/bpe_2017_statistical_release.pdf. Contains public sector information licensed under the Open Government Licence v3.0.

What factors do you think might affect the density of businesses in different parts of the UK (shown in Figure 1.4)?

ANALYSING THE BUSINESS DATA

Table 1.1 Number of business enterprises per country, total and by number of employees

Country	Total no. of enterprises	Breakdown by no. of employees				
		0–9	10–19	20–49	50–249	Over 250
Germany	205,028	131,323	36,624	16,281	16,464	4,336
Greece	63,890	59,886	2,150	1,180	563	111
Italy	389,317	321,837	39,159	18,771	8,338	1,212
Luxembourg	786	481	99	99	83	24
Norway	17,141	13,915	1,354	1,089	663	120
Poland	187,374	164,535	7,768	7,289	6,193	1,589
Turkey	335,311	305,768	0	18,037	9,665	1,841
USA	341,912	229,045	46,635	37,495	23,065	5,672
Romania	48,405	34,974	5,014	4,495	3,147	775

Source: data.oecd.org/entrepreneur/enterprises-by-business-size.htm#indicator-chart

Table 1.1 shows the total number of business enterprises in nine countries in 2015, analysed by number of employees.

Question

1. Why do you think the total number of businesses varies between countries?
2. Discuss the significance of the data in terms of numbers of employees (a) within countries and (b) between countries.

RESEARCH TASK

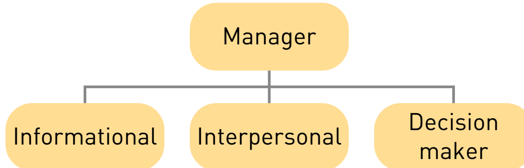
Research the number of recent startups in your economy. Produce a report on the factors that are likely to influence the number of startups and their chances of survival.

The roles of a manager

Although each individual management job may have its specific demands, objectives, and areas of control, there are some aspects that management jobs may have in common to some degree. According to the management writer Henry Mintzberg, a manager has several roles (Figure 1.5).

- **A manager is a source of information.** For example, she will gather information on the work being done, she will communicate information to those within the organization, and she will act as a spokesperson representing the business.

Figure 1.5 Mintzberg's model



- **A manager works with others: this is an interpersonal role.** She will be regarded as the figurehead of the business, she will be the leader setting out the vision and strategy, and she will liaise between different groups within the organization.
- **A manager is a decision maker.** She will solve disputes, identify new opportunities, allocate resources, and negotiate to defend the interests of the business.

The relative importance of these roles will vary from time to time, and according to the level of management and the precise job of the manager being considered.

READ MORE

If you would like to learn more about the role of a manager, you can read

Mintzberg, H. (1973), *The Nature of Managerial Work*, New York: Harper & Row.

MANAGEMENT TASK

You have worked your way up from being the team manager of a particular shift in a retail outlet to regional sales manager and now chief executive. Although you have always been a manager, your role has changed as you have been promoted. Explain how you think the relative balance of your different roles, as named in Mintzberg's model, have changed as you have been promoted.

Why managers and economists have a lot in common

Problem solving

Managers have to assess the best way of solving problems. For example, in order to boost profits, should the focus be on increasing revenue? Or cutting costs? Managers will have to weigh up the alternatives and make a judgement on what is 'right' for the business. Economists also have to make decisions. If we think people are drinking too much alcohol, should we tax alcohol? Subsidize non-alcoholic drinks? Or invest more in education? Economists will consider how best to resolve an issue given the resources they have. Economic policy involves developing ways of solving economic problems. Politicians who decide on what economic policy to pursue will be judged via the ballot box. Managers will be judged on the performance of their company, which will affect their rewards and whether they keep their jobs.

Data analysis

In terms of how managers make decisions there are again similarities with economists. To make decisions managers will need data. They will gather information to understand the possible causes of any problem and ways in which it might be solved. Economists also analyse data to understand how different elements of the economy work and are related to each in order to come up with better policy decisions.

