Chapter 12

**How does economic change affect people and businesses?**

Reducing the deficit

When the coalition government came to power in 2010, it was perfectly clear that the government would need to economise. Even the Labour opposition said that they would have to cut spending. Government spending had exceeded tax revenue for some time. It was obvious that the financial institutions that lend to the UK government were becoming less confident and would require progressively higher rates of interest in the future. George Osborne, Chancellor of the Exchequer, wanted to restore confidence in the UK government and to do that, he planned to cut spending and raise taxes. He promised to eliminate the deficit by 2015 - the expected date of the next election.

The Chancellor succeeded in restoring confidence. Soon the UK government was able to borrow at far lower rates of interest than most other governments. But the deficit remained stubbornly high. In the 2012 Budget, Mr Osborne announced new investment projects, designed to improve the UK's infrastructure by building and improving roads and bridges, as well as other vital facilities that could in the long run make businesses more productive.

Discussion points

1. One of the road improvements was a notorious bottleneck on the A21 in Kent, that was holding up traffic even with the economy in recession. What type of business might benefit from this kind of development, and how?
2. Mr Osborne cut spending on defence and certain disability benefits, among many other things. Consider in each case how these cuts would affect the economy. (Example: cuts in grants to local authorities could reduce their spending on parks and gardens. This is likely to mean that some of the gardeners lose their jobs. Those people will have lower incomes if they cannot find other jobs. They will spend less and this will result in lower levels of demand for some consumer products. Some businesses will find their sales revenue falling and if they are near the edge, they may end in closing down, leading to further job losses.)

Government expenditure and tax revenue

Over the long run, governments in the UK usually account for very roughly 40% of economic activity. The government has its own employees - civil servants, the staff in local council offices, NHS employees (over Public 1 million of them), teachers, the armed forces and so on. This is what we call the public sector. But the

spending government also pays many businesses to carry out the services it requires. Veolia is a big company

specialising in recycling and waste management generally and works for many local authorities, which pay private sector businesses to do the jobs that need doing.

For some big businesses, the government is the customer. Small businesses do not get many opportunities in this field. Getting a government contract usually means getting into a tender process, which means bidding for the job. This in itself requires particular skills and the backing of an organisation. Government agencies do use consultants, who may be individuals with their own small business, to do certain kinds of work e.g. running small scale training projects. But for the most part, suppliers of government services are big.

So government expenditure pays for many jobs in both the public and private sector. Whe^ the :: ~~ ~

cuts expenditure, almost always there will be job cuts. Many people who are made redundar: - :\* \* ~c

it easy to get another job quickly. Their income will fall, probably for a time to the level of any bene~^i . can get. They will spend less and many businesses will face falling sales revenue. Small businesses are likely to be hit hard, because they have limited savings from past profits. So they are the ones least I ke . to survive a period of slack demand. Closing businesses means even more redundancies and the process can continue in a vicious circle. Everyone will feel less confident about the future.

Government expenditure: spending by the government on services to the public, e.g law and order, welfare benefits for the elderly, disabled and unemployed, public housing etc. Decisions are likely to be taken in the public interest, rather than for profit.

Public sector: that part of the economy that is directly organised by the government, either local or national, using its own employees.

Private sector: all the businesses and self-employed people that take their decisions independently. They must at least cover their costs if they are to stay alive, and most will see making a profit as an important objective.

There is a third sector that is growing gradually, over the years - the voluntary sector. In includes charities, not-for-profit and community organisations. This is like the private sector in that organisations that cannot cover their costs will not survive for long. It includes hospices, clubs, professional associations and a host of other small ventures run by groups of committed people.

Expenditure Wherever there is government spending, cuts will have a direct effect on employment and incomes. The

cuts flow chart shows how this plays out. Sometimes the threat of redundancies is enough to make people

image1image2spend less - loss of confidence makes both employees and employers cautious. Equally, if the economy starts to grow again and confidence returns, a virtuous circle will follow in which there will be money to expand both public and private sector activity and incomes and employment will rise.

Redundancies

Falling incomes

Reduced spending  
on consumer  
products

Reduced sales  
revenue for  
many businesses

f

Some businesses contract output or close down

More

redundancies

Lower tax ^ Less money

revenues ^ to spend

Paying for public services

Taxing and Tax revenue is vital to pay for services. When unemployment is low and incomes are growing, tax revenue

borrowing will be growing too. More services look affordable. For a long period, from the mid 1990s until 2007, it

seemed that the economy was growing in a sustainable way, incomes rose and tax revenues rose. Both governments and individuals could spend more. Some of that time, the government spent less than it received in tax revenue - there was a surplus. Later it borrowed more.

Borrowing can fund investments in new projects and expansion of public services such as the NHS. When the economy grows more slowly and recession is looming any past surplus and borrowing can together make it possible to keep employment and incomes from falling. The government stimulates the economy with more spending. If this works fairly quickly to get the economy going everyone benefits -

businesses can stay in business and most employees keep their jobs. (This is not what happened in the period 2008-12.)

**Corporation**

**tax**

**VAT**

When taxes are increased to pay for higher spending, the economy changes but does not actually shrink. But if taxes are increased to reduce the government deficit, everyone has less spending power and we get the kind of outcome shown in the flow chart above.

Spending more on community care

As fewer and fewer people stay in hospital for a long time, care in the community has expanded. Governments are spending more on community care, partly to keep NH5 costs down and partly to care better for the ageing population. Much of this community care is actually provided by small businesses. They usually call themselves care agencies and they can be not-for-profit organisations but many are, quite simply, businesses.

Money spent on community care comes partly from tax revenue. Expenditure cuts in this area will reduce the agencies' revenue and profits.

Discussion point

How would falling revenue affect a care agency? What would actually happen if demand decreases?

Some changes have helped business

* Taxes are levied on businesses as well as people. Corporation tax in 2012 took 20% of profit for businesses with turnover up to £300,000 per year. Up to 2010, the rate was 21%. Obviously this will help small businesses - a bit. Bigger businesses pay a little more in corporation tax, the rate rising to 24% where turnover is above £1.5 million. The rate in 2010 was 28%, and in 2013 it goes down to 23%. This is a much more substantial cut but it will not help small businesses except insofar as they may get more orders from growing customer businesses. Neither cut will help businesses that are making no profit at all.
* In 2012 the Department for Business, Innovation and Skills (BIS) offered employers a wage incentive of up to £2,275 for each job they could create for an 18 to 24 year-old from the Government's Work Programme, if the job lasted at least 26 weeks.

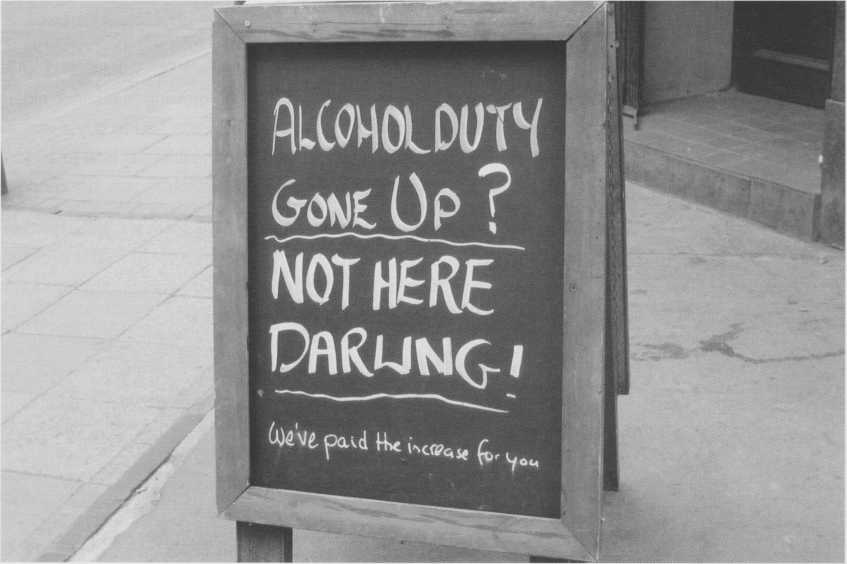
Tax - the business view

Besides corporation tax, businesses pay Business Rates - to their local authorities. These can be a hefty expense and add to their costs. Essentially business rates are just another tax. Arguably they pay for the services that businesses require, but not everyone sees it that way.

South Road

In 2011, many of the shop owners and cafes in the street got angry about their business rates. Almost all are small businesses, with just the one outlet. Sonia's World of Cakes specialises in cakes for celebrations - their adverts say 'Our only limit is your imagination'. They had to pay £4,850 to Sefton Council. This is enough to make a big dent in profits. Sonia said "The amount of money we have to pay in business rates is not fair."

For a very long time Value Added Tax (VAT) stood at 17.5%. It is paid on sales of all consumer products except for food eaten at home, housing, books and newspapers and public transport (with a few other exceptions). In late 2008 it was reduced to 15%, to give people a bit more spending power and lift the



Token in Euston Rood, London /VI/l/7, soon after Budget Day, 2009.

economy generally. In January 2010 it went back up to 17.5%. When VAT rises, most retailers put the price up to cover the extra tax. But not quite all do. Just a few will hold the price to keep the competition away. (As of 2012, VAT was 20%.) The same applies to other sales taxes, like alcohol duty.

**Interest rates**

The main problem with VAT from the business point of view is that an increase puts up prices and reduces customers' spending power. If the product is something customers can manage without, sales revenue will fall. VAT also creates an administrative burden. In general business communities usually favour tax cuts and dislike tax increases because of the effect on demand across the economy.

Monetary policy

The Bank of England tries to keep inflation under control, mainly by adjusting interest rates. When the Bank of England changes its interest rate, all the banks adjust their lending rates by a similar percentage. If the rate goes up, business loans become more expensive, along with mortgages and personal loans. It gets harder for businesses to expand and for consumers to buy homes and big ticket items like cars. It is also harder for businesses to raise prices and this slows down the rate of inflation.

In 2006-2008, inflation was inching upwards and the Bank of England kept its interest rate around 5%. But as the recession deepened, the economy needed a stimulus and the rate was cut. Since early 2009, it has been at kept at 0.5%, phenomenally low. The idea was to encourage spending at a time when demand in the economy was at a very low level.

The snag was that confidence was so low in the period 2008-12 that few businesses dared to expand. Many didn't want loans at any price. Similarly, mortgages were so hard to get that the price to be paid for them - the interest rate - hardly mattered. However, the low rate clearly did have some value:

At the beginning of the chapter we used the formula:

PROFIT = REVENUE-COST

We can expand this formula using what you have learned about revenue and about costs. Remember that SALES REVENUE = SV x SP

and, from Chapter 13, pages 78-79:

TOTAL COST = FIXED COST + TOTAL VARIABLE COST (the variable cost per item x SV) Still following this? In which case, we can say that

PROFIT = (SV x SP) - (FC + (VC x SV))

and this is a very important formula because it highlights all of the variables which affect the profit made by a business. To increase profit:

a business can seek to increase sales volume

or it may raise the selling price

or it may look for a way to cut either fixed or variable costs.

