AQA AS Business Studies

Unit1 (BUSS1)

Course Companion

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Introduction to AQA AS Business Unit 1

This course companion provides you with a comprehensive set of notes and revision questions for the new AQA AS Business Studies specification for Unit 1 (BUSS1).

BUSS1 is named **"Planning and Financing a Business".**

The focus of BUSS1 is on **starting** a **small business**. The important word there is **small.** As in:

- A business with very few resources (finance, people, assets)
- Operating in local or national markets (though it may grow later to operate in international markets)
- A business with no existing customers

You need to remember this emphasis on small businesses. It affects the actions the business can take and the options available to it.

Our Course Companion closely follows the structure of the BUSS1 specification. We've also picked out the most important elements and given them special emphasis, so you can be sure that you have a set of notes here that will help you prepare effectively for the exam.

We would also encourage you to visit the tutor2u BUSS1 daily blog, on which we'll provide you with further support during your studies.

The study notes in this Companion are organised by topic under each of the main specification headings. Access them using the menu bar at the top of every page (interactive version only). If you need to print them out at any time, just right-click on the page content and choose your printing options.

Please note that these resources are protected by copyright, and must not be reproduced or sold. That's a good example of a small business protecting its business ideas (section 2!)

Section 1: Starting a Business

It seems appropriate that the start of your AS Business Studies course asks you to consider what is involved in starting a business!

Section 1 of BUSS1 is all about the process of **starting a small business**. What you'll cover in this section is highly practical. Over 400,000 small businesses are started in the UK every year. The entrepreneurs behind these start-ups look at the very issues you'll cover in this section.

Here are the key topics you cover in Section 1:

- Why entrepreneurs start new businesses and what it takes to succeed
- Where the ideas for start-ups come from and how a good business idea can be protected
- The key concepts of risk, reward and opportunity cost
- The ways in which a business can add value to a product so that profits can be made
- Putting a business plan together, both to raise finance and also to make sure that the risks of the start-up are properly understood
- Using market research to support the business plan and help the entrepreneur understand the size and structure of the market, and how much competition the new business will face
- Raising finance - one of the toughest challenges for a start-up
- The key factors that the start-up must address when it comes to choosing a location for the business
- What kind of employees (if any) to bring into the business

The main focus on Section 1 is on **business planning**. Each of the activities that are covered is brought together into the business plan. Later on in the course, you get the chance to assess how successful the business planning of a start-up has been.

Enterprise and Entrepreneurs

Introduction

The long line of budding entrepreneurs and publicity-seekers climbing the stairs into the Dragon's Den is proof that enterprise has captured the imagination in the UK. The sheer variety of product and business ideas pitched to the Dragons suggests that it is quite easy to come up with a new business concept. The problem is that turning an idea into a successful business is actually quite difficult!

The difficulty of running a business doesn't seem to put people off! In the UK there are around 4.5 million separate businesses, of which 3.3 million have no staff.

The vast majority of businesses in Britain are small. Only 6,000 businesses have more than 250 staff.

Every year, a substantial number of new businesses are formed. Figures released by Barclays in July 2008 showed that there were 409,000 start-ups in the year to March 2008. Unfortunately, in the same period, 458,000 businesses closed. Many start-ups don't survive much beyond their third birthday – but still people keep "stepping up to the plate" to have a go.

Your BUSS1 course encourages you to study the process of starting a business, looking at the skills, challenges and pitfalls that face every entrepreneur.

This introductory section is important since it goes right to the heart of the business start-up process. Here's what you need to know:

- What is meant by the terms "enterprise" and "entrepreneur"
- Why entrepreneurs take risks and what rewards do they want in return?
- What is meant by the concept of "opportunity cost"?
- The other motives (in addition to financial returns) for starting a business
- How government provides support to encourage enterprise and new businesses

Entrepreneurs

In recent years the media have glamorised the challenge of starting and growing a business. A quick search on Amazon.co.uk will display many books by entrepreneurs and other "business experts" describing "how they made it", "my first million" etc. Prime-time television shows such as Dragons Den, Risking it All and The Apprentice have proved hugely popular by showcasing the challenges faced in setting up a business. Entrepreneurs such as Sir Alan Sugar, Sir Richard Branson and Sir James Dyson have earned enormous fortunes and provide inspiration for the next generation of budding business leaders.

Entrepreneurs play an important role in society. They **make a major contribution to economic activity**. Imagine how many jobs are created by the 400k+ start-ups each year and by the small businesses that prosper and take on more staff. They encourage innovation through investment and risk-taking. Many of the products and services you use on a day-to-day basis have been developed through entrepreneurial activity rather than in the research laboratories or board-rooms of large multinationals.

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

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

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

Key characteristics of successful entrepreneurs:

- **Passionate** about their product or service and about getting things right for the customer
- **Visionary** – they have faith in what they are trying to do
- **Energetic and driven** – prepared to work consistently long hours, especially in the early stages
- **Self-starting and decisive** – they don't wait for others to take decisions
- **Calculated risk-taking** – not reckless; they are prepared to take a risk in order to maximise the rewards
- **Multitasker** – able to take on more than one role (product development, selling, recruitment)
- **Resilient** – able to handle problems and overcome hurdles
- **Focused** – sets clear goals and self-imposed high standards
- **Results-orientated** – take pleasure from achieving targets and setting the bar higher

The important thing to remember about the list above is that an entrepreneur is unlikely to possess all these characteristics! Anyone who starts a business has strengths and weaknesses. However, the savvy entrepreneur recognises where his/her weaknesses lie and takes steps to address them (e.g. recruit someone with the right skills).

Motives for starting a business

What motivates someone to become an entrepreneur?

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

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

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

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

- More control over working life – want to choose what kind of work is done
- Need a more flexible work schedule, including being able to work from or close to home
- Feel that skills are being wasted and that potential is not being fulfilled
- Want to escape an uninteresting job or career
- A desire to pursue an interest or hobby
- Fed up with being told what to do – what to be the boss!
- Want the feeling of satisfaction from building a business
- Want more of the rewards from the effort being put in
- Fed up with working in a business hierarchy or bureaucratic organisation
- As a response to a shock in personal circumstances – e.g. redundancy, illness, bereavement

Downsides of starting a business

The BUSS1 textbooks (there are eight of them!) focus almost entirely on the positive reasons for starting a business. However, there are many potential **drawbacks** to being an entrepreneur.