Limited resources

Economics is about analysing how the limited resources in an economy (such as land, labour, capital, and entrepreneurship) are allocated given the unlimited demands of consumers. Given the scarcity of resources but the unlimited wants, choices have to be made. For example, an economy cannot produce more of everything given the resources available. The government, on behalf of the people, must decide how best to use these resources—for example, how much resource to direct to health, education, or defence. Even within an area such as health care, decisions have to be made about how to use scarce resources. Should the focus be on mental health? Cancer? Our resources are limited. Managers also have limited resources (for example, limited time, limited staff, and limited equipment) and have to decide how best to allocate these. What is the priority? In what order should tasks be completed? Managers, like economists, have to understand that choices must be made and have to consider how best to make those choices.

KEY CONCEPT

Resources are factors of production such as land, labour, capital, and entrepreneurship that are used in the transformation process.

Short- and long-term demands

Managers will be juggling short- and long-term demands. A common issue in the UK is that business owners often push for short-term rewards and this means there are insufficient funds for the long term. However, managers themselves may be guilty of a short-termist view. This is because they may be looking to advance their own careers. Given that managers may change their jobs fairly frequently, this means they are particularly interested in projects that generate fairly quick returns. Longer investments may be less appealing because the returns may arrive after the manager has moved on to a new role.

Model-building

Managers have to anticipate demand and costs. To do this, they build models in which they make various assumptions, notably about relationships such as the link between income changes and demand. Economists also build models—of the economy. These models also make a variety of assumptions: for example, about the ease of entry and exit into a market and the impact of price on quantity demanded and supplied. Using these models, economists can predict the effect of changes in the economy: for example, they can predict the effect on price and quantity of a change in demand. The model may not exactly reflect reality but may help to anticipate the outcomes that occur. Of course, economists will argue about the nature of their models and the assumptions made. If the outcomes that occur do not match those predicted by the model, economists will review and debate why the model was wrong and try and adjust it accordingly. Models provide useful simplications of the real world; however, they do need to be reviewed because there may be changes in behaviour or in the environment that mean the model needs to be adjusted. Similarly, managers will continually review the outcomes of the business relative to the plan, and will adjust polices if the business is not meeting targets.

Economists are also very interested in the time period being considered. Conditions in the short term may be very different from conditions in the long term, for example. In economics we often look at the short term in markets where there are an existing number of providers and compare this to the long term, when we assume it is possible for businesses to enter or leave. This means the structure of the industry can change over time. Short- and long-term issues also arise in considerations about how resources in an economy should, or could, be allocated. For example, there is a danger that individuals will focus on consuming as much as they can now and not plan enough for the future. This may mean that the government will want to intervene to ensure that more resources are allocated to investment for the future rather than being consumed today.

READ MORE

Peter Drucker was one of the great writers on management. To find out more about what managers actually do, you might want to read

Drucker, P.F. (1954), *The Practice of Management*, New York: Harper.

MANAGEMENT TASK

Your shareholders want more of the profits paid out now in dividends. You want to retain more of them, believing this is in the shareholders' best interests. Explain to your investors why you believe this.

BUSINESS CASE QUESTIONS: CAN YOU NOW ANSWER . . .

What do you think the managers of Facebook do?

How might economists and managers approach problems differently?

Managers will be juggling many constraints when making a decision. They will have many different stakeholders involved, such as employees, customers, suppliers, investors, and the local community. To keep all these groups happy, a manager may not be able to focus purely on profit. Managers' decisions may focus on financial factors but are also likely to include a range of other factors less easy to quantify, such as the impact of a decision on employee morale or on the company's brand. Economists are likely to concentrate on the measurable costs and revenues. The economist will want to identify the likely returns on any project; she will want all aspects of a project measured in financial terms.

READ MORE

If you want to know more about how economists can help managers make better decisions, you could read

Casson, J.J. (1996), 'The Role of Business Economists in Business Planning', *Business Economics* Vol. 31, No. 3 (July), pp. 45–9.

This article highlights the value that economists can add to decision making but also the fact that their skills are often not fully utilized.

1.3 QUICK CHECK

For each of the following statements, say whether it is true or false.

a. There are unlimited resources in an economy.
b. Economic models fully reflect reality.
c. The resources of business are goods and services.
d. A company is owned by its managers.