The most successful strategy would be to aim to achieve all of these goals at the same time, since this would generate the largest increase in profit.

Show your understanding

Think of a small business in your area. Working with a partner and using the expanded formula for profit above, explain to each other all of the different ways that the business could act to increase its profit. Be as specific as you can, giving examples and suggestions related to the business. Discuss each part of the formula in turn.

Finally, decide between you which strategy you think would work best for your chosen business. Make sure that you can explain your reasoning clearly.

Reducing overheads can be achieved by doing administrative tasks more efficiently or finding cheaper premises or suppliers (e.g. for insurance). In extreme circumstances, pay may be reduced - as in the period 2008-12 (see Chapter 11, page 65.)

Increasing sales revenue by raising prices, but only if the market is growing, as the price rise will not put people off. If in fact there is a cheaper competing substitute for the product, this will not work.

Daniel could see from his profit and loss account in 2011 that he would need to do something. He was lucky in that getting better known was creating interest in his product: many new businesses fail in the first few years. But putting the price up worked for him. He could have considered many alternatives though: using cheaper wood, cutting the price and hoping to make and sell more, moving to cheaper premises and so on. In general, these are the possibilities:

Reducing COGS can mean using the available labour more efficiently, or cutting the cost of inputs, perhaps by finding a cheaper supplier.

Show your understanding

Pete Reynolds lost his job as a department manager in a DIY store that closed down in 2009. He decided to try garden maintenance and targeted the growing number of elderly people who find the bigger garden jobs more than they can manage. Peter had to buy a van, a mower and hedge cutting gear and he needed insurance - some gardening jobs can lead to accident or injury. He got a small bank loan and his income, though less than previously, was just enough to live on.

Other people were not so lucky because although bank loans were cheap, they were very hard to get. Banks were very wary. They had taken too many risks in the past and changed their approach. So many people with good ideas found either that the process of getting a loan was very long and slow, or that the bank refused to lend anything at all.

Question

Peter's solution sounds easy enough. Explain three reasons why most redundant employees do not go along a similar route.

The impact of exchange rate changes

Chapter 11 showed how a low exchange rate favours exporters and UK businesses that compete with imports. A low rate makes both groups more competitive. But there are other businesses and people for whom a low exchange rate is not so helpful.

* When the exchange rate falls, the price of imported inputs rises. This raises costs of production. This can affect all sorts of products from tinned sardines to electrical goods and some UK businesses will raise their prices, making them less competitive.

**Competitive­**

**ness**

* Retailers, including the supermarkets, that sell imported products, will also suffer when they have to pay more for their imported stock. They will have to choose between putting the price up, which means losing some sales, and keeping it the same and losing some profit.
* Some people may benefit from a lower exchange rate, especially if they can get a job in a business that exports. But most people will find that the rising prices of imports mean their purchasing power is reduced. For example, holidays abroad will cost more. They will simply have to buy less and their standards of living may fall.

Think!

Would you be a gainer or a loser if the £ fell further this year? Remember, the effects of the fall in the exchange rate will take 2-3 years to work through completely.

Inflation has consequences - pros and cons

A business with big bank loans may find that when it is time to pay back the loan, its value in terms of its purchasing power is actually less. This could be helpful. But the other likely consequences of inflation are much less so:

Inflation can mean losing competitiveness. This happened in the UK in the 1970s. It happened in Greece in recent years. Exports will be hard to sell and imports selling all too easily. The problem can be avoided if the exchange rate is free to fall, but that reduces stability.

Inflation is unpredictable - this uncertainty makes it harder for businesses to plan for the future.There are accounting issues. Sales revenue may rise just because prices rose - but this disguises the fact that the business really did not grow. Accounts need to be interpreted with care.

* Businesses with fixed price contracts may find profits falling if their costs rise.

The labour market

Trouble at the tank factory

In 2012, BAe Systems decided to close its Armstrong Plant in Newcastle upon Tyne. 620 jobs were at stake. The factory produced the Terrier engineering vehicle, which builds trenches and barriers. But government expenditure cuts, and the drawing to a close of the war in Afghanistan, meant that no more government orders could be expected. It was a sad time for local people - during the First World War the factory had produced tanks and ships and had long traditions.

For the many skilled people amongst the workforce, there was hope. Nissan, with the largest UK car manufacturing plant nearby in Sunderland, was known to be hiring. It would look out for people with scarce skills.

Questions

1. Would there be any point in trying to keep the Armstrong Plant open?
2. What would be the likely impact of the closure on small businesses nearby and in the north east generally?
3. Flow would these small businesses react?
4. How might Nissan benefit from the closure?

A tight labour market goes along with high levels of demand and boom conditions. To recruit, employers will have to offer higher pay.

**Recruiting**

IMISSAIM

But when there is a high level of unemployment, the pressure for pay rises may be much less. Pay seldom falls, but it may stay the same for many employees for some time, whatever the rate of inflation. This means that purchasing power falls - very much a feature of life in the period 2008-12, when many people got pay rises that were less than the rate of inflation. In general:



How might Nissan gain from the closure of the BAe Systems factory?

* Relations between employees and employers are quite likely to be less tense when unem­ployment is high or rising. Employees will not want demands for a big pay rise to increase the chances of the business going bust.
* The very best time to recruit employees with scarce skills is when unemployment is rising.

People with skills who have been made redundant will be looking for work. Usually, finding a skilled person means offering them higher pay than they are getting elsewhere.

When unemployment is high or rising, this won't be necessary.

• When unemployment is rising, the economy is going into recession and for many businesses, demand for the product is likely to be at best stagnating and at worst, falling fast. Low levels of confidence in the future are like a wet blanket, making it very difficult for businesses to expand. Government incentives to take on employees, like the one on page 72 can help somewhat.

Show your understanding

The International Monetary Fund (IMF) watches over the world economy and lends to countries that are having difficulty paying their debts. It does an annual health-check on each of its member countries.

When it came to the UK in 2011, it said "In the event of a prolonged period of weak growth and high unemployment, the Bank of England should try to stimulate the economy and the government should also consider temporary tax cuts." When the Fund came back in 2012 the situation had barely changed. The head of the IMF, Christine Lagarde, said "Policies to bolster demand, before low growth becomes entrenched, are needed." She suggested that the Bank of England and the Treasury should help the banks to lend more to businesses. She concluded that if existing measures fail to stimulate the economy, then the Chancellor should consider cutting taxes, or increasing spending, or both - i.e. Plan B.

**The IMF**

List and explain all the ways in which each of these policies might help small businesses.

Chapter 13

**Financing the costs of production**

Herbs of Distinction

Rachel Highcroft set up Herbs of Distinction after being made redundant from her job in advertising. She had always been a keen gardener and chef and she spotted a gap in the market for mail order fresh herbs which customers could keep in their kitchen so that they would always have fresh herbs available.

Rachel already had a small greenhouse in her garden and some tools so initially she just had to buy pots, soil and seeds. She also paid to attend a one day course on setting up in business. Rachel planted her first batch of seeds and waited for them to grow. In the meantime she was busy building a website for her business and ringing lots of restaurants to try to create demand for her herbs. She paid for adverts in some well-known cookery magazines which she hoped would encourage potential customers to visit her website. After three months Rachel's first batch was ready to pack and send. Rachel was delighted at the packaging she had helped to design with a local box supplier: it was a bit more expensive than she had planned but she knew that it was important for the plants to arrive in a perfect condition. The revenue from this first batch meant that Rachel could afford to buy more pots, soil and seeds to start again.

Discussion points

1. What different costs did the business face?
2. Try to classify the costs: sort them into different groups. What categories did you use to classify the costs?
3. Do you think all businesses face similar costs? Which particular types of business might face higher or lower costs than others?

Put very simply, businesses operate by taking inputs, changing them in ways that add value, and producing outputs.

**Costs of production**

Inputs

Process  
(adds value)

Output

Incurs costs Generates revenue

Outputs are sold in order to generate sales revenue. Revenue is money gained by the business when selling goods or services. The process of producing outputs incurs costs for the business. These costs of production must be paid for by the business. We can classify costs, placing them in different groups.

Classifying costs - starting up

Start-up costs

These are costs faced when an entrepreneur sets up a business. They are costs that only need to be paid once. They include:

* payments for services such as business advice and market research
* fixtures and fittings
* the tools, machines and specialist equipment that are needed to create the product.

These costs are usually paid before the business starts trading, so the entrepreneur will need to have sufficient finance to cover the costs until enough revenue is earned to pay them off.

Capital spending

In the case study above, Rachel's start-up costs included her initial stock, her training course and the packaging design.

Businesses can also incur significant one-off costs when making large changes or additions to operations. For example, when expanding into new premises or introducing a new product line, they may require new machinery or tools or staff training.

If Rachel's business continues to grow she will need a larger greenhouse and more equipment to use in it. This would mean a large financial outlay for Rachel which she would need to pay for somehow.

Start-up and capital costs include many items that would be classified as investment. When a business buys premises and equipment that will last for some time and make it possible to produce over a period of years, they are investing now in order to have sales revenue and profit in the future. Often, we regard spending on training or research into possible new products as investment too. Training makes employees more efficient and productive.

**Investment**

Start-up costs are incurred in setting up a business organisation.

Capital spending occurs when a business invests in fixed assets or something of long term benefit to the business.

Investment involves spending now which generates income in the future. It may involve buying capital equipment or spending on research or training.

Classifying costs - running costs

These are costs which an entrepreneur has to pay regularly while the business is operating. Literally, they keep the business running. Running costs fall into two categories: fixed costs and variable costs. Total costs include both fixed and variable costs.

Fixed costs are not directly affected by how much the business produces. For example, insurance, utility bills and rent or mortgage payments have to be paid each month regardless of how much has been produced. These costs are not 'fixed' forever in terms of how much the business pays - it is likely that insurance costs will rise after the business makes a claim, for example. It is common for rents and utility charges to increase with inflation. The key issue here is that the level of fixed costs is not linked to the level of output. A rising level of output will not immediately affect the fixed costs of a business.

**Fixed costs**

If a business grows significantly it is likely that fixed costs will increase, especially in the long term. This is because growth may require larger premises -this is likely to mean higher rent, utility and insurance costs. Additional staff may be recruited, increasing the overall cost of salaries. Flowever, one extra unit of output will not directly incur extra costs in any of these areas.

**Developing New Business ideas for AS Level**

Variable costs are directly linked to the level of output of a business. They are the costs of resources used to produce units of output, or to deliver a service. They include raw materials and the cost of labour used in the production process. If the level of output rises, total variable costs will also increase proportionately.

**Variable costs**

Labour costs can be fixed or variable. If a member of staff is paid a fixed salary regardless of how much work they do, they are incurring a fixed cost because it doesn't change according to output. If they are paid directly according to how much they produce (for example, piece-rate workers in a factory, or taxi drivers who receive a percentage of the revenue from each journey driven) then the wage is a variable cost because it goes up directly when the employee produces more.