Running a business means that an entrepreneur will:

- Face occasional loneliness and isolation. This is often the case for home-based start-ups.
- Be unable to blame others when things go wrong – the buck stops with the entrepreneur
- Probably be under financial pressure – earning little or sometimes nothing as the business tries to establish itself
- Have to work much harder than in a conventional job – average working of 70+ hours per week is common. This puts a great strain on family and social life
- Probably suffer from higher stress levels
- Have to rely on multi-tasking rather than call on an established network of specialists (available in a larger business)
- Usually have to work whilst sick, and not get sick pay
- Experience a roller-coaster of emotions

Put simply, starting a new business is not for the faint-hearted!

Risk and reward

If setting up a new business was risk-free (i.e. a “dead-cert”) then we’d all do it. The bad news for entrepreneurs is that investing in a start-up is risky.

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

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

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

Taken together, you can see why these risks are often the motivation for an entrepreneur to keep going, even when the business is struggling badly. When you are "risking it all" then you put heart and soul into making the business a success.

So what about the rewards?

We looked earlier at the motivations for setting up a business. Many of the intangible rewards that arise from being in business happen because these motives are achieved. A sense of satisfaction, being in control, making that first sale, achieving break-even or getting great feedback from customers. These are the kind of rewards that give entrepreneurs a buzz.

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

To illustrate the potential financial rewards, here are a couple of examples:

- Karen Darby sold her business SimplySwitch, a service allowing consumers to compare rates for gas and electricity suppliers among other things, to the Daily Mail for £22 million.
- Linda Bennett, one of Britain's most successful female entrepreneurs, sold her women's fashion chain, LK Bennett, to two venture capitalists for £70 million.

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

Opportunity cost

This is an important concept that applies to much of your studies in BUSS1.

Opportunity cost arises whenever a business decision is taken.

The opportunity cost of a decision is the cost of missing out on the next best alternative. It refers to the benefits that could have been obtained by taking a different decision.

If you think about the decisions an entrepreneur takes, then it is possible to identify the possible opportunity costs. Here are some examples:

Decision	**Opportunity Cost**
Mark decides to leave his job as a Bank Manager and set up a franchise	The loss of salary and other benefits from working at the bank
Sheila spends her start-up marketing budget of £15,000 on a direct mailing campaign	The £15,000 could have been spent on a radio and magazine advertising campaign, or a lower amount spent on marketing with the balance saved

To finance his start-up, Gavin takes out a £100,000 bank loan on which interest of 10% will be paid	The annual £10,000 interest to be paid on the loan could been used to invest in extra production capacity, if Gavin had invested his own funds in the business

Although this is an important concept in your BUSS1 course, in reality, entrepreneurs don't spend lots of time agonising over opportunity costs. In fact, most entrepreneurs won't recognise the term.

However, they do weigh up alternatives and, using a combination of calculation and instinct ("gut feel"), they make the decisions that they believe are best for the business.

Government and entrepreneurs

It is interesting that the AQA course asks you to study how governments help entrepreneurs. When you speak with successful entrepreneurs, they will often claim that their achievements are in spite of government action rather than because of government support!

Nevertheless we have to cover this, so here are the key points.

Firstly, you should appreciate that government likes enterprise and entrepreneurial activity. As mentioned earlier, entrepreneurs:

- Create jobs and help keep unemployment low
- Invest and innovate
- Generate substantial export earnings
- Pay substantial amounts of tax
- Encourage competition in markets

So what help does government provide to entrepreneurs? Here are the key elements:

Business Link	Advice on how to start, run or grow a business; includes a superb website
Department for Business, Enterprise and Regulatory Reform ("BERR")	The main government department that coordinates the support provided to businesses. BERR also provides funding for various business support organisations. Website click here
Companies House	Manages the formation, administration and closure of companies, including the provision of company information. Website click here
UK Trade & Investment	Provides business opportunities, expert trade advice and support to UK-based companies wishing to grow their business overseas. Website click here
Competition	Manage competition regulation and provide support and advice

Commission & Office of Fair Trading	regarding the treatment of consumers. OFT website here.
Regional Development Agencies	Nine regional organisations (in England) that channel government investment and support into key priorities. Website click here
Government Grants	Not available to all businesses. Grants are available from several sources, such as the government, European Union, Regional Development Agencies, Business Link and local authorities. Website click here

Exam tips

Risk is not something for an entrepreneur to fear. It is a part of business life. The challenge is to identify the key risks, evaluate them, and then make decisions using sound judgement.

It is relatively easy to start a new business in the UK. The support provided by the government for entrepreneurs is limited - few start-ups make use of government help.

Running a start-up is always tough - even a successful business might seem to have many problems and challenges to overcome. Remember this when the examiner describes a business that seems to be in trouble.

It is vital that you are able to describe the reasons why people want to become entrepreneurs and the characteristics that successful entrepreneurs tend to have.

Guided revision questions

Revision questions for Enterprise & Entrepreneurs

(1) Define the term "entrepreneur" (2 marks)

(2) What do you understand by the word "enterprise"? (2 marks)

(3) Give three characteristics of a successful entrepreneur (3 marks)

(4) Explain what is meant by the terms "risk" and "reward" (4 marks)

(5) State three possible problems that might be faced by an entrepreneur starting a business for the first time (3 marks)

(6) Define the term "opportunity cost" and give an example for a management consultant who leaves her job to set up an e-commerce business (4 marks)

(7) Explain why the time of an entrepreneur is an important aspect of opportunity cost for a start-up (5 marks)

(8) Give three reasons why it is important for a developed economy to encourage enterprise and entrepreneurship (4 marks)

(9) Suggest two ways in which the government could encourage more people to start their own businesses (4 marks)

Generating and Protecting Business Ideas

Introduction

This section of BUSS1 covers questions such as:

- Where does an entrepreneur get a good idea that can be turned into a successful business?
- Is it possible to identify the characteristics of a good business idea (i.e. one with potential) as compared with ideas that are likely to fail?
- Once found, how can a good business idea be protected, if at all, against unfair copying?
- Should an entrepreneur develop his/her own idea, or is it better to invest in setting up a business using an existing business format (e.g. franchising)?