KEY CONCEPT

Short-termism occurs when decision makers focus on relatively short-term rewards rather than planning for the longer term.

SUMMARY

There are several different legal forms of business which have their own characteristics and features. Most businesses in the UK are sole proprietorships—individuals set up and run their own businesses. In some cases they take on partners. In other cases they create a separate legal identity called a company. A company provides limited liability, which makes it more attractive to investors. This enables there to be managers who specialize in running the businesses financed by investors. Managers have several roles including informational, interpersonal, and decision-making activities. Managers, like economists, have to understand how best to use limited resources to achieve their objectives.

KEY LEARNING POINTS

- There are different forms of business you can choose from, such as a sole proprietorship, partnership, or company.
- Limited liability means there is a limit to your financial risk if you invest in a company.
- Managers' roles include informational, interpersonal, and decision-making activities.
- Managers and economists are problem solvers.
- There may be pressure on managers to be short-termist in their thinking.
- Economic models do not necessarily reflect reality—they are a simplification of it.
- Economic models can be used to anticipate outcomes and estimate the effects of changes in policy.

BUSINESS CASE EXTENSION QUESTIONS

1. Research the performance of Facebook since it became a public limited company. Does it seem to have changed its approach in any way?
2. What has happened to Facebook's share price since it became a public limited company? Can you explain how it has changed?
3. Can you find an example in the news of a shareholder revolt? Is there a company at the moment where the shareholders are demanding a change in management and approach? Why?
4. Research a senior manager who has resigned recently. What caused this resignation?

QUICK QUESTIONS

1. What are the key features of a business?
2. In what way are businesses involved in a transformation process?
3. What are the functions of a business?
4. What is the significance of limited liability?
5. What is the difference between the primary, secondary, and tertiary sectors?
6. What do managers do?
7. What are the typical roles of managers, according to Mintzberg?
8. Why do investors buy shares?
9. Why might a manager be short-termist?
10. What is meant by the macro environment of business?

CHAPTER 2

Mission and objectives

WHY DO I NEED TO KNOW ABOUT MISSION AND OBJECTIVES?

> I joined the company a few months ago and I still don't know what it is I am supposed to be focusing on. One minute I am being told to get costs down. The next minute someone asks me how we can get sales up. Then there will be a request about new overseas options—with Brexit happening we are all suddenly looking for new markets outside of Europe. It's just not clear what the priorities are supposed to be. I can probably get the sales up but it will cost us money and we may have to cut prices. I am not sure I can get sales up, revenue up, and costs down!
>
> It makes life very difficult when I am trying to organize my time and resources and I don't know what the priority is. I wish someone would ask me what I think, put it into a plan and then tell me what it is!

Managers will sometimes be unsure of exactly what they should be doing or how they will be measured. The role of a mission and objectives is to clarify for everyone what the targets are. However, as we shall see, these objectives can vary between organizations and over time.

BY THE END OF THIS CHAPTER YOU WILL BE ABLE TO . . .

- explain what a mission is and how objectives differ from mission
- explain why managers may want to maximize profits
- explain other common objectives of business
- explain what is meant by corporate social responsibility

BUSINESS CASE: AMAZON—IT'S ALL ABOUT THE LONG TERM

The following statement was made to Amazon's shareholders in 1997. It is sent out to them each year to reinforce Amazon's message about its ongoing commitment to growth.

> We believe that a fundamental measure of our success will be the shareholder value we create over the long term. This value will be a direct result of our ability to extend and solidify our current market leadership position.

The stronger our market leadership, the more powerful our economic model. Market leadership can translate directly to higher revenue, higher profitability, greater capital velocity, and correspondingly stronger returns on invested capital.

Our decisions have consistently reflected this focus. We first measure ourselves in terms of the metrics most indicative of our market leadership: customer and revenue growth, the degree to which our customers continue to purchase from us on a repeat basis, and the strength of our brand. We have invested and will continue to invest aggressively to expand and leverage our customer base, brand, and infrastructure as we move to establish an enduring franchise.