Rachel's fixed costs at present are low - she just has to pay for the heat, lighting and water for her greenhouse and for any additional marketing she carries out. Her variable costs are everything directly linked to growing, packing and sending the herbs - soil, pots, seeds, packaging and postage.

Example

In Chapter 2 you met Tamara Knight, a massage therapist. When Tamara set up her business she had to pay a number of start-up costs. She had to buy a massage table, towels, uniform, first aid kit and a bag for transporting her equipment. She also paid for her qualification in massage therapy and a first aid course.

Now that Tamara is running her business she has to pay some monthly costs: she has public liability insurance, membership of a professional association for therapists and car licence and insurance costs for her car. These are all fixed costs because they have to be paid whether Tamara sees one client or a hundred clients. In fact, if she gave no massages at all, she would still have to pay these fixed costs.

Each time Tamara gives a massage she incurs some additional costs. She has to pay for petrol to drive to the client; she uses up massage oil and she has to pay to launder the towels and sheets used during the treatment. These are variable costs because the more clients Tamara sees, the more she will have to pay for petrol, oils and laundry.

Running costs are paid by a business organisation on a regular basis. Running costs may be fixed or variable costs.

Fixed costs are not directly linked to the level of output of the business. They do not change when output increases or decreases. These are sometimes called indirect costs or overheads. Fixed costs include all capital spending but also some regular costs such as staff salaries.

Variable costs are directly linked to the level of output of the business. They change as output increases or decreases. These are sometimes called direct costs. They include the cost of paying employees who are paid solely according to their contribution to the actual production process (direct labour).

Show your understanding

Think of a small business in your area. Make a list of the different costs that this business faces. Croup these costs into start-up, and running (fixed and variable) costs. Identify potential capital spending that might be necessary as the business grows.

Now compare your ideas with your peers. You should see that different types of business will incur costs to different degrees. Some have high fixed costs and few variable costs (for example, hairdressing salons) and others have low fixed costs with much higher variable costs (for example, a mobile painter and decorator).

Chapter 14

**Sources of finance**

Abundant Ltd.

In Chapter 1 you met Shane Wall, owner of Abundant Ltd., and learned a little about his business history. In this chapter you will learn more about how Shane has financed his businesses.



*Abundant staff raising their profile at an industry event hosting many potential customers.*

When Shane first became a partner in Abundant Holidays he put in £12,000 of his own money. This was money saved from Shane's wedding disco business. This money paid the start-up and running costs of the holiday business and meant that hotels and DJs could be booked before all guests had paid in full for their holidays.

On taking full ownership of Abundant Ltd., Shane put in some more of his personal savings to get the business started. Initially he was not earning much from commissions so this money paid Shane a 'salary' so that he could afford his personal expenses. Married and with growing children by this time, Shane gave 50% of the company to his wife in recognition of the fact that their shared savings were funding the business.

In 2011 when the business moved to a larger office and took on new staff, Shane realised that he needed finance to cover the capital costs of expansion. With too little cash in the bank, Shane had to choose between approaching his bank for a loan and accepting an offer from a business associate who wanted to buy 25% of the business for £100,000. Shane turned down the offer and instead took out a large loan, committing himself for 5 years to high monthly repayments. The bank demanded that Shane provide his house as security for the loan - if the loan couldn't be repaid, Shane and his family would have to sell up, use some of the money to repay the bank and move somewhere smaller. Securing the loan decreases the risk for the bank but increases it for the entrepreneur.

Discussion points

1. For what different reasons did Shane need finance?
2. How might Shane have funded his business at each of the stages outlined above?
3. Why do you think that Shane turned down the offer of £100,000 for 25% of his business and instead put his family home at risk?

You have learned already that businesses need finance for different reasons - to get the business started; to fund capital expenditure and to keep the business running. You might be wondering where this finance can come from. Broadly, finance can come from two sources: internal (from within a business) or external (from outside the business).

Internal sources of finance

Retained profit: once a business is operational it should be generating revenue. So long as total costs are lower than total revenue, there will be some profit. This profit can either be taken out of the business by the owner(s) as a reward for their enterprise, or can be retained and reinvested in the business. Retained profit can therefore be used to pay the costs of a business if necessary.

Remember that entrepreneurs usually (although not always) have profit as at least one of their motives. Retained profit cannot be paid out to the owner. The owner will have to be confident that the retained profit is being used to generate future value, or they are likely to prefer to take it as income for themselves.

Sale of assets: an asset is something of value. In a business this could refer to physical resources such as vans, machines, buildings, land or stocks, or it could be something less tangible such as a successful brand or a patent for a particular technical design. Any asset can be sold to generate cash which can then be used to cover the costs of a business.

**Internal**

**finance**

Working capital: this refers to cash that a business has immediate access to. This is a simple source of finance for businesses with a good cash balance. Holding stock reduces working capital as the stock is paid for using cash and is then held by the business until it is processed or sold. A business needing to increase working capital can do this by reducing the total guantity of stock held.

Internal finance comes from within the business. It can be retained profit or cash raised from the sale of assets.

Retained profit is profit that can be reinvested in the business rather than being given to the owner(s) of the business in the form of income (unincorporated business) or dividend payments (incorporated business). It does not incur interest payments or dilute ownership of the business. It is a long term source of finance.

The sale of assets can refer to physical assets such as machinery or property, or to intangible assets such as the patent to a particular product. It is a long term source of finance.

Working capital is cash held by the business and used to keep day-to-day business going in the short run.

External sources of finance

External finance comes from individuals or organisations which are not part of the business. This finance is often in the form of loans, which have to be paid back, or it may be offered in exchange for equity. (Equity finance means that the business gets money in exchange for ownership of a share of the business.) This money does not have to be paid back. Sometimes it is possible for an entrepreneur to get a grant, which is finance that neither has to be paid back nor involves giving up ownership of any of the business. The government and certain charities such as the Prince's Trust offer grants to some businesses when they start up. It can also be possible to get low-interest loans from these organisations if entrepreneurs meet certain criteria.

Loans are one of the most common forms of external finance. The business borrows a fixed sum of mone. for a fixed period of time, making fixed regular repayments. The lender will demand interest as their re,\ = — for lending the money. Entrepreneurs may seek loans from a bank, or from willing family or friends

The rate of interest will depend on a number of factors including:

* the current Bank of England interest rate
* the size of the loan
* the repayment period
* how the lender perceives the risk of the business defaulting on the loan (not paying it back).

Overdrafts are loans offered for short-term finance by banks. An overdraft allows a business to spend more money than is available in the business bank account. Effectively, an overdraft is an allowed negative bank balance. Interest is calculated daily on the overdrawn balance, usually at a rate higher than is charged for a fixed loan.

**Interest**

**External**

**finance**

**For**

Loans High Street banks may see well-

established businesses as low-risk and give low-interest loans.

For business start-ups, family or friends of the business owner(s) may provide finance, which is helpful if banks are unwilling to lend to an entrepreneur with no security and no trading history.

Overdrafts Overdrafts can be used to borrow a flexible amount for a short time.

As soon as money is deposited in a business bank account, it goes towards paying off or reducing the overdraft balance.

**Against**

The higher the perceived risk, the higher the interest rate. New businesses may find it hard to get a loan from a bank at a low rate.

Often loans are secured on specific assets.

If the business is unable to repay the loan, the asset becomes the property of the lender. The lender can sell the asset in order to recover their money. The most commonly secured assets are buildings which are used for long term loans. This is what happened when Abundant took out a bank loan.

A bank is able to cancel an overdraft at any time and request full repayment.

The interest rate on an overdraft is variable so changes in the Bank of England interest rate can be passed on quickly. This increases the risk for the entrepreneur.

Debentures are like long term loans in that they carry a fixed interest rate. The interest must be paid before dividends - so if profits are poor, debenture holders have priority over shareholders. But they are different from loans in that they can be sold in the same way as shares. (For this reason they are more often referred to in the press as bonds, or corporate bonds or loan stocks.) Debentures are a safe way for people and organisations to invest in medium-sized or large businesses, but because their interest rates are fixed, debenture holders do not benefit from extra profits when the business is doing well.

Venture capital is a form of long-term equity finance where an investor provides a sum of money for the business in exchange for a share of its ownership. Entrepreneurs generally seek venture capital when they are unable to raise the money needed through other channels, since giving up ownership of the business is long-term and reduces control over the business. It also means that any future profits will have to be shared with the venture capitalist. Venture capitalists are willing to take greater risks with their money than other lenders so are often used when, for example, banks refuse to lend to a business. Venture capital is usually sought where large, long-term investments are needed, for example to fund a business start-up or in the development and launch of a new technological product where there are high costs of design, development and production. Venture capitalists may offer advice and support to entrepreneurs as well as their financial investment. Some demand a say in how a business is run if they are to invest their money.

Example

The television programme Dragons' Den is based around venture capital. The Dragons are all venture capitalists who decide whether they are willing to risk investing their money in new business ideas. On the programme you can see negotiations between the Dragons and entrepreneurs where they decide how much money will be invested in exchange for a specific share of ownership of the business. The Dragons only invest in a business where they believe that their investment will generate returns, either from future profits or because the share can later be sold for more than the value of the original investment. In the case study, Shane turned down an offer like this.

*Ordinary share capital is capital (money) raised by selling shares in the business. This can raise the large sums of money that may be necessary, e.g. to invest in the development of a new product or to fund the expansion of a business. Only incorporated businesses can raise share capital. (You will learn what this means in Chapter 15.)*

Against

**For**

**Share capital**

Share capital Share capital does not have to be

paid back and does not incur interest.

The original owner of the business gives up some control over it.

The new shareholder(s) will expect to receive a portion of future profits (dividends) as a reward for investing, so the original owner will receive less profit in the future.

Leasing is used by businesses that need land, buildings or equipment which they are unable or unwilling to buy outright. It is the name given to 'renting' an asset. Many businesses lease vehicles, or office equipment such as photocopiers, or office space. Leasing allows the business to avoid making one large payment - instead monthly payments are made to the owner of the asset.

For Against

The business never takes ownership of the item.

The business will pay more than the market value of the leased items in the long term.

Leasing is a more flexible way to acquire an asset than outright purchase.

Leasing can be used for long-term or short-term finance.

Trade credit is short-term finance offered to a business by suppliers. It means that a business can receive goods or services from the supplier and pay for them later. For many businesses this means that there is time to generate revenue from sales to customers before costs have to be paid. Trade credit is typically offered for between 30 and 60 days although there is no limit to what a supplier can choose to offer, and it may be possible for a business to bargain for a longer credit period with some suppliers. In times of financial difficulty a supplier may shorten the credit period or limit the total credit offered because they themselves are short of cash.

**Trade credit**

Share capital can raise large sums of money for a business.