As you work through this section, you might find the following equation helpful:

Good idea + Entrepreneur = Business Potential

This equation isn't a mathematical formula. It is intended to point out that, for a start-up business, it is not enough to just have a good idea. The idea needs to developed, refined and exploited by the entrepreneur in order to achieve the business potential. Business history is littered with good ideas that were not successfully exploited by the first person who thought of them!

Sources of business ideas

The main sources of business ideas for a start-up are summarised below:

Business experience

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

- Better insights into customer needs and wants
- Knowledge of competitors, pricing, distribution channels, suppliers etc
- Less need for start-up market research
- More realistic assumptions about sales, costs
- Industry contacts, who might then become the first customers of the start-up!

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

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

Personal experience

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

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

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

Hobbies and interests are also a rich source of business ideas, although you have to be careful to avoid assuming that, just because you have a passion for collecting rare tin openers, there is a ready market from people with similar interests. Many people have tried to turn their hobby into a business and found that generates only a small contribution to household income.

Observation

Simply observing what goes on around you can be a good way of spotting an idea. Often an idea will be launched in another country and has not yet been tried in other, similar economies. When Stephen Waring was in the USA attending a wedding, by luck he sat next to someone who ran a household service business (treating lawns). After some brief market research, Stephen found out that there was no similar business in the UK, so he launched one. It has since become a hugely successful franchise business – Green Thumb.

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

Business	**Entrepreneur**	**Where the Idea Came From**

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

What makes a good idea?

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

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

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

Franchises

As we mentioned earlier, a business idea for a start-up doesn't have to be original. Many new businesses are formed with the intention of offering an existing business idea. The use of franchises is a great example of that.

The basic idea for a franchise is this. A franchisor grants a licence (the "franchise" to another business (the "franchisee") to allow it to trade using the brand or business format. That might sound a bit complicated! The trick is to remember that the franchisor is in charge - the franchisor is the original owner of the business idea.

Franchises are a significant part of business life in the UK and other developed economies. Here are some quick statistics that illustrate that:

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

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

- It is still your own business
- The investment should be in a tried and tested format and brand
- The franchisee gets advice, support and training
- It is easier to raise finance - the high street banks have significant experience of providing finance to franchises
- No industry expertise is required in most cases
- The franchisee benefits from the buying power of the franchisor

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

However, as with all business decisions (remember opportunity cost!) there are several disadvantages for the franchisee:

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

In terms of your BUSS1 exams, here are some key points to remember about franchises:

There are many good franchise opportunities available for a start-up, but some poor ones too. So there is still a need for the entrepreneur to do market research into the franchise

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

Protecting a business Idea

Have you ever wondered what the TM letters mean when you see them next to a business name, logo or brand? Ask some entrepreneurs about TM and they will tell you that it stands for "Totally Meaningless", and they would have a point. It is often difficult to protect a business idea, whether the entrepreneur tries to use a registered trademark, patent or by using the protection of copyright. Nevertheless, it is worth trying to gain protection where available.

You should remember that a small business does not have to be based on an invention or innovative product design. It is more important that there are sufficient customers that want to buy the product.

However, if the entrepreneur has come up with an invention, an innovative name or design on which the business is based, then the law provides a variety of protection methods to prevent other people from copying the idea. It is not enough to rely on these protections or the law. A start-up or small business needs to be on the lookout for "pirates" so that it can take action.

Protecting a business idea is really about protecting the "intellectual property" (often shortened to "IP") of the business. The owner of IP can control, and be rewarded for, its use. For example, they can sell IP, hire it or licence it out. The problem is that IP is quite easy for other people to steal or use without permission. Anyone who has downloaded pirate mp3 files is guilty of this theft, as are the many vendors of pirated goods that you come across in city centres and car boot sales around the UK.

The main kinds of legal protection are summarised below:

Patents

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

(1) New

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

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

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

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

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

Trademarks

Actually, TM does not stand for "Totally Meaningless". A trademark ("TM") is something that identifies a product in the eyes of the customer. In other words, the customer recognises the symbol, logo or name because it is distinctive!

Registering a trademark gives a business the right to prevent others from using an identical or confusingly similar mark on goods and services that are the same (or similar) to the trade-marked product. Once granted, protection lasts for 10 years.

Copyright

This is an important protection for many businesses, particularly in areas such as media, design and publishing.

Copyright is an automatic right that protects the way an original idea is expressed in a piece of work. That work might be a book, a website, a film, musical composition etc. Copyright protection for the author of the work lasts for 70 years after the author's death - i.e. for a long time! Copyright comes into effect as soon as a work is created.

The owner of copyrighted content can control how the work is exploited, for example by licensing others to publish the work in return for a licence fee or royalty.

Exam tips

Remember that the best business ideas are usually copied, often very quickly, by other competitors. Relatively few start-ups are able to get protection from patents, copyright or trademarks. The best protection for a small business comes from delivering a great product and building customer loyalty.

Make sure you know the precise difference between a trademark, patent and copyright. They offer different kinds of protection. Patents, in particular, are quite difficult to obtain.

You should appreciate that a start-up doesn't have to have a new idea. It might be focusing on doing the same thing as a competitor, only cheaper, quicker or better.

Small businesses are also constrained by their time and resources. A business idea often comes from personal or business experience, and is developed whilst the entrepreneur is working for someone else!