Because of our emphasis on the long term, we may make decisions and weigh tradeoffs differently than some companies. Accordingly, we want to share with you our fundamental management and decision-making approach so that you, our shareholders, may confirm that it is consistent with your investment philosophy:

- We will continue to focus relentlessly on our customers.
- We will continue to make investment decisions in light of long-term market leadership considerations rather than short-term profitability considerations or short-term Wall Street reactions.
- We will continue to measure our programs and the effectiveness of our investments analytically, to jettison those that do not provide acceptable returns, and to step up our investment in those that work best. We will continue to learn from both our successes and our failures.
- We will make bold rather than timid investment decisions where we see a sufficient probability of gaining market leadership advantages. Some of these investments will pay off, others will not, and we will have learned another valuable lesson in either case.
- When forced to choose between optimizing the appearance of our GAAP accounting and maximizing the present value of future cash flows, we'll take the cash flows.
- We will share our strategic thought processes with you when we make bold choices (to the extent competitive pressures allow), so that you may evaluate for yourselves whether we are making rational long-term leadership investments.
- We will work hard to spend wisely and maintain our lean culture. We understand the importance of continually reinforcing a cost-conscious culture, particularly in a business incurring net losses.
- We will balance our focus on growth with emphasis on long-term profitability and capital management.
- At this stage, we choose to prioritize growth because we believe that scale is central to achieving the potential of our business model.
- We will continue to focus on hiring and retaining versatile and talented employees, and continue to weight their compensation to stock options rather than cash.

> We know our success will be largely affected by our ability to attract and retain a motivated employee base, each of whom must think like, and therefore must actually be, an owner.

We aren't so bold as to claim that the above is the 'right' investment philosophy, but it's ours, and we would be remiss if we weren't clear in the approach we have taken and will continue to take.

Source: Amazon Annual Report 1997 and 2016
https://blog.aboutamazon.com/working-at-amazon/amazons-original-1997-letter-to-shareholders
www.amazon.com/p/feature/z6o9g6sysxur57t

BUSINESS CASE QUESTIONS

This chapter will help you answer the following questions.

1. What do you think the mission of Amazon might be?
2. Why do you think Amazon has set an objective of growth?
3. How might this objective affect its decisions within the business?

Mission

The mission of an organization sets out why it exists. What was it set up to achieve and what its owners see as the reason for its existence? Defining the mission of an organization can have very significant impact on decisions within the business; it should influence everything the business does. A mission is a general outline of what a business wants to be. This is then turned into more specific targets in the form of objectives. The mission will be shaped by the owners. Some organizations may have constitutions that set out some aspects of why they exist—for example, if they are a charity, or if they are owned by their employees as in the case of John Lewis. When a company is formed it must set out some description of what it is there to do; this can be changed, but at any moment it defines at least the scope of its activities.

KEY CONCEPT

The **mission** of an organization sets out why it exists.

2.1 BUSINESS INSIGHT: MISSIONS OF GOOGLE AND UBER

The mission of a business can be the subject of much debate. Take Google, for example. Is it a content provider or a search engine? It argues that it is a search engine—this means it helps people to find the information they want. Whatever people might find on the web, it is not Google's problem; it is not there to monitor, police, or control what is shown. For Google, this is a useful interpretation of its mission because it means it does not have to take responsibility for what people find from Google searches. However, if Google defines itself as a content provider then it clearly is responsible for what can be found through searching and should therefore act as a censor.

The question of 'who and what are we?' also became significant with Uber. Uber sees itself as a technology company, but many governments define it as a taxi business. As a taxi business, it needs to be licensed and to meet a number of regulations that would not apply to a technology business.

Question

Do you think Google should take more responsibility for content on the internet?

BUSINESS CASE QUESTIONS: CAN YOU NOW ANSWER . . .

What do you think the mission of Amazon might be?

MANAGEMENT TASK

a. You have a senior position within the police force. Some say the police are there to prevent crime. Some say they are there to solve crime. How might these different missions affect the way you allocate resources?

b. You are the chief executive of a health trust. Should the mission of your trust be to save lives or reduce pain? Why might these two potential missions conflict?