Leasing It is usually possible to upgrade the

item leased, e.g. by switching a photocopier for a newer model on its release.

Maintenance and technical support are often included in the lease agreement.

Example

A bakery needs supplies of flour, butter and sugar in order to produce cakes for sale. The bakery bank account has a balance of £0 so there is no money available to pay for the supplies immediately. The bank has refused an overdraft on the account. Luckily, the supplier of these raw materials allows 30 days trade credit. This means that the bakery can receive the raw materials without having to pay for them and has time to bake and sell cakes, receiving revenue from these sales. By the end of the 30 day credit period the business has enough revenue in the bank account to be able to pay the bill from the supplier.

**External**

**finance**

A loan is a fixed amount of money borrowed for a fixed period at a fixed interest rate. The loan is paid back in regular instalments until the total amount plus interest is repaid. Loans are medium- to long-term sources of finance.

An overdraft is a short-term flexible loan where a bank allows a business to operate with a negative bank balance. Interest is paid on the amount overdrawn, usually at a higher rate than is charged for a fixed sum loan.

Debentures (sometimes called bonds) are loans that can be bought and sold in the same way as shares. They have a fixed interest rate. They do not give part-ownership of the company but they are much less risky than shares, for the investor.

Venture capital is money invested in a new business by one or more individuals who believe that the business will succeed and therefore increase in value, but are willing to accept the risk that the business idea may fail. Venture capitalists may offer advice and technical support as well as finance. Venture capital is long-term and provided in exchange for a share of the equity of a business.

Ordinary share capital is long-term finance raised by selling shares in a business. Money raised does not have to be repaid. Investors receive part-ownership of the business and a share of the profits in the form of dividends.

Equities - another name for shares.

Leasing allows a business to use an asset without owning it, by making regular payments to the owner of the asset. Over time the total sum paid for the lease may be more than the cost of buying the asset outright. It reduces the need for external finance from other sources.

Trade credit is a short-term source of finance offered when suppliers allow a time period before payment for supplies must be made. The credit period will vary between suppliers and may be changed by the supplier at any time.

Find out

Visit the websites of two or three high street banks and compare the rates offered for small business loans. Calculate the repayments on a loan of £5,000 taken out over 5 years.

Find out the typical rate at the same banks for overdraft borrowing. Try to explain the difference between the two rates of interest.

Now research typical interest rates for these loans over the last 20 years. Discuss with your teacher how the current rate of interest for business loans compares to this, and how this might affect the decision by an entrepreneur as to whether or not to take out a loan.

Choosing a source of finance

The choice of finance in any situation will depend on three main factors:

* what the finance is needed for
* the resources of the business
* the objectives of the business owner(s).

The first consideration is the purpose of the finance. How much is needed and for how long? The principle of matching says that the source of finance chosen should suit the purpose. So a long-term financial commitment such as buying a new office building, would require a long-term source of finance. A short­term purpose, such as paying for stock, should be funded through a short-term source of finance, perhaps working capital or overdraft facilities.

**Short- or long-term?**

The resources of a business will partly determine the sources of finance available.

Purpose

'Resources' here is used in the same way as in the acronym LOSER. (This is explained on page 2, in the Introductory chapter.) Clearly, retained profit is only available to a profitable business and share capital is not

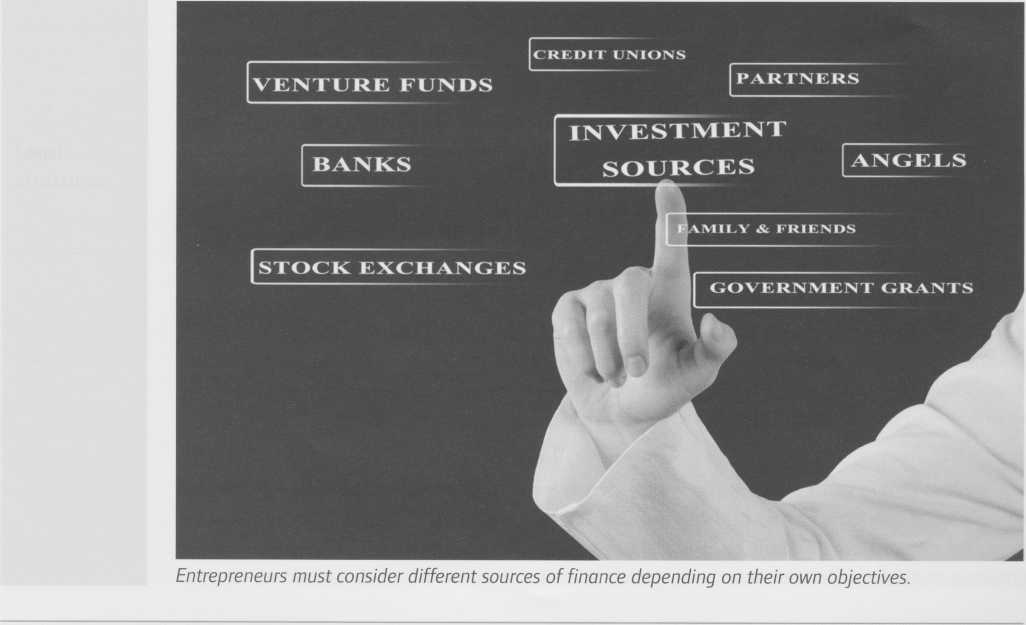
Source  
of finance  
chosen

an option for a sole trader. Loans will be

r- j r .. u . r i Resources Objectives

easier to find if the business has a successful

trading record or assets to offer as security.

The objectives of the owner(s) will also influence choices made. Some entrepreneurs would prefer to retain full control of their business so take out loans rather than give up equity in their business. Others are uncomfortable with the notion of being in debt or don't want the stress of meeting repayment deadlines. In this case equity finance may be a better choice than borrowing. Entrepreneurs who have growth as an important objective may not be willing to wait until they have enough retained profit to fund expansion, preferring to raise external finance in order to achieve their objective more quickly.

**Internal or external?**

**A WATCH OUT!**

Whilst retained profit is often the preferred source of finance for a business, it is too simplistic simply to state that 'this business should use retained profit to fund xyz venture'. Remember that all choices incur a trade-off of some kind. The use of retained profit assumes, of course, that the business has sufficient profit available to it, but it also means that the owner(s) of the business cannot benefit personally by receiving the profit in the form of dividends. If this does not suit the objectives of the owners at the time, retained profit will be an inappropriate source of finance.

Exam style question

Carol and Richard Faulkner have a love of food and of cooking. For many years they have talked about opening up their own restaurant and now they are finally doing it. They have taken out a 12-month lease on a site in their local town centre, furnished it in a simple, homely style and chosen a menu that is getting very positive feedback from customers so far.

Both Carol and Richard gave up well-paid jobs in order to start the restaurant and, although they are currently living on the last of their savings, neither regrets their decision. They are enjoying the excitement of running a new business and the freedom which comes from being their own boss. They are hoping that the restaurant will break even in the next 6 months and be profitable by the end of the year.

1. Briefly explain two sources of finance that Carol and Richard could have used to fund the rental and furnishing of their new restaurant. (8 marks)
2. Carol and Richard chose to fund their business idea using a bank loan as well as personal savings rather than to borrow money from friends and family. Evaluate the merits of their choice. (9 marks)

Chapter 15

**Business structure**

Tamara Knight and Abundant Ltd.

By now you are familiar with Tamara and Shane and some of the key features of their businesses.

Tamara's business is small. She buys little stock and runs her business from the summer house in her garden. Her spending is low and she never owes more than £100 on her business credit card. If her massage work ended tomorrow, Tamara would not earn any more money, but nor would she be in debt. Tamara is a sole trader. You will learn about sole traders in this chapter.

Shane, on the other hand, runs a much more substantial company. The business has commitments to large, regular payments. There is the rent on the office in central London and salaries for 15 employees and freelancers, not to mention the repayments on the loan he has taken out. If Abundant stopped getting work now, Shane would be responsible for significant ongoing costs. It is unlikely that there would be sufficient cash in the bank to pay all of these costs so the assets of the business may have to be sold to raise more cash. Even this may not be enough. With creditors knocking at the door, Shane wants to be sure that his personal possessions won't be taken to pay any outstanding debts. Abundant is a private limited company. You will learn more about this type of ownership in this chapter.

Discussion points

1. What concerns might an entrepreneur have when setting up a business, specifically related to their personal assets?
2. What actions could an entrepreneur take to protect his or her personal assets from business debts?

Any entrepreneur setting up a business has to choose the legal structure of that business. Broadly, the two choices are either unincorporated or incorporated.

Unincorporated businesses

An unincorporated business is one which is legally indistinguishable from the owner(s). A sole trader has one owner and a partnership has more than one owner. These are easy businesses to set up - the owner(s) simply has to inform HMRC that the business exists and to keep records of business income and expenses. At the end of each tax year the sole trader or the partners must complete a tax return and pay tax on their income. They must also pay National Insurance contributions. (HMRC stands for Her Majesty's Revenue and Customs.)

**Legal**

**structures**

Sole traders

The advantages of setting up as a sole trader are that the entrepreneur has full control over the business and gets to keep all the profit. However, it can be hard to raise finance since the sole trader may have limited personal savings and banks may see the business idea as risky, reducing their willingness to lend to the sole trader.

Sole traders have unlimited liability. This means that they are legally the same entity as their business and are fully responsible (liable) for its actions. If the business incurs debts which it cannot pay, for example by buying stock which cannot be sold or letting utility or rent bills build up, the sole trader becomes personally liable for the business debts. This means that the sole trader's personal assets (cash, possessions, property)

could be used to repay the business debts. This is a significant concern for sole traders who operate businesses with high running costs because the potential debts will be high.

**Unincorporated**

**businesses**

**Limited**

**liability**

Partnerships

A partnership can be beneficial because there are more owners to contribute finance (and to help run the business). However, profit must be shared and there is the potential for conflict in decision making. In addition to this, each partner is jointly liable for all debts. This means that each individual has unlimited liability for all of the debts, even if they were incurred because of the actions of a partner in the business. This means that partners must have complete trust in each other. Partnerships work well for solicitors and other professionals. They work less well for businesses that will face heavy capital spending from the start.

A sole trader is an unincorporated business owned and operated by one person. The sole trader may employ workers but it is most common that they work alone. The sole trader has unlimited liability for the debts of his/her business.

A simple partnership is an unincorporated business owned and operated by two or more individuals. The partners are jointly and severally liable for the debts of the business - this means that they are each individually responsible for all of the business debts.

Incorporated businesses

When a business is incorporated it gains its own separate legal identity. This means that debts incurred are the debts of the business, not the owner(s). So personal assets cannot be used to repay business debts. This is called limited liability - the liability (responsibility) of the owner(s) for any debts is limited to the money invested in the business by the individual. This means that they can potentially lose all their investments but their personal assets are not at risk.