Guided revision questions

Revision questions for Generating and Protecting Business Ideas

Sources of business ideas

(1) Outline three factors that can determine the success of a new business idea (6 marks)

(2) Explain why it is not enough simply to have a good business idea for a new business to succeed (6 marks)

(3) What is meant by "brainstorming"? (2 marks)

(4) Explain why start-up businesses are often started by people with significant business experience in the relevant market (4 marks)

(5) Define the term "market niche" (2 marks)

(6) Explain what is meant by the term "gap in the market" (4 marks)

(7) Identify an example of a niche product in each of the following markets: (8 marks)

  (1) Overseas holidays or travel

  (2) Consumer electronics

  (3) High street retailing

  (4) Magazines or newspapers

(8) Why might it be the case that a large business would not compete in a small niche market? (4 marks)

(9) Briefly describe two key factors that an entrepreneur would need to consider before targeting a market niche (4 marks)

(10) What do you understand by the term "USP"? (2 marks)

(11) Outline three factors that would help an entrepreneur assess how attractive a target market is for a start-up opportunity (6 marks)

Franchises

(1) List four examples of a business format franchise operating in the UK (4 marks)

(2) Explain the difference between a "franchisor" and a "franchisee" (4 marks)

(3) Outline two advantages and two disadvantages of setting up a new business to run a franchise (4 marks)

(4) List four parts of the support package that a franchisee could expect to receive from a franchisor (4 marks)

(5) Explain why franchises tend to operate in the tertiary (or service) sector (4 marks)

(6) Outline the main advantages to a franchisor or using franchises as part of a growth strategy (4 marks)

Protecting business ideas

(1) List the three main ways in which a business can protect its ideas (3 marks)

(2) Outline two reasons why a business would want to protect a good business idea (4 marks)

(3) Define the term "patent" (2 marks)

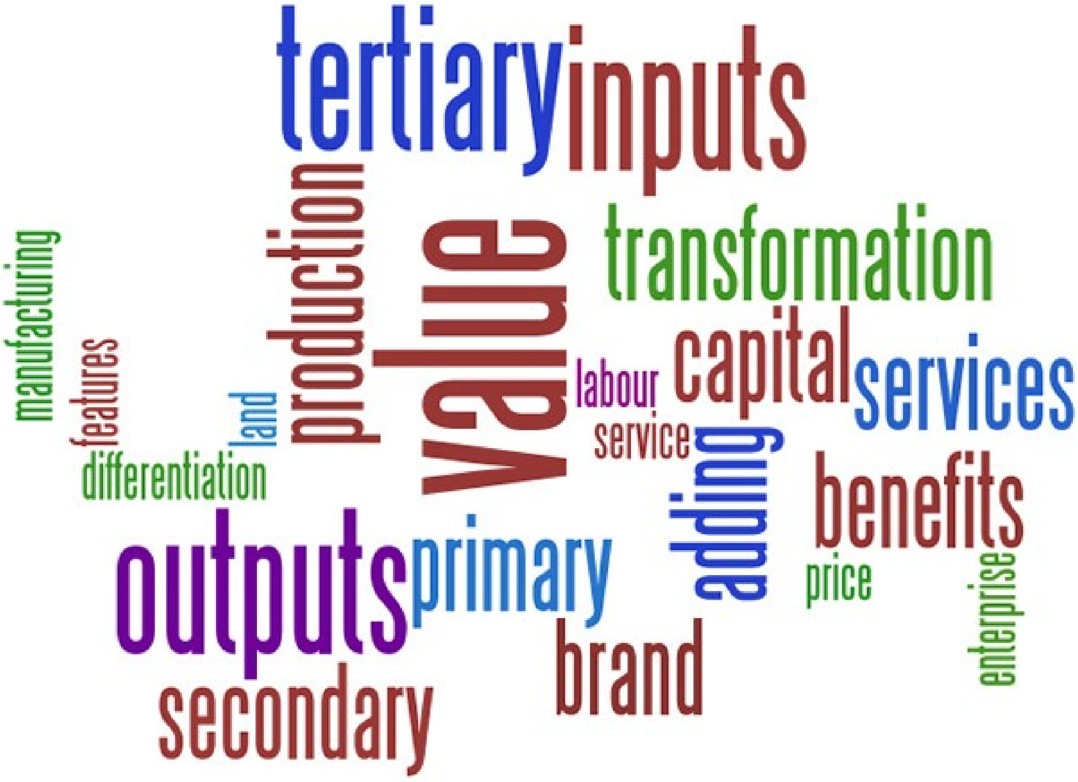
(4) Explain why a start-up might struggle if the success of the business largely relies on a successful patent application (4 marks)

(5) Briefly explain why the development and protection of intellectual property is increasingly important for businesses start-ups in tertiary industries such as software development, media and design (6 marks)

(6) What type of business idea could be protected by copyright? (2 marks)

(7) Explain the difference between a patent and a trademark (4 marks)

Transforming Resources into Goods and Services



Introduction

A good way to think of a business is to imagine **inputs** entering an imaginary black box. What come out of the box are **outputs**. The black box is the business – what is does how it does it and so on.

A new business needs resources in order to trade. The activities of a new business should be designed to turn those resources into products and services that customers are willing to pay for. This process is known as the "**transformation process".**

If the **value** of what customers pay for the outputs is more than the cost of the inputs, then the business can be said to have "added value".

So, in summary, the transformation process is about adding value.

That sounds pretty theoretical. So, let's take a look at some practical examples of what is involved in the transformation process.

Inputs to the transformation process

In order to make products and deliver services, a business needs resources – i.e. inputs. The textbooks often refer to these as "factors of production", which is a slightly boring way of describing real resources such as:

Labour – the time and effort of people involved in the business: employees, suppliers etc

Land – think of this as the natural resources that are used by the business – e.g. actual land, energy, and other natural resources

Capital – capital includes physical assets such as machinery, computers, transport which are used during production. Capital can also include finance – the investment that is required in order for the business activities to take place.

Enterprise – enterprise is the entrepreneurial “fairy-dust” that brings together or organises the other inputs. The entrepreneur takes the decisions about how much capital, what kind of labour etc and how & when they are needed in the business. You will probably agree that enterprise is the most important input for a successful business.

Inputs by themselves are rarely enough for a start-up to succeed. They need to be the right kind of inputs, in the right mix. So, for example, a successful entrepreneur will be keen to ensure:

High quality people are employed (the best the business can afford at each stage of development) and that these people are retained and invested in (training)

Capital investment is focused on efficiency and quality – use of modern machinery or IT systems of the right kind can have a significant effect whether a small business is able to compete

Outputs from the transformation process

The outputs of business activities are reflected in the products and services sold to customers. It is quite useful to think of ways in which similar business activities can be grouped based on those outputs.

Economists and business examiners alike have traditionally categorised the outputs from the transformation process into these three groups:

Sector	Businesses involved in…
Primary	Extraction of natural resources (e.g. oil, gas) and farming activities
Secondary	Production of finished goods and components (e.g. flat-screen TVs, computer memory chips, games consoles, industrial equipment, motor vehicles. The secondary sector is also often referred to as the “manufacturing sector”.
Tertiary	Providing a service of some kind. E.g. health, travel, legal, finance, building, security. The list of potential services is endless. Think of this as any business activity that involves people doing things for you! Retail businesses are in the tertiary sector.