RESEARCH TASK

1. Find the mission statement of the pharmaceutical company Johnson & Johnson (called 'Our Credo'). How do you think this might affect behaviour within the business?
2. Compare and contrast the mission statements of two other public limited companies of your choice.

Objectives

An objective is a target that managers aim to achieve. To be effective, an objective should be SMART. This means it should meet the following criteria.

- Specific: it should specify exactly what is being measured.
- Measurable: it should be possible to quantify it.

- Agreed: a target should not just be imposed on people but should be agreed between those setting it and those who have to achieve it.
- Realistic: a target should be achievable, otherwise people will not be committed to it.
- Time-specific: there should be a clear time limit setting out when the target will be achieved.

Objectives are important for managers because they set out what is to be achieved. They also determine how a manager's performance will be assessed—did she achieve the target in the given time to the agreed standard? Objectives should, therefore, clarify what you are there to do. You can then focus on how to achieve this. The objective will determine how you allocate resources and what your priorities are.

Profit as an objective

For many managers, profit is a very common objective. Profit occurs when the value of the output produced is greater than the value of the inputs that have been used to produce and sell the items involved. It is measured by the difference between total revenue and total costs. If a business generates a profit, this shows that the managers have used the resources effectively in that they have produced something worth more than it cost to provide them. If a profit is made, the business is adding value. If a loss is made, this means that the value of the output is less than the resources used up to provide it.

2.1 DOING THE BUSINESS MATHS

Complete the table.

Output (units)	Total revenue (£)	Total costs (£)	Profit (£)
10	100	20	
20	150	100	
30	300	120	
40	600	220	
50	1,000	700	

Questions

1. At which output is revenue maximized?
2. At which output are costs the lowest?
3. At which output is profit maximized?

KEY CONCEPT

An **objective** sets out specific, time-related targets.

2.1 QUICK CHECK

For each of the following statements, say whether it is true or false.

A business objective should be

a. specific.
b. measurable.
c. ambiguous.
d. reductionist.
e. tentative.

Return on investment

Of course, simply making a profit may not, in itself, justify a particular investment in resources. What is important is to consider the scale of the profit relative to the inputs used to achieve it. If, for example, you worked all year to make a £32 profit this may not be regarded as worthwhile. For a particular project, managers will generally be assessed on their return on investment (ROI). This is measured as a percentage.

ROI = (profit ÷ investment) × 100

For example, if a business makes a profit of £10 million on an investment of £50 million this is a return of (£10 ÷ £50) × 100 = 20%.

Return on capital employed

In terms of the overall performance of the business, the measure of return on investment often used is actually called the return on capital employed (ROCE).

The capital employed is the total long-term finance that the business has. It is made up of funds from

- loans
- shares
- retained profit

The return on capital employed measures the profit generated by the business in a year.

ROCE = (profit ÷ capital employed) × 100

Table 2.1 Calculating and analysing the return on capital employed

	Business A	Business B	Business C
Profit	£1m	£2m	£200m
Capital employed	£10m	£20m	£5000m
Return on capital employed	(£1 ÷ £10) × 100 = 10%	(£2 ÷ £20) × 100 = 10%	(£200 ÷ £5,000) × 100 = 4%

If, for example, the capital employed is £20 million and the profit generated in a year is £1 million, this is 5% return on capital employed.

If the capital employed is £200 million and the profit generated in a year is £1 million, this is 0.5% return on capital employed.

If the return on capital employed is too low, managers may be criticized because funds could have been used more profitably elsewhere. Remember there is always an opportunity cost. Whenever funds are being used by managers, the questions will always be—what else could they be used for? Investors will consider the possible returns in alternative investments.

The value of profit is measured in absolute terms, i.e. the number of pounds of profit. Profitability measures the profit in relation to something else such as the capital employed. Profitability is measured as a percentage.

YOU, THE MANAGER

You are considering major expansion and need to raise long-term funds. Should you borrow, or should you recommend issuing more shares?