The owners of an incorporated business are called shareholders since they own a share of the business. One person can be the sole shareholder of a business or shares can be sold to others in order to raise finance for the business (you read about this in Chapter 14). There are two types of incorporated business: private limited companies (with the suffix Ltd.) and public limited companies (with the suffix PLC).

Private limited companies

Entrepreneurs setting up in business would use a private limited company (Ltd.), selling shares only to people they know. In exchange for part ownership of the business the entrepreneur can raise significant finance to invest in the business. In return the shareholders will receive part of the business profit in the form of dividends. Some shareholders may want to have input into how the business is run while others will be happy to receive their dividend without having any regular contact with the business. There are more regulations governing private limited companies than sole traders and partnerships, which increases the cost and complexity of administration in running the business.

Sole traders Private limited companies

Advantages Advantages

Full control of the business Limited liability for business debts

Owner receives all profit. Easier to raise finance.

Disadvantages Disadvantages

Unlimited liability for all debts More regulation

Can be hard to raise finance. Sharing the profits

Shareholder involvement.



*A partnership is an unincorporated business owned and operated by two or more individuals.*

Public limited companies

Public limited companies issue shares publicly and are governed by many more regulations than private limited companies. This is not an option for entrepreneurs when setting up a business since the initial share offering must raise at least £50,000. This is very unlikely for a business with no trading history! Public limited companies must publish their financial accounts each year - you can read the accounts of many well-known businesses by searching through their websites to find the pages where this information is published.

**PLCs**

Find out

Use the website [www.businesslink.gov.uk](http://www.businesslink.gov.uk) to find out more about the processes involved in setting up different types of business organisation.

Unlimited liability means that an individual has no legal separation from their business and is therefore personally responsible for the debts of the business. Their personal assets could be used to pay business debts if the business assets are not sufficient to pay debts incurred.

Limited liability protects shareholders of incorporated businesses. This means that the individual is not fully liable for the debts of the business, which is legally separate from the shareholders. The most that shareholders have to contribute towards business debts is the amount of capital originally invested in buying shares.

The owners of private limited companies have limited liability for business debts but cannot raise finance from the general public. They are often family businesses and the shareholders are members of the family or personal friends. They are usually small or medium-sized businesses.

Public limited companies (PLCs) are owned by their shareholders, who have limited liability. The companies can raise finance by selling shares to the general public and large organisations such as pension funds. In this way they can raise substantial finance in order to expand.

**A WATCH OUT!**

When writing about sources of finance, remember that share capital is only an option for incorporated businesses. For small businesses this means that they would need to be a private limited company rather than a sole trader or partnership.

It is a good idea when considering issues related to business structure and finance to balance out benefits, such as the ability to raise share capital, with drawbacks such as increased administration or loss of some control and some of the profit.

Exam style question

Shanaz Begum had always loved fashion. At school she put on fashion shows and by the time she was at college she was funding her social life by making accessories for her friends. After completing a university course in fashion, Shanaz was ready to set up her own business making and selling bags and scarves.

With large personal debts built up as a student, Shanaz knew she would need to raise capital to fund her business start-up idea. She decided to create a private limited company, selling shares to a tutor from her college and also to two family members.

1. Briefly explain two factors that Shanaz would have considered when deciding on the legal structure of her business. (8 marks)
2. Assess the impact on Shanaz' future business operations of her decision to set up as a private limited company rather than as a sole trader. (12 marks)

Chapter 16

**Estimating sales levels, costs and profit**

Clinton Cards

Founded in 1968, Clinton Cards grew to be the biggest card retailer in the UK. It employed over 8,000 people in 767 high street stores when, in May 2012, it went into administration. This was despite the greetings card market actually growing overall, partly because there are now more occasions than ever for which a celebratory card is available ('you are pregnant', 'you're getting divorced' and 'you passed your driving test' are just a few examples of these). Clinton Cards lost £3.7m in the 6 months to Jan 2012 and, with recent like-for-like sales revenue 3.5% lower than the previous year, struggled to generate enough income to cover all of their costs. Eventually their creditors called in debts which the business couldn't pay, forcing Clinton Cards into administration. Perhaps a competitor should produce a 'we're sorry to hear that your business is in trouble' card.

Discussion points

1. Why might sales revenue have fallen in 2012? What could Clinton Cards have done to increase sales revenue during this time?
2. Apart from falling revenue, for what other reason(s) may Clinton Cards have made a loss in the previous six months?
3. Clinton Cards had been operating at a loss for some time. Why is it not possible for a business to survive when it is not making a profit?

You have already learned that businesses are set up in order to achieve specific objectives set by the owners, and that objectives can be finonciol or non-financial in nature. Even where the business is driven by strong non-financial objectives, such as ethical reasons or to contribute to the local community, profit is still important for the majority of entrepreneurs. This is because the entrepreneur is giving up their time and effort to run the business, and the profit made is the reward for their time and effort and the risks they are taking.

Pr°fltS You have learned that: PROFIT = REVENUE - COST

and losses

In the example above, Clinton Cards was making a loss rather than a profit because costs were higher than revenue. In this chapter we will explore the profit formula in more detail, investigating how entrepreneurs make decisions which affect their overall level of profit. By the end of this chapter you should be able to answer the questions on Clinton Cards in more detail, using precise business language. If you need to, revise the content of Chapter 13 on costs.

Revenue

Revenue is money coming into a business. Soles revenue (also sometimes called turnover) is earned through the sale of goods and services. A business may also receive revenue from interest payments, dividends or royalties paid by other businesses. Here we will concentrate on sales revenue.

SALES REVENUE = SALES VOLUME x SELLING PRICE Or SR = SV x SP

Where SV = the quantity of goods/services sold SP = the price charged for each good/service

Therefore, in order to maximise sales revenue, an entrepreneur has to balance the total number of units sold with the revenue earned from each sale. As you learned in Chapter 5, for a normal good an increase in price will lead to a fall in demand. If buyers are very sensitive to a change in price, an entrepreneur may maximise SR by setting the SP lower than that of a competitor and hoping to increase the sales volume substantially.

Profit is the money remaining from sales revenue after all costs have been paid. It is the entre­preneur's reward for investing their personal resources (time, enterprise, assets) in a business and taking risks.

A business makes a loss when revenue earned is less than costs to be paid.

Revenue is money earned by a business.

Sales revenue is money earned by selling goods and services. It is calculated by multiplying the sales volume by the unit selling price.

Sales volume refers to the number of goods or services sold by a business in a period of time. Selling price is the amount charged to a customer for the purchase of a good or service.

Identifying a pricing strategy to be used

The price charged must be profitable - that is, it must cover the variable costs of producing the product and also contribute towards the fixed costs or overheads of the business. An entrepreneur can use a range of strategies for setting prices:

Cost plus pricing

This is a simple method of setting prices. The entrepreneur calculates the costs of production and adds on a percentage of this as a mark-up. This represents the profit made on the sale. It is a simple calculation as it requires no additional information or market research - only cost data from within the business.

A muffin costs The baker adds The muffin will

**Deciding on a price**

50 pence ■-> a mark-up of 60% 1 be sold for

to make i.e. 30 pence 80 pence

This approach suits entrepreneurs who want a very simple pricing strategy. It will also work well if competition is not based on price but focuses instead on sources of competitive advantage, such as quality or convenience. However, it does not take account of the price of competitor products or consider likely demand at this price.

Competitor based pricing

This strategy suits businesses in very competitive markets where sales are particularly sensitive to price. It involves the entrepreneur carrying out research into prices charged by competitors and then setting a price either in line with this or slightly below, in order to attract increased sales. This strategy requires some investment in market research in order to ensure that prices remain competitive over time.

Think

The well-known tag line of the John Lewis Partnership is 'never knowingly undersold'. Why might this be such a successful strategy for this particular business?

Premium pricing

Some products are differentiated by quality, targeting consumers with high incomes and aspirations. In this case the consumer may view a high price as an indication of the quality of the item, increasing its perceived value. The entrepreneur may choose to price the item at a premium (a particularly high price), in order to reinforce this perception.

This strategy is generally more successful with products targeted at niche markets, rather than at consumers in a mass market, where price competition tends to be more important to sales.

Price discrimination

This strategy involves charging different prices to consumers in different segments of the market, for the same product. Some of the most common examples are student discounts given in many high street shops, or cheaper off-peak fares charged on rail and bus services. This can be a good way to 'smooth' demand for services by encouraging customers who are flexible to use the service at a less busy time. A hairdresser may offer a discount to pensioners on Tuesday afternoons when there is little custom, encouraging the pensioners, who have more free time than other clients, to free up appointments at times when other customers may be competing to book an appointment. This strategy only works where groups are clearly identifiable and where it is not possible for the product bought at a discount to be re-sold by the customer at the higher, market price.

**Pricing**

**strategies**

The importance of the correct pricing strategy

'Price' is one element of the marketing mix, the others being 'place', 'product' and 'promotion'. These four aspects of a product or service work together to create an offering which attracts customers. It isn't possible to say comprehensively that one is more important than another - if any element were inappropriate for a customer it would reduce the value perceived by that customer and reduce sales. It is correct, though, to say that the price charged should be in line with the other elements of the marketing mix. This is why Primark can successfully (and very profitably) sell low-priced (and low cost) clothing and accessories, while at the same time Louis Vuitton sells their branded clothing and accessories at a much higher, premium price, equally profitably.

Cost plus pricing calculates the cost of producing a product then adds a percentage of this cost to arrive at a price. The added amount is called the mark-up.

Competitor based pricing takes account of prices charged for similar products in the market, setting a price similar to or just below this.

Premium pricing charges a high price for the product, above the market price. This reflects the high quality of the product itself and may help to convey matching customer perceptions of the quality.

Price discrimination charges customers in different market segments different prices for the same product in order to reach as many customers as possible.

The marketing mix is a model for considering different aspects of a product and its market. Also known as the 4 'P's, the aspects are price, place, product and promotion.

Sales volume

This refers to the quantity of the product sold over a period of time. Many entrepreneurs set a specific objective of increasing sales volume. At any given selling price, the higher the sales volume, the higher the total revenue.

Sales volume typically increases when prices are lowered. Other strategies which can be used to increase sales volume involve adapting different elements of the marketing mix. For example:

Promotional activity

**Making a profit**

Advertising, sponsorship and effective public relations can all increase sales volume for a business. Promotion can encourage existing customers to purchase more or attract new customers to the brand. However, these activities incur costs so an entrepreneur should ensure that the forecast increase in sales volume will generate enough extra revenue to more than cover these costs.

**Using the marketing mix**

Modify the product

Updating a product so that it meets customer needs more effectively can give the product competitive advantage and attract a greater number of competitors.

Alternatively, changing the way that customers use a product can lead to increased sales volume. Advertising for Kellogg's Special K breakfast cereal recently suggested that it could be used as part of a weight loss programme if eaten for breakfast and lunch, with a main meal in the evening. Straight away this doubled the amount eaten by individuals who were used to eating cereal only for breakfast and now ate a second bowl for lunch each day.