In recent years, some textbooks have also suggested that there is a fourth sector – the **Quaternary sector**. The quaternary sector consists of those industries providing information services, such as computing and ICT (information and communication technologies), consultancy (offering advice to businesses) and R&D (research, particular in scientific fields).

In most textbooks you will see the outputs of the Quaternary sector included in the tertiary sector. Don’t worry; the distinction isn’t important. What is important is that you remember that the Tertiary sector in the UK has grown strongly over recent decades and now accounts for about 75% (three quarters) of all business activity.

Importantly for AQA Unit 1, most start-up businesses are in the tertiary sector.

A final word about the categorisation of business activities (outputs) into sectors. Remember that is perfectly possible for a single business to be operating in more than one sector.

For example, many farms in Britain (farming = primary sector) also offer holiday accommodation (tertiary sector) and produce processed foods such as cheese and ice-cream from farm supplies (secondary sector).

Here is another example. Morrison's supermarkets (i.e. tertiary sector - one of the four largest supermarkets in the UK) also own and operate its own factories that make many of the food products sold in store (secondary sector).

Adding value

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

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

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

You may remember the adverts showing part-built cars rolling down the production line being assembled by robots. The final, completed and shiny new car that comes off the production line has a value (price) that is more than the cost of the sum of the parts. Value has been added. How much value is determined by the price that a customer is persuaded to pay.

Alternatively, imagine Gordon Ramsay preparing some fish for a meal at Claridge's. 30 minutes of cooking later the meal is being served for a high price, substantially more than the cost of buying the ingredients. Value has been added.

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

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

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

- Charging a higher price
- Creating a point of difference from the competition
- Protecting from competitors trying to steal customers by charging lower prices
- Focusing a business more closely on its target market segment

Exam tips

The concept of "adding value" is an important one in BUSS1. You should think about how different kinds of business can add value, but also how they can keep their business simple and low-cost (i.e. not add too many "bells and whistles" that customers are not prepared to pay for).

Look out for low profit margins as a sign that the BUSS1 case study business is not adding sufficient value. Are input costs too high? Is the selling price of the output too low?

Remember that the transformation process (inputs turned into outputs) isn't just about physical things. Service sector businesses also have a transformation process – e.g. the time of people + creative skills and software turned into services.

Guided revision questions

Revision questions for Transforming Resources into Goods and Services

(1) What are the four factors of production? (4 marks)

(2) State, with an example of a business in each, the three main sectors of the UK economy (6 marks)

(3) Explain what is meant by the term “adding value” (2 marks)

(4) Give an example of how a business could operate in **both** the primary and secondary sectors (4 marks)

(5) Which industry sector is largest in the UK? (2 marks)

(6) Distinguish, using an example, between an input and an output (4 marks)

Business Plans

Introduction

There is no doubt that the physical process of writing a business plan is one of the most boring activities that a start-up entrepreneur has to do. However, it is also perhaps the most important part of the start-up process.

The business plan brings together the answers to the key questions that any start-up must be able to answer:

- What is the product and how is it different or unique?
- What is the target market segment and who are the potential competitors?
- Who are the customers; how much will they buy and at what price?
- What will it cost to produce and sell the product?
- At what stage will the business break-even and what are the likely profits?
- What investment is required to launch and establish the business?
- Where will the money come from and what type of finance is required?

Answering these questions honestly is crucial if the start-up is to stand a chance of getting off the ground. The questions get answered in the business plan. The plan might be a one page summary, or a detailed 30 page booklet with many appendices. The format doesn't matter. What matters is the process of putting the plan together and how the plan is used.

Here are the main reasons why a start-up should have a business plan:

- Provides a focus on the business idea - is it really a good one, and why?
- Producing a document helps clarify thoughts and identify gaps in information
- The plan provides a logical structure to thinking about the business

- It encourages the entrepreneur to focus on what the business is really about and how customers and finance-providers can be convinced
- It helps test the financial viability of the idea - can the business achieve the required level of profitability
- The plan provides something which can be used to measure actual performance
- A business plan is essential to raising finance from outside providers - particular investors and banks

The above list will prove helpful in your BUSS1 exams. If the examiner asks a question about business planning, it is important to remember that the plan is about more than just raising money from the bank or investors

Limitations of a business plan

Business planning is not an easy process. For a start-up, the plan is often produced with incomplete or out-dated information, it can be time-consuming and there is a danger than the financial forecasts produced might create misplaced optimism about the business prospects.

For the entrepreneur, a common complaint is that he/she does not have time to plan. A detailed business plan is certainly time-consuming, although there are plenty of resources available to help The trick is to remain well organised, to do enough (but not too much market research) and to seek help (ideally free) when needed.

Contents of a business plan

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

We'll take you through the main contents of these types of plan, but first a word of caution. The main thing to remember in BUSS1 is why a reader of a business plan would want to know the information provided. The purpose of the plan needs to suit the audience for the plan; it should be written with the reader in mind.

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

The idea - a simple description of the proposed business

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

The **detailed business plan** is needed if a more complicated or larger business is planned as a start-up, or if the entrepreneur needs to raise money from business angels or get a substantial loan from a bank. There are hundreds of books and other guides which are designed to help the production of such plans. Banks and firms of accountants provide specialist support for this kind of document. However, in terms of your BUSS1 course, the main thing is to know what needs to go into the detailed plan. So here is a summary of the key content:

Executive summary: a brief 1-2 page summary of the detail! Should contain nothing new, but highlight the key points

Market: a profile of the target market segment based on market research

Product: what it is and how it is differentiated from existing products in the market (the "unique selling point")

Competition: an honest description of the competition in the target market - what they do well, their weaknesses and their likely response once the start-up has entered the market

Protecting the idea: how the product and business can be protected from competition - e.g. patents, trademarks, distinctive approaches to marketing or distribution that competitors will find hard to replicate

Management team: a crucial area for any investor. Who is involved in the start-up and what will they be doing? What experience and expertise do they bring? Which management roles will need to be filled as the business grows? Appendices should contain the employment histories of key management.