In Table 2.1, Business B has generated more profit in absolute terms than Business A (£20m vs. £10m). However, given that it had more funds invested in the business to begin with it is a similar rate of return. Business C makes much more profit than the other two businesses. However, it is a much bigger business and relatively its performance is not as good.

Why do profits matter?

Profits matter because they mean that all the endeavours of the managers and staff have generated a financial surplus over a given period. Provided that profit is high enough as a rate of return in the investment, the project was worthwhile in financial terms.

This profit has several functions.

- It can be paid to investors as dividends. Dividends are part of the rewards that investors get; shareholders also benefit if the share price increases (this is called a capital gain).

- It can be used for funds for investment. This will be cheaper than having to borrow funds, as interest will have to be paid on borrowed funds.
- It can be used as an indicator of how successful the managers are in financial terms; this may matter for their career and rewards.

ANALYSING THE BUSINESS DATA: TESCO PLC

The table shows Tesco's return on capital employed over an eight-year period. Comment on Tesco's ROCE.

Year	Return on capital employed
2017	0.55%
2016	0.67%
2015	–26.13%
2014	7.85%
2013	6.29%
2012	12.05%
2011	11.99%

Source: FAME; www.tescoplc.com/investors/

2.2 BUSINESS INSIGHT: DIVIDEND PAYOUTS IN THE UK

Here is an extract from an article published in the *Financial Times* on 17 December 2017.

> Large asset managers have recently warned British companies to reconsider their dividend policies as fears grow that UK business is shunning investment in favour of investor payouts. [. . .] Global dividends grew at the fastest pace in three years in the third quarter of 2017. UK payouts picked up dramatically, rising 17.5 per cent—the fastest underlying rate in the world—as commodity prices increased, according to the Janus Henderson Global Dividend Index report. [. . .] According to the Janus Henderson report, published last month, payouts by UK companies stood at $93bn last year, down 3 per cent on 2015.

The article reports a fear that the dividends being paid out by business were not sustainable and that not enough was being put into research and development. Some businesses were even taking on debt to pay out dividends.

Source: www.ft.com/content/02081042-d391-11e7-a303-9060cb1e5f44

Questions

1. What do you think managers need to consider when deciding how much to pay as dividends?
2. Why would managers borrow money to pay dividends?

Profit maximization

Standard economic theory assumes that businesses will aim to maximize their profits, i.e. generate the maximum possible positive difference between the total revenue and total costs possible. This may well make sense in theory—as a rational decision maker, if you want to make a profit then presumably you will want to make the most possible. However, this assumption may not match what happens in reality, not least because of information problems. Managers may not actually know exactly what the different cost and revenue implications are of any decision they make. They may not therefore be able to maximize profits even if they want to. You cannot be certain what the revenue will be at different prices, for example; you can only estimate. By the time you have gathered all the relevant cost data on production, this may not reflect the current cost of the production that is now happening. Although developments in technology mean that information can be gathered and analysed much faster than in the past, there is still likely to be a difference between what is happening in 'real time' and what the business has measured in terms of costs and revenues.

KEY CONCEPT

Profit maximization occurs when there is the highest possible positive difference between revenue and costs.

Other objectives

What managers are aiming to achieve will depend in part on what their rewards are linked to. In some cases, this will be the sales revenue. It may well be that the bigger the sales revenue the business generates, the higher the manager's bonus, for example. In this case, revenue rather profit may be the priority. To generate revenue, managers may be willing to incur additional costs. Profit may fall while revenue increases.

The rewards of other managers may be linked to the overall size of the business; the bigger the output, the more they might receive in some form of rewards. Again, this may not be compatible with profit maximization, at least in the short term. Businesses may invest to grow, and profits may fall as a result. More staff, more capital equipment, more premises, more stock may require heavy spending and thus lower profits in any given period. Another motive for growth may be to dominate markets and benefit from being a larger-scale company. The long-term objective of Amazon may be profit, but to get there it invests heavily to grow.

Whatever drives the rewards of managers is likely to drive their decision making. In many cases this may not be profits, not least because managers may argue that many aspects of their costs are out of their control and may therefore not want this as part of their reward package. The profit figure declared in accounts can also be manipulated by creative accounting (see 2.2 Doing the business maths), and so managers and investors may prefer to link rewards to a slightly less ambiguous target.