Increase availability of the product

Making a product available in new geographical areas (a different part of the UK, or exporting to new countries) or through new channels in existing markets (in stores as well as online, for example) can increase sales volume because more customers have easy access to the product.

Increasing profit [[1]](#footnote-1) [[2]](#footnote-2)



Profit is equal to revenue minus cost

**A WATCH OUT!**

It is vital that you are clear on the elements that make up profit revenue and cost for a business, and how these affect each other:

* Profit is affected by changes in either cost or sales revenue.
* Sales revenue is directly affected only by changes in sales volume or selling price, not by changing costs.
* Increasing sales volume will increase costs because each unit sold incurs additional variable costs, and vice versa if volume is decreased.
* A price cut may or may not increase sales volume. Market research may be needed to determine whether it will increase sales by enough to cover a price cut and increase sales revenue.

Exam style question

Thomas and Andre met at college in Cambridge where they were studying for an NVQ in Vehicle Mechanics. They stayed friends after graduating and, after gaining a few years' experience, decided to set up their own garage: Cambridge Car Surgery Ltd. They rented space on an industrial estate in the north of the city and spent the little savings they had on buying spare parts and tools needed for vehicle maintenance, topping this up with a bank loan to cover their early running costs. The friends were pleased when they won a lucrative contract servicing the vehicles of a local taxi firm as this added to the income they made from local residents and passing trade. Although their first year of trading was less profitable than they had hoped, both Thomas and Andre enjoyed the freedom of running their own business and making their own decisions. In quiet moments the friends discussed their dream of owning a chain of garages across south-east England.

1. Briefly explain two ways that Thomas and Andre could increase the profit made at the garage. (8 marks)
2. Discuss the extent to which maximising profit is vital for Thomas and Andre. (12 marks)

Chapter 17

**Reaching break-even**

Esther Webb Life Coaching

Esther Webb has a successful career working for a corporate communications agency, but she is planning to change careers. She would like to train as a life coach and set up her own business working with individual and corporate clients. Esther believes that she will gain great personal satisfaction from helping her clients achieve their goals and is looking forward to being in full control of her working life. Whilst her main objective is personal rather than financial, Esther knows that she needs to make enough profit from her business to maintain her standard of living, so she has thought about her finances and identified the following information:

Fixed costs per month: £900 - room hire, insurance, advertising, miscellaneous.

Variable costs per client: £5 for refreshments and record-keeping.

Esther plans to charge clients £50 per hour.

Discussion points

1. If Esther sees 18 clients in her first month, will she make a profit or a loss? Calculate the figure exactly.
2. If Esther continued to attract 18 clients a month but put up her prices to £60 per hour, what would her monthly profit/loss now be?
3. Flow many clients does Esther have to see at £50 an hour in order to make £4,000 profit in a month? Show your workings.
4. Why might it be useful for Esther to carry out calculations like these before setting up her life coaching business?

The cost of production

You have already learned that a business incurs running costs when producing a product or service. You also know that these running costs are either fixed costs (not directly linked to the volume produced) or variable costs (which change directly as the volume produced increases or decreases). Remember: total variable cost is calculated by multiplying the product's variable cost by output.

TOTAL COST = FIXED COST + TOTAL VARIABLE COST

A business producing zero units of output will still have to pay fixed costs but will have no revenue. It will therefore be making a loss because costs are greater than revenue. As more units are produced these will start to contribute towards paying off the fixed costs, and eventually the total revenue will exactly cover the costs. Above this level of sales the business will be profitable because costs are less than revenue.

**Breaking**

**even**

The point at which costs are equal to revenue is called the break-even point or the break-even level of sales. It is very useful for entrepreneurs to know what this is for their business so that they can make judgements about how likely it is that they will be profitable.

**Output**

Zero

Below break-even Break-even Above break-even

**Costs and Revenue**

**Outcome**

Fixed costs only, revenue zero Fixed costs + variable costs > Revenue Fixed costs + variable costs = Revenue Fixed costs + variable costs < Revenue

Loss

Loss

No loss, no profit Profits made

By the end of this chapter you need to be able to:

**Break-even**

**analysis**

* Use a formula to calculate break-even (BE) for a business, given cost and revenue data
* Interpret a BE chart
* Explain how an entrepreneur might use BE data
* Evaluate the factors limiting the use of BE analysis.

Break-even revenue level - the amount of sales revenue needed to exactly cover all of the costs of a business. At this revenue level the business makes neither a profit nor a loss; it just covers its costs.

Break-even point - the volume of sales at which a business breaks even, so revenue covers costs exactly.

Break-even analysis - the process of calculating and interpreting information relating to the break-even revenue level.

Contribution

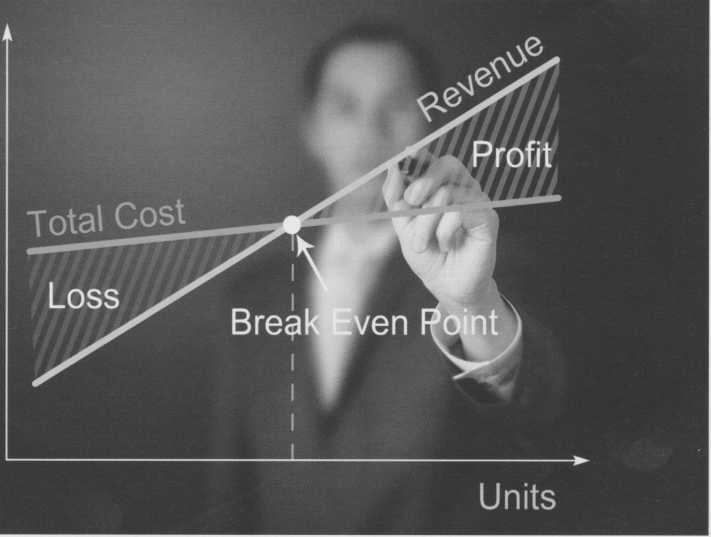
Example

BestBurger sells high quality handmade beefburgers from a mobile unit at a market in the town centre. The fixed costs for the business total £2,500 per month. This covers staff salaries, pitch rental and insurance.

Each burger incurs £1.50 variable costs (bun, meat, salad and packaging) and is sold for £4.00. From each £4.00 of sales revenue, £1.50 immediately covers the variable cost of the burger.

This leaves £2.50 to contribute towards the fixed costs. This is called the contribution.

CONTRIBUTION = SELLING PRICE - VARIABLE COST

****

*Break-even point is the volume of sales where revenue covers costs exactly.*

Identifying the break-even output level

We can calculate the number of contributions needed to pay off the fixed costs by using either one of these formulae:

**FIXED COSTS** or **FIXED COSTS** CONTRIBUTION (SP-VC)

* So, for BestBurger, the BE level of sales is fixed costs divided by contribution,

£2500/(£4.00-£l .50) = 1000 burgers.

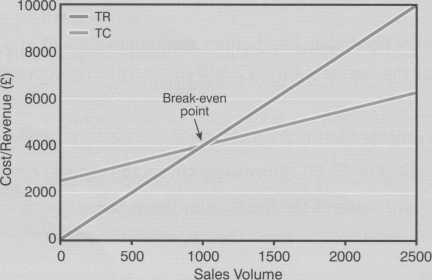
* Or you can look at it as fixed costs divided by the difference between selling price and variable cost, £2500/£2.50 = 1000 burgers.
* Below monthly sales of 1000 burgers, BestBurger will make an overall loss. Above 1,000 burgers per month BestBurger will make a profit.

**Selling**

**enough**

We can also plot this information on a graph. In Figure 17.1 you can see two lines - total cost (TC) and total revenue (TR). Your teacher might choose to show you a more detailed graph.

Figure 17.1: Breok-even chart for BestBurger

Look at the point where the two lines cross. This is the BE point. You can see on the x-axis that this is at 1000 burgers, matching the result of the calculation above. At any level of sales below this point (to the left of the BE point), BestBurger will make a loss. The size of the loss is represented by the gap between the TC and TR lines. You can see that the loss is larger as fewer burgers are sold. Conversely, to the right of the BE point BestBurger is making a profit. This profit increases as more burgers are sold: because all fixed costs are now covered, the contribution from each burger represents clear profit for the business. Hence, total profit can be calculated as:

PROFIT = (SALES VOLUME-BE LEVEL OF SALES) x CONTRIBUTION

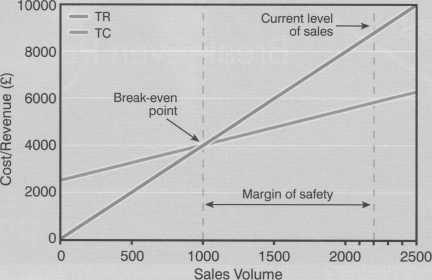
Margin of safety

At any level of sales above the BE point, a business is profitable. There is a number of units by which sales volume can fall before reaching the BE point, known as the margin of safety. The larger the margin of

In the BE graph shown in Figure 17.2, BestBurger's current level of sales is 2200 burgers/month. The margin of safety is 2200 - 1000 = 1200 burgers/month.

*Figure 17.2: Break-even chart for BestBurger* safetthe 9reater the faN in sales the

business can absorb before making a loss.



The purpose of break-even analysis

BE analysis can be used for a number of different purposes:

* To decide on pricing

An entrepreneur may calculate the break-even level of sales at a range of different prices as a way of helping to decide how much to charge for a product or service. S/he will want to be sure that predicted sales volumes will allow the business to make a desired level of profit, bearing in mind potential demand.

**Using**

**break-even**

Contribution - that part of sales revenue which can be put towards paying the fixed costs of a business. Contribution = selling price - variable cost per unit.

Margin of safety - the amount by which sales can fall from their current level before reaching the break-even point.

* To predict profit

If a business is using competitor-based pricing, they will not have much choice about the price they charge. The owner may, therefore, want to use BE analysis as a tool to predict how much profit they are likely to make at different volumes of sales.

* To seek finance

Investors and lenders will only commit money to a business idea if they are confident that the venture will be profitable. BE analysis can form part of a business plan (you'll learn more about this in Chapter 19). It is a document used to promote a business idea to potential investors or lenders.

* To conduct 'what-if' analysis

Entrepreneurs may want to 'model' the impact of changes within the business, such as changing price (see above) or forecast the impact of possible changes in demand, or fixed or variable costs. BE analysis allows these changes to be included in the BE calculation so that new BE levels can be identified. If demand (or total sales) is forecast to change, BE analysis can focus on the margin of safety and whether this will be sufficient for the business to remain profitable.

Limitations of break-even analysis

BE analysis assumes that fixed and variable costs are known. Especially during business planning, an entrepreneur may have to make a 'best guess' at costs. Hence, the quality of BE analysis will depend on the accuracy of the assumptions made.

BE analysis identifies total revenue and profit at different sales volumes. However, it doesn't guarantee that a business will generate sufficient demand to sell at this level. An entrepreneur needs to be able to judge accurately the likely demand for a product as well as to calculate BE data. BE analysis can highlight the need to market the product more effectively in order to sell enough to cover costs.