Marketing: the key elements of the marketing mix should be explained here. Remember that for a start-up the marketing budget is likely to limited, so the plan should describe a credible approach to promoting the product and include realistic assumptions about how many customers will buy and at what price

Production /operations: this explains what is involved in the production process, what capacity is needed, who will supply the business, where it will be located etc. A reader of the plan will want to know that the detailed operational issues have been considered carefully, and that the cash flow forecast takes account of all operational requirements

Financial projections: a summary of the cash flow and trading forecasts. This section should highlight the key assumptions that have been made and also outline the main risks and opportunities in the forecasts (i.e. what might go wrong, or where things might prove better than forecast). The detailed projections would be included in the appendices.

Funding requirements: here the figures from the cash flow forecast are taken and used to highlight what funding the business needs, and when. This section would explain proposals for where the funding needs to come from (founder, banks, investors etc).

Exit strategy: another key area for any investor. This is a description of how the entrepreneur expects investors to get a return on their investment. Who might eventually buy the business, when, and for how much?

Sources of information and guidance

Given the importance of business planning, it is not surprising that there is a wealth of free and other guidance available to the entrepreneur.

Here are some of the main support resources available:

Banks:

The main high street banks all provide specialist support to start-ups to help produce a business plan.

Barclays Bank

HSBC

Lloyds TSB

Bank of Scotland

RBS

Business Link

The Government-funded agency provides comprehensive guidance on the business planning process

Other sources

Many commercial organisations that deal with start-ups and small businesses provide advice on business planning: e.g.

BT

Websites dedicated to small business are also active in this area: e.g.

Startups

Smallbusiness

Exam tips

Remember that a business plan isn't just written to raise finance. It plays an important role in the whole start-up process.

A start-up's business plan needs to be flexible. The figures are bound to change once the business starts trading and the entrepreneur discovers what the market is really like.

A good business plan provides a focus and a discipline for the entrepreneur. However, it is no substitute for what really matters to make the business a success - i.e. hard work, skill, luck etc.

Too much business planning is a bit like procrastination - putting off more important work. The entrepreneur needs to spend most time out in the market, finding customers, promoting the product etc.

Guided revision questions

Revision questions for Business Plans

(1) Define the term “business plan” (2 marks)

(2) Outline the main purpose of a business plan (2 marks)

(3) Why is it important that a business plan contains key targets and objectives? (6 marks)

(4) What is meant by the term "executive summary"? (2 marks)

(5) List six sections that are likely to be contained in a detailed business plan (6 marks)

(6) Why is it important that a business plan should address the target market for a business and the nature of competition it faces? (4 marks)

(7) Explain why writing a business plan can help an entrepreneur identify the potential problems with a new business idea (6 marks)

(8) Name three external organisations that could help an entrepreneur develop a business plan for a start-up (3 marks)

(9) Briefly explain why an entrepreneur might be reluctant to write a business plan during the start-up process (4 marks)

Market Research for a Start-up

Introduction

You have the business idea, or perhaps you have narrowed the choice down to a few business ideas. You may know which market your new business wishes to enter. So what happens next?

The answer is **market research**. For a start-up, this is a crucial activity. Understanding the target marketplace in as much detail as possible (given time and cost constraints) comes before raising money, choosing a location or putting together a business plan.

Market research is particularly important if a start-up needs to raise finance. A new business will find it very hard to raise finance if it cannot demonstrate that it understands the structure of the target market and that is has a clear idea of how the product it intends to offer will be positioned in the market.

A good way to think about the market research process is to remember that it involves two parts:

(1) What a start-up business needs to know
(2) How that knowledge and understanding can be obtained (research methods)

What a Start-up Business Needs to Know

Market fundamentals

The starting point for market research is to identify the market fundamentals:

- How big is the market? (measured by sales, volume etc)

- How fast is the market growing and what is the market growth potential?
- Who are the existing competitors and what market shares do they have?
- How is the market segmented? ("segments" are the different parts of a larger market – e.g. low price or high quality)
- What kind of customers are there in the market? What are their preferences in terms of when and where they buy, what prices they pay and which methods of promotion are effective?

Finding a niche

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

Why should start-ups aim for a market niche? Because surviving in high volume or **mass-market** segments is rarely possible for a start-up. The largest market segments are normally dominated by well-established businesses that enjoy lower costs and can charge low prices. In other words, a start-up will face stiff competition from much stronger competitors if it tries to set-up in a mass market.

An entrepreneur needs to be satisfied that there is likely to be a demand for the product or service. However, at the start-up stage, funds are often limited and a new, small business is constrained by how much research can actually be carried out.

Effective market research is not about getting hold of lots of statistics or detailed reports. It is about getting the details and insights that help plan an effective business strategy. Remember that a small business can learn much about the market by simply trading, talking to customers and suppliers on a day-to-day basis etc.

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

Primary data: data collected first-hand for a specific purpose by the entrepreneur

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

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

Secondary Data

Once a business starts trading, it quickly develops data that can help it understand the market. Sales reports, financial data, customer feedback and other information are really useful sources of insights into a market and a how the products of a business are performing. This kind of data is called "internal" data – i.e. information that comes from within the business.

The problem for a start-up is that this internal research data does not exist – it needs to start trading before the data is created! So the start-up entrepreneur has to rely mainly on external secondary data – information that is available from sources outside of the business.

There is a wide variety of external secondary sources, many of which are free. Here are some examples of cost-effective and useful external secondary research:

Google	The essential starting point for any secondary market research! Effective searching on Google quickly identifies the main reports, websites and organisations that can speed up the research

	process.
Government sources	Office of National Statistics provide detailed insights on the UK economy and society; individual departments provide detailed reports on many industry sectors
Trade associations	Most industries have one or more industry associations which existing to promote the market and protect member interests. They are a great source of market analysis
Trade press & magazines	Essential reading for an entrepreneur, particularly if the start-up is in a market in which the founder has little or no experience. A great of keeping up-to-date with market news, new products etc
Directories	Online and offline, there are many excellent directories of existing competitors and suppliers in a market.
Price-comparison websites	Made possible by the Internet, the rapid growth of price-comparison sites allows a start-up to compare and contrast pricing strategies of existing competitors. Note these tend to focus on larger consumer markets (e.g. insurance, travel, retail) rather than industrial markets.
Competition websites, marketing materials, price lists	Also essential reading before launching a start-up. The entrepreneur gets valuable information on the marketing mix (product, price, promotion and distribution) of the businesses against which the start-up must compete.
Market research reports	Organisations such as Mintel, Keynote and others produce a wide variety of reports that analyse individual markets. Often expensive (typically £500 each), these reports are best for giving an overview rather than detailed insights into a specific market.