2.2 DOING THE BUSINESS MATHS

To an accountant, the 'costs' incurred by a business means the value of resources used up in a given period. Often this requires assumptions to be made about how resources have been used. These assumptions are stated in the company accounts. Changes in assumptions will affect the profits declared for any given period.

For example, imagine a business buys equipment for £100,000. If it is assumed that the equipment will last 4 years, the cost per year (called 'depreciation') is £25,000. If the accountants change the assumption to a lifetime of 5 years, the cost per year is now £20,000. Changing to this assumption would reduce the annual costs for the first four years by £5,000, boosting profits in those years. In year 5, the depreciation would have been £0 under the first assumption but will be £20,000 under the second assumption. Depreciating over 5 years reduces the costs (and boost profits) for years 1 to 4 but increases costs (and reduces profits) in year 5. Overall, £100,000 is allocated as a cost in both cases, but what differs is the timings of this allocation which affects declared profits within the 5-year period.

Example

A computer system is purchased for £50,000 and has a resale value of £10,000. Show the effect on the annual costs in the accounts if the asset is expected to last (i) 2 years or (ii) 5 years.

Year	Annual cost (£000) Expected life span of 2 years	Annual cost (£000) Expected life span of 5 years
1		
2		
3		
4		
5		

Questions

1. What is the overall effect on profits of allocating over 2 or 5 years?
2. What is the impact on profits in (a) Year 1 and (b) Year 5 of the two different methods?

The shareholders, however, may be very keen on profits, as this may affect their dividends and the share price. They may worry that managers are pursuing their own interests rather than shareholders' interests, and they may fear that this will be difficult to discover. This is because of 'asymmetric information': that is, the two groups do not have the same information available. Managers will be very close to all aspects of the business and know what is happening inside and out. Investors may have nothing to do with the business on a day-to-day basis. They will elect a board of directors to represent them, but even then they will only really know what managers tell them. There is an information imbalance.

Shareholders might therefore develop reward packages to incentivize managers to pursue the same objectives as shareholders have. For example, they may link rewards directly to profits through bonuses, or they may give managers share options. This can fix a price at which managers can buy shares at a given point in the future. Imagine you are given the option to buy 100,000 shares at £1.50 in three years' time. If, in three years, the share price has fallen to £0.90, you will not take up this option. If the share price has gone up to £2.00, you can buy 100,000 at £1.50 according to the deal and them immediately resell at £2.00. You have just made 50 pence on 100,000 shares, i.e. £50,000. If you have managed to get the share price even higher you will have made even more money. This type of deal gives you an incentive to get the share price as high as you can; you will focus on whatever drives up the share price, and this will benefit both you and your investors.

RESEARCH TASK

Visit the website of a public limited company and go to the section called 'Investor Relations'. Look for the most recent annual report and read the chief executive's review of the year. Summarize your findings in terms of the actions the business took and the environment in which it operated.

How in theory do managers know when they are maximizing profit?

Profits are measured as total revenue minus total costs. Profits will be maximized when there is the biggest positive difference between total revenue and total costs.

Economists often analyse decisions by looking at what happens at the margin, i.e. when an extra unit (a marginal unit) is sold.

- If the marginal revenue on the unit is greater than the marginal cost of the unit, this means the extra revenue from selling a unit is greater than the extra cost of producing and selling that unit. A profit is made on this extra unit, and total profits will increase if this unit is sold.
- If marginal revenue is equal to marginal cost, this means the extra revenue from selling the unit is equal to the extra cost of producing and selling it. No more profit is made on this extra unit because profits are maximized.
- If the marginal revenue is less than the marginal cost, this means the extra revenue from selling a unit is less than the extra cost of producing and selling it. A loss is made on this extra unit, and total profits will decrease if this unit is sold.

The marginal condition for profit maximization is that this occurs at the level of output where marginal revenue = marginal costs.

2.3 DOING THE BUSINESS MATHS

Example

The table shows how many units are produced, and the marginal revenue and marginal cost for each number of units. Complete the table.