Exam style question

John-Paul Jones is a carpenter who specialises in handmade dining tables and chairs. His average selling price is £1,200 per dining set. The wood for each order costs approximately £300. John-Paul has fixed costs each month of £1800.

1. How many dining sets must John-Paul sell each month in order to break even? Show all of your working. (4 marks)
2. The economy is booming, trade is brisk and John-Paul is thinking of expanding his business. He would need to take out a bank loan in order to buy and fit out a larger workshop. He would also take on an assistant to help in his workshop. Explain two ways in which break-even analysis might be useful to John-Paul in this situation. (8 marks)

Chapter 18

**Measuring profit**

Beautiful bowls

Daniel is a skilled craftsman who works with wood. He makes salad bowls which sell well in upmarket gift shops and by mail order. He has set up a small limited company and is more or less breaking even. Daniel has premises in a group of farm buildings that have been converted into a mini­industrial estate. He rents two rooms, one of which serves as a workshop for making the bowls. The other provides space for storing, packaging and distributing the salad bowls and a desk and computer for handling the admin side of the business.

The cost of the wood and other materials needed is usually £8 for each bowl. Turning the bowl on the lathe and creating a smooth finish takes about 2 hours for each bowl. Daniel pays himself £12 per hour, to provide him with a basic income. These are all variable costs - they will be directly proportional to the number of bowls made. Bowls are sold for £38 each, plus a £5 post and packing charge.

The fixed costs include the monthly rent of £300. Electricity, business rates, administrative costs and marketing expenses add up to a further £150 per month. These fixed costs will have to be paid regardless of how many bowls Daniel can sell.

Daniel bought his lathe and hand tools, a workbench, the computer, a table and a few other bits of basic furniture, using a loan of £4,000 from a relative. The interest and repayment he must make to his lender is £80 per month. This too is a fixed cost.

Questions

1. How much is the contribution that each bowl sold makes towards fixed costs?
2. Work out what Daniel's break-even level of output will be.
3. How much profit would Daniel make if he sold 900 bowls in a year?
4. What will happen if he tries to sell more?
5. Would you describe this business as successful?

Recording profit and loss

Businesses are legally obliged to keep account of their profits and losses. Small businesses produce a profit and loss account. (Bigger businesses use the term Income Statement, but the principles are very similar.) This document itemises all the costs and revenues over the course of a year.



*Businesses ore legally obliged to keep account of their profits and losses.*

**Accounting**

Break-even analysis is a useful tool for forecasting and it gives the business a view about how it might be able to succeed in the future. But businesses also need to look back at what has already happened: this too will give them many clues about how to plan for the future. The diagram on the next page shows how a profit and loss account can be used to create a historical record..

• This gives net profit, a key measure of business performance.

Daniel's profit and loss account after a year in which he sold 900 bowls would look like this: Beautiful Bowls - Profit and loss account 2011

Sales revenue £38,700

Less Cost of goods sold £33,300

Gross profit £5,400

Less Overheads £6,360

Net profit (£960)

**A WATCH OUT!**

Often there are more words than one for the terms used in accounts. You need to be able to recognise all these terms but even if the use made of them varies, they do mean the same.

* Sales revenue may be called turnover in a P&L account.
* Cost of goods sold (COGS) may just be called cost of soles. This item is usually equivalent to variable costs.
* Overheads may be called sales expenses or administrative expenses, depending on the nature of the business. 'Overheads' usually includes all the fixed costs.
* Net profit is often called operating profit - they mean the same.

Can you see what happened to Daniel?

Although he managed to cover his variable costs, Daniel actually made a loss of £960. His overheads were greater than his gross profit, so net profit was negative. This isn't too bad for the first year of a business. With what he learned in the first year, he can probably make changes that will help to bring the business to profit next year. Bearing in mind that he paid himself £24 for each bowl sold, he made an income of £21,600. It is clear that his business can't support that level of income for himself, and effectively his income is lower because of the losses. He has to work very hard because in addition to making the bowls he does all the packaging and posting, the administrative tasks and the accounts. But he is still in business and he can build on his experience, even though he had to fall back on his loan finance to cover the loss.

**Losses**

A

Cost of goods sold

minus cost of sales

= gross profit

**Gross profit**

**Net profit**

Overheads

minus

overheads

= net profit

Net profit

* The profit and loss account always starts with sales revenue. The first deduction is the cost of goods sold (COGS). These are the costs of the resources that are needed to actually make production happen. These are variable costs that relate directly to the amount of output produced. For Daniel they include wood, his own pay for time spent working on the bowls and postage and packing.
* This gives gross profit. From that will be deducted the overhead costs. These will vary from one business to another but are likely to include rent, rates, insurance, management salaries, general office costs, interest payments and marketing costs (like advertising). Daniel's overheads include rent and business rates, office costs, and marketing.

Show your understanding

Daniel thought that in 2012, he might pay himself just £10 an hour for working on the bowls. How much would his income fall if this was the only change he made? Rewrite the P&L account to show what it would look like if he did this.

As an alternative strategy, he considered raising the price to £41. He assumed that his sales volume would not change. If he is right, what will happen? Rewrite the P&L account to show this change.

Assess the likelihood of Daniel continuing to sell the same number of bowls at this price.

Are there other things Daniel could do to make his business more profitable?

Gross and net profit margins

You can compare profit levels from year to year but if you really want to analyse the meaning of a certain level of profit, you need to look at profit margins. They can be used to measure how effective a business is in turning sales revenue into profit.

Gross profit margin is gross profit as a percentage of sales revenue.

Gross profit margin = Cr°SS pr°flt [[3]](#footnote-3)100 Sales revenue

**Evaluating**

**performance**

The profit and loss account starts with a statement of sales revenue and deducts each different group of costs to arrive at a measurement of profit.

Turnover means total sales revenue for the year.

'Cost of goods sold' means the cost of inputs to the actual production process, e.g. labour, components, raw materials. It excludes overheads. It will vary directly with the amount produced.

Overheads are the costs that stay the same regardless of how much is produced.

Gross profit means sales revenue less the immediate costs of producing the goods sold.

Net profit Is what remains from sales revenue after the deduction of all operating costs, including overheads. If a loss has been made the figures will be in brackets. Net profit is a revealing measure of performance which can be used to make comparisons over a number of years. Larger businesses refer to net profit as operating profit.

Net profit margin is calculated in the same way as gross profit margin. It is net profit as a percentage of sales revenue.

iu \* r«. Net profit

Net profit margin = **xlOO**

Sales revenue

Daniel's gross profit margin for 2011 was ——- x 100 = 13.95%

38,700

Daniel's net profit margin for 2011 was x 100 = -2.5%

38,700

As you can see, a loss means a negative net profit margin in 2011. Efforts to cut costs might be called for. Alternatively he might try to increase sales revenue.

Profit margins can be compared from year to year. A good profit margin would not be the same for all businesses. Supermarkets tend to have small profit margins, because every item has to be bought in and the supermarket simply sells it. It does not actually create the products. A manufacturer of electrical products would expect higher profit margins because much of the work done to create the product will happen in the factory.

**Decisions**

A small business would concentrate on increasing its profit margins, year by year. Larger businesses can sometimes compare their profit margins with those of similar competing companies - if they can get access to the accounts.

**Margins vary**

Gross profit margin is gross profit as a percentage of sales revenue.

Net profit margin is net profit as a percentage of sales revenue. It can be used as a performance measure, giving a view of how successful the business has been, in comparison to past years.

Show your understanding

In fact, Daniel decided to pay himself the same in 2012 as he had in 2011. But he did raise his price from £38 to £41, + P&P. He felt that the quality of his work was such that he could still sell the same number of bowls at the higher price. His reputation as a craftsman was growing by word of mouth and he felt his market was growing too. He was right - sales volume stayed the same in spite of the price increase. Calculate both gross and net profit margins for 2011 and 2012.

Using profit and loss accounts

Budding entrepreneurs who need to attract bank finance or to impress individual investors must produce estimated P&L accounts. Established businesses need to look back at the accounts from the past for a whole range of reasons:

* to identify trends over time. These can be very revealing.
* to raise finance, as proof of past performance. The bank will want to study all the accounts carefully.

**Analysis**

* to analyse the success of the business in meeting its profit objectives.
* to compare with those of others in the same industry, in order to judge efficiency.
* to set objectives for the future.

Improving profits

Daniel could see from his profit and loss account in 2011 that he would need to do something. He was lucky in that getting better known was creating interest in his product: many new businesses fail in the first few years. But putting the price up worked for him. He could have considered many alternatives though: using cheaper wood, cutting the price and hoping to make and sell more, moving to cheaper premises and so on. In general, these are the possibilities:

Reducing COGS can mean using the available labour more efficiently, or cutting the cost of inputs, perhaps by finding a cheaper supplier.Reducing overheads can be achieved by doing administrative tasks more efficiently or finding cheaper premises or suppliers (e.g. for insurance). In extreme circumstances, pay may be reduced - as in the period 2008-12 (see Chapter 11, page 65.)

Increasing sales revenue by raising prices, but only if the market is growing, as the price rise will not put people off. If in fact there is a cheaper competing substitute for the product, this will not work.

• Cutting prices can increase sales revenue if it means selling to a wider market. Some businesses can move from a small niche market to a mass market in this way. But the business would have to look carefully at the increase in COGS as a result of increasing output. There might also be an increase in overheads, such as marketing expenses. Trying out different possibilities using break-even analysis might help to analyse the likely outcomes.

Exam style question Sharpies Technology Ltd

Sarah Sharpies decided to set up a business which could support and maintain small business IT systems. This involves identifying appropriate hardware and software for her clients, setting up their IT system and customising it to the individual needs of the business. She has been quite successful in recent years because she can combine IT expertise with excellent customer service. Sarah's profit and loss account is shown below.

Sharpies Technology Ltd - Profit and loss account, year ending 31 December, 2011

£ £

Turnover 450,000

Cost of sales 300,000

Gross profit Overheads

* Rent, rates and insurance

**Competition**

22,000

1,000

80,000

* Heat and light

-Administrative expenses (including pay)

Net profit

Then, 2012 saw a change of fortunes. A competing business set up nearby, a subsidiary of a much larger company. Sharpies Technology lost some of its market share. Sales fell by 20%. Cost of goods sold fell proportionately, but overheads remained the same.

Questions

1. Calculate the missing figures for gross and net profit in the P&L account above. (4 marks)
2. Calculate the following for both 2011 and 2012.
3. Cross profit margin
4. Net profit margin (8 marks)
5. Using the figures you have calculated, explain what has happened to Sarah's profitability.