By its nature, secondary research will vary in terms of its usefulness to a start-up – after all, it has been created for a difference purpose, it may be out-of-date and it may be subject to bias. It may also not quite be in the right format or focused on the right target market.

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

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

Primary Research

In most cases, a start-up will still have gaps in its understanding of a market even after looking at the available secondary data. Primary research is usually used by a new business to fill these gaps – as far as is possible given the time and funding available.

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

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

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

There are various methods of primary research, each with their own advantages and disadvantages:

Method	**Comments**
Observation	Watching how consumers behave provides many insights, but can leave many questions unanswered. Observation works well for in retail markets; sit outside a shop and watch how many people walk by, look at the window display etc. Observation is a good way of assessing how products are packaged, displayed. However, observation will not, by itself, explain why consumers are doing what they do!
Surveys The use of survey questionnaires is a popular way of generating primary data. The questionnaire poses a series of questions about a product or service and also requests details about the person completing the survey so that responses can be profiled and grouped. There a various survey methods, the most popular of which are:	
Postal surveys	Sent to the address of potential customers who complete the form and send back in a pre-paid envelope. A relatively cheap method, a postal survey can cover a wide geographical area and avoids the potential for interviewer bias. However, response rates (the proportion of people sending back a completed survey) are often very low and it can take many weeks before an acceptable number of surveys are returned.
Telephone interviews	Not to be confused with “telesales” (which is a method of selling), the telephone interview allow quicker feedback than a postal survey. However, potential customers are often wary of being called and may be reluctant to give anything other than short answers.
Online surveys	Increasingly popular and relatively low cost, online surveys are now widely used by small businesses as a way of capturing the views of existing and potential customers. Online surveys are suitable for a start-up in the pre-trading period; they can be set-up for very low cost and can be updated frequently generating high

	quality, topical data.
Face-to-face surveys	Personal interviews conducted face-to-face. Good for getting detailed insights from an individual and the interviewer can probe answers more closely to improve the insights gained. However, face-to-face surveys can be influenced by interviewer bias, the respondent may be giving the answers he/she thinks are wanted, and the method is time-consuming and costly.
Experiments	Similar to test marketing, experiments allow a business to discover how customers respond to different product options (e.g. different packaging, pricing, promotional offers). In the start-up phase, experimenting with these variables can generate very useful customer insights without going to the expense of a full product launch. Experiments are particularly useful for products or services sold online – where prices and other marketing messages can be changed quickly.
Focus groups	Groups of potential customers are brought together to discuss their feelings about a product or market. Focus groups are a good way of getting detailed information about customer tastes and preferences. Assuming that the members of the group are representative of the target customer base, a focus group can provide useful insights into how a new product will be received in the market. They are effectively for testing various elements of the marketing mix – e.g. packaging, branding and price.
Test marketing	This involves selling a new product in a restricted section of the market in order to assess customer reaction. For example, a start-up could start by selling to a limited local area in order to iron-out product issues. Software firms often test-market their products by offering "beta" versions for testing by a small group of potential customers. Test marketing can be a good predictor of how a new product or service will be received by the larger market. However there is a danger that the impact of the full launch of a new product will be diminished, particularly if competitors find out about the test!

Given the range of primary research methods available, which ones are best for start-ups? The answer is – it depends! When answering exam questions in this area, you should remember that the start-up is likely to be restricted in terms of finance and time. The best primary research for a start-up is likely to be research that is low-cost and timely and which fills the gaps in market knowledge that are not covered by secondary research.

Quantitative and qualitative research

The distinction between primary and secondary research is really about the different **sources** of market information. An alternative way of thinking about market research is to consider the two main **approaches** – qualitative and quantitative. Market research can be classified into two kinds of information:

Qualitative research

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

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

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

Quantitative research

This is research based on larger samples and is, therefore, more statistically valid. Quantitative research is concerned with data and addresses question such as “how many?”, “how often”, “who?”, “when?” and “where?”

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

- 35% of customers rate the new product as “attractive”
- 70% of potential customers use the Internet to buy their hotel accommodation in Dorset
- 3 out of 5 customers will buy a new food product after being offered a free in-store sample

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

Sampling

Sampling is a particularly important concept when undertaking primary market research.

Market research is aimed at understanding a market as a whole. However it is rarely possible to get the views of all customers, or speak to all suppliers. Research therefore relies on taking a sample and trusting that the findings from a sample are representative of the market population as a whole.

In market research, a **sample** is a group of people that is intended to represent the overall target population.

Primary market research is undertaken by **sampling** the views of a selection of customers. The sample size is simply the number of people in the sample.

What should the sample size be? Remember that in BUSS1 we are concerned with small businesses, so cost and time is an issue. There is a trade-off (choice) to be made between cost and accuracy. Large sample sizes increase the reliability of the research, however lower sample sizes reduce the cost of the research. It all depends on what the entrepreneur needs to know!

The degree to which the results from a sample are a reliable predictor of the overall market is known as the confidence level. For example, a confidence level of 90% means that the results of the research will be right nine times out of ten.

Choosing a sampling method

There are three main methods that are used to choose a sample in market research:

Random sample	A random sample gives each member of a population an equal chance of being chosen. For example, a random number generator may select contact details from a spreadsheet; a researcher may stop and talk to every 20th person who passes outside a shop. The main advantage of this is that bias is not introduced when the sample is chosen. However, a random sample also assumes that all members of the population are the same, which is rarely the case! The main drawback of random sampling for a start-up is the cost of the required sample size. Random sampling needs large sample sizes in order to achieve acceptable confidence levels.
Quota sample	Quota sampling involves the population being segmented (broken up) into groups that share specific characteristics. The research then focuses on a specific sample size (quota) chosen for each group. For example, the quota might be for the research to interview 25 A Level students and 75 GCSE students from a secondary school, or the quota may state that 60% of those surveyed must be women aged 45-55. Quota sampling can help market research focus more closely on the target customers or market segments. However, it takes more time than random sampling and is the sampling method most likely to result in bias.
Stratified sample	Stratified samples are used when the research wants to provide insights into specific market segments or customer groups. Once the target group is selected the sample is chosen at random from that group. A stratified sample still has the benefit of being random (i.e. low bias) and is not as expensive or difficult to obtain as a full random sample.