(8 marks)

1. Recommend two strategies Sarah could use to increase her net profit margin. (10 marks)

Chapter 19

**Creating a business plan**

Rooms to rent

John and Tracy have lived in Margate, a fairly small seaside town on the Kent coast, for years. Margate has until recently suffered from a poor reputation and little investment. Now, however, the town is on the up and is returning to the tourist map. There is a new art gallery on the seafront which is helping to attract visitors, especially since an upgraded train service means that they can travel from London in a little over an hour. The local council is also investing money in renovating an historic entertainment venue and investors are buying up cheap local properties.

John and Tracy have a large house on a street by the sea. Their grown-up children have left home and Tracy is considering converting the house into a bed and breakfast business, renting out rooms to tourists and business visitors. Neighbours on local streets have already set up their own businesses, which charge between £40 and £90 a night per room. Tracy is confident that they can make enough money each month so that she can give up her job in the town's tourist office, to be available to look after their guests.

Discussion points

1. What start-up and running costs is the bed and breakfast likely to incur?
2. What questions should John and Tracy ask themselves before committing to setting up their new business?
3. Adapting their family home to become a bed and breakfast will cost the couple money, which they will need to borrow from their bank. How might they persuade the bank manager to lend the money they need?

If you've ever watched the television show Dragons' Den, you'll be familiar with the sight of nervous entrepreneurs struggling to respond to the relentless questioning of the 'dragons' - a panel of venture capitalists who decide whether or not to invest their money in the business ideas pitched to them. Members of the panel typically fire questions at each entrepreneur. These focus on different aspects of the business idea, such as the details of the product or service; projected sales and revenue figures; market data and targets for growing the business. Each 'dragon' must be satisfied that any money they invest will be used to generate future profits, or they will choose not to invest at all.

Making Whilst the Dragons' Den is a television format, the questions asked of the candidates on it are typical of

a plan the questions that any entrepreneur should ask themselves when developing a new business idea. Any new

business incurs opportunity costs - the entrepreneur gives up time, usually money too, resources which could otherwise be invested elsewhere. So the business idea needs to be worth the risk taken with these resources. The construction of a business plan is a common way to explore the business idea and to reduce the risk that it will fail.

Investment means spending now that will yield income in the future. It can mean investing in one's own business, either to start up or to expand, or taking a part share in someone else's.

Business plan - a written document detailing all aspects of a business idea. A business plan includes information on the product or service, marketing, production, human resources, equipment needed and financial information.

Business planning - the process of carrying out market research and thinking through a business idea in order to construct a business plan.

**What is a business plan?**

A business plan is a written document which contains detailed information on different aspects of a business idea. It is a formal report used by the entrepreneur for their own planning and also to support applications for finance for the business idea. A business plan completed with care and diligence is likely to take some time to construct because of the need to carry out market research and to prepare financial information.

**The purpose of business planning**

In the case study above, John and Tracy need to ask themselves many questions.

* Can they afford the initial conversion work to their house?
* How much demand will they be likely to have now and in the future?
* How might demand vary over the year - few tourists visit the seaside in winter?
* How much profit can they hope to make?
* How much competition will they face?

The issue of competition is important: they need to identify a secure source of competitive advantage. Writing a business plan will help John and Tracy to address these questions in a thorough and logical way.

to gain finance

to reduce  
the risk  
of failure

**The purpose  
of business  
planning**

to give focus and direction

to support  
monitoring  
and

evaluation

**Competitive**

**advantage**

Completing a business plan helps to reduce the risk of the business idea failing, since potential pitfalls should be identified early and can be addressed. It forces the entrepreneur to consider many different aspects of their business idea:

* how it is different from competing products
* who it is aimed at - the target market
* how it will be marketed
* the costs of production.

Most entrepreneurs will need some sort of financing either when starting their business or, later, when seeking to expand. A key purpose of business planning is to provide evidence to support the gaining of finance. This could be from investors or from lenders. As in the Dragons' Den example above, investors or lenders will want to make sure that their money will be used effectively and that it will generate a return.

By reading the business plan they can make an informed decision about whether or not to invest - a solid business plan significantly increases the chance of gaining funding.

A third purpose of business planning is to give focus and direction to a business. The plan should identify targets for the business over time, such as plans for expansion or profit targets. Clear goals can help to motivate entrepreneurs as well as provide a measure against which to compare progress overtime.

The fourth purpose, supporting monitoring and evaluation, is important because the circumstances surrounding the business can change unexpectedly. Will everything go according to plan? Probably not. As changes occur, the situation can be compared with the scenario set out in the business plan. This will help in devising ways to adapt to change.

The flow chart shows the process. There may be good reasons why targets are not met, but action may be required when things do not turn out as expected.

Conduct

market

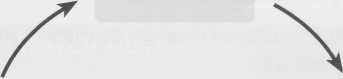
research

i

Write business plan - set targets

i

Monitor business against targets



Adapt business where needed

Update  
business plan

Constructing a business plan

Templates for writing a business plan can be found easily online or in business start-up packs provided by high street banks. These give suggested structures which encourage an entrepreneur to consider all aspects of their business. In order to answer many of these questions, entrepreneurs need to conduct research - they are likely to use many of the methods of primary and secondary market research which you learned about in Chapter 8. Although this can be time-consuming, the more detailed the research which supports a business plan, the more useful the plan is likely to be in helping the entrepreneur to achieve their objectives.

**Market**

**research**

Find out

The website [www.startups.co.uk](http://www.startups.co.uk) contains lots of information for entrepreneurs considering starting their own business. Use this site to find out more about business planning - what it is, why it is useful and tips for successful business planning.

The features of a business plan

There is no one format which must be followed in writing a business plan. Whatever approach is taken, the

following information will typically be included:

* Product or service to be produced - detailed drawings, descriptions and images are needed to show what the business will produce and sell.
* Marketing plan - shows how the business will be marketed including the pricing strategy, how and where it will be sold and advertising or promotional activities to be undertaken.
* Production plan - saying how the product will be produced or the service delivered. This should be detailed, identifying sources of added value and of competitive advantage.
* Premises and equipment needed - this is a list of all capital items as well as consumables used in producing and delivering the product or service.

**Information**

**required**

*A business plan contains detailed information on different aspects of a business idea.*

* Human resources plan - an outline of staff needed including numbers, working hours and training necessary. Personal details of staff are not necessary, although it is common to identify the specific skills and experience that key staff will need, where these will contribute to the success of the business.
* Sources of finance - how the costs of the business will be financed, at start-up and once the business is in operation.
* Profit and loss forecast - providing a prediction of the profits or loss generated by the business in the first few years of operation. (It may be clear from the start that the business will take time to become profitable.) This should be based on detailed research and should include the different measures of profit which you learned about in Chapter 18. It is good practice to compare predicted profit margins to typical margins for businesses in the chosen industry.
* Cash flow forecast - this is a summary of how cash is predicted to flow into and out of the business. It is important because without adequate cash to cover costs, the business may not survive, even though it could be profitable in the long run.

Cash flow forecasting

As you have learned, businesses incur costs and generate revenue. A key issue for many businesses is that payments, or outflows, may be needed before revenue, or inflows, are generated. In the case study at the beginning of this chapter, you can imagine that John and Tracy would have to spend money on washing towels and bed linen and on buying items for breakfast before guests arrive, but would not be paid until guests leave. In this case, the outflows may only occur a day or two before the inflows and are relatively small. But imagine how different this might be for a builder installing a new conservatory, or for a pharmaceutical company developing a new medicine.

A cash flow forecast aims to predict when cash outflows and inflows will occur. This enables the entrepreneur to identify times when finance will be needed to cover any cash shortfalls - they can then seek a source of finance appropriate to the amount of money and the length of time for which it is needed. One of the main causes of businesses failing, or becoming insolvent, is poor cash flow management, rather than a business idea that is basically unprofitable. For this reason, an entrepreneur needs to be sure that they have sufficient working capital to bridge the gap between spending on costs and receiving revenue.

**Cash flow**

Cash flow forecast - a month by month prediction of the timing of expected cash inflows and outflows in a business.

Cash inflows - money coming into a business. This includes revenue, investment and borrowing.

Cash outflows - money leaving a business. This includes fixed and variable costs as well as cash withdrawals by the business owner(s).

Insolvency - when a business fails because a sustained lack of working capital means that debts cannot be paid.

**A WATCH OUT!**

A business can be basically profitable but, because of poor cash flow management, can fail. Make sure you are clear on the difference between working capital and profit. (Working capital was covered in Chapter 14, page 81.)

The limitations of business planning

A business plan isn't a guarantee of success, but the process of writing the plan should help to identify key issues which can be addressed if necessary. Obviously, the more skilled an entrepreneur is in carrying out and interpreting market research, the more accurate, and therefore useful, their plan is likely to be.

You have learned that a business plan can give focus and direction to a business. This will only happen if the entrepreneur makes time to return to their plan regularly, reflecting on progress and making changes to the business where necessary. A business plan does nothing on its own, sitting at the back of a filing cabinet. It cannot make up for mistakes like failing to keep in close touch with suppliers or to communicate effectively with employees.

**Making the plan work**

Finally, a business plan needs to be updated regularly to reflect changes in the market and the business. The best business plans are flexible working documents - up to date information gives the people running the business a better basis for decision making and therefore increases the chance of the business succeeding.

Sources of help

The BIS website (created by the Department for Business, Innovation and Skills) has much useful information. Local business advisers are often also able to provide advice to individual businesses. The Prince's Trust provides some funding for unemployed or disadvantaged people under the age of 30 to start their own business. Producing a business plan sometimes reveals that the potential entrepreneur is not yet ready to strike out on their own in business - which can lead to a good decision not to go ahead yet. Taking time to get more advice can be a good move.

Exam style question

1. Explain why a bank might want to see an entrepreneur's business plan before deciding whether to offer them a start-up loan. (6 marks)
2. Briefly outline the content and purpose of business planning for an entrepreneur. (6 marks)

no

1. At the beginning of the chapter we used the formula:

   PROFIT = REVENUE-COST

   We can expand this formula using what you have learned about revenue and about costs. Remember that SALES REVENUE = SV x SP

   and, from Chapter 13, pages 78-79:

   TOTAL COST = FIXED COST + TOTAL VARIABLE COST (the variable cost per item x SV) Still following this? In which case, we can say that

   PROFIT = (SV x SP) - (FC + (VC x SV))

   and this is a very important formula because it highlights all of the variables which affect the profit made by a business. To increase profit:

   a business can seek to increase sales volume

   or it may raise the selling price [↑](#footnote-ref-1)
2. or it may look for a way to cut either fixed or variable costs.

   The most successful strategy would be to aim to achieve all of these goals at the same time, since this would generate the largest increase in profit.

   Show your understanding

   Think of a small business in your area. Working with a partner and using the expanded formula for profit above, explain to each other all of the different ways that the business could act to increase its profit. Be as specific as you can, giving examples and suggestions related to the business. Discuss each part of the formula in turn.

   Finally, decide between you which strategy you think would work best for your chosen business. Make sure that you can explain your reasoning clearly. [↑](#footnote-ref-2)
3. [↑](#footnote-ref-3)