Given the range of sampling methods available, which should a start-up or small business use?

The main factors affecting the choice of sampling method are:

Finance and cost	This is perhaps the most important consideration. Start-ups are unlikely to be able to afford substantial market research. Market research in the early stages of a new business is likely to be low cost, or even better, free!
Type of product	If the start-up is looking to provide an existing product or service, then it is likely that there will be substantial secondary research already available. By contrast, a new product is less likely to have secondary data available

Level of risk	The newer the product and the greater the investment prior to launch – the greater the risk. If the start-up is investing significantly upfront and there is a high chance of failure, this increases the need for effective primary research. In such a situation, there is a case for choosing a random sample, backed up by additional quota or stratified samples.
Target market	If the start-up's product is targeted at a specific segment (e.g. geographical, age, income) then it becomes easier to target primary research. If the business can identify the target customers, then it is usually more appropriate to conduct research using a stratified sample.

Exam tips

BUSS1 focuses on small businesses that do not have the resources to invest in substantial market research. Research that is undertaken by a start-up should be closely focused and ideally low-cost.

You need to make sure that you are able to state concisely the advantages and disadvantages of the different kinds of market research.

You should also question the data that is provided about market research in BUSS1. Was the sample size large enough? Is it out-of-date? How relevant is it to the target market and customers?

The best market research insights for a start-up often come simply from trading, talking to customers and suppliers, observing what happens with a product launch etc.

Guided revision questions

Revision questions for Market Research for a Start-up

(1) Define the term "market research" (2 marks)

(2) Distinguish between primary and secondary research (4 marks)

(3) List four probable sources of secondary research for a new e-commerce business targeting the women's fashion market (4 marks)

(4) List three possible sources of primary market research that could help an entrepreneur estimate the likely demand for a local gardening services business (4 marks)

(5) Explain why samples are used in primary market research (4 marks)

(6) Briefly explain stratified sampling (3 marks)

(7) List three factors that a start-up business should consider before conducting a survey (3 marks)

(8) Outline three reasons why market research information might prove inaccurate (6 marks)

(9) List two advantages and disadvantages of using large sample sizes in primary market research (4 marks)

(10) Explain why businesses increasingly use online surveys as a source of market research (4 marks)

(11) Describe the difference between quantitative and qualitative research (4 marks)

(12) A hotel wants to measure customer satisfaction with their stay. Which would be the most appropriate approach – quantitative or qualitative research? (4 marks)

Understanding Markets

Introduction

This part of the BUSS1 course requires you to focus on the place where a start-up business must compete; the place where buyers and sellers come together. We're talking about the **market.**

Quite simply, a new business is bound to fail unless it has a reasonable understanding of its **target market.** What does the new business need to understand?

- The needs and wants of customers, and how these differ
- The **buying behaviour** of customers – why, what and how they buy
- The ways in which a market is split up into different parts to serve different customer needs – these are known as **market segments**
- The nature of demand in the market – how are prices set & the factors that influence the quantity of demand
- The size and growth rate of the overall market and its segments
- The proportion of market demand that is already taken by competitors – an important concept known as **market share**

As you can see, there is a lot to understand! However, this is a really important area in BUSS1, so take time to work through each part of this section.

Defining a market

Let's start with a definition:

A market is anywhere where buyers and sellers come together to transact with each other.

The traditional image of a market is a **physical place** where buyers and sellers come together in one place. This still happens, of course. Take a drive along any main road on a Sunday and you will come across car boot sales – the classic example of a physical market in action. The UK has many towns that are referred to as "market towns", so-called because they host a town-centre market on regular dates throughout the year.

However, the term market has a much wider relevance when it comes to business studies. A market exists whenever buyers and sellers come together. So you should appreciate that the buyer and seller don't have to be in the same place in order to conduct transactions with each other.

Do you sell or buy items on EBay? Have you bought products from Amazon.co.uk, bought tracks from iTunes? Have you bought something from a catalogue by making a phone call? In all these examples, you have participated in a market, although you were not physically with the other party to the transaction!

So, there are many different kinds of market. The BUSS1 specification requires that you understand how the variety of market types can be categorised. Here is a summary of the main market categories:

Geographical markets

The two main categories of geographical markets (from the point of view of a start-up) are:

<table>
<tr><td>Local markets

Definition:

Where customers are a short distance from suppliers</td><td>Common for the sale of fresh and locally-sourced products and the delivery of locally-supplied services. The car boot sale is a great example of a local product market. The use of local services (e.g. franchise operations, hairdressers) is another good example. Your local high street or retail park is another example, where consumer goods are sold to people who tend to live pretty close.

Businesses operating in local markets enjoy several advantages. They are physically closer to their customers, so are better placed to understand local cultural issues and traditions. It is also easier to develop relationships with local customers, to engage in market research and to respond quickly to changes in the market.

The main downside to operating in local markets is that the market size may be relatively small.</td></tr>
<tr><td>National markets

Definition:

A market where customers are spread throughout the country or over a large area</td><td>National markets are very common in the UK. Here, the same product or service is offered to customers who are spread around the country. A business may have several (or many) locations in the country in order to reach those customers.

One way to illustrate this is to think of businesses that seem to be everywhere as you travel round the UK. For example, you'll see BT phone vans, BSkyB satellite dishes, Tescos, McDonalds and Subway branches in just about every town and city in the UK. These businesses are operating in national markets – e.g. the markets for telephones, television, groceries and fast food. However, you will notice from the examples given that businesses which are national in terms of the scope of their operations are definitely not small businesses! Your BUSS1 case study business in the exam is very unlikely to be so large or complex.

Another way to think of a national market is in terms of the total sales</td></tr>
</table>

	of a product or service across the country. For example, the total demand for greetings cards, jams or loft conversions. A start-up or small business can be focused on a national market, although it is likely that it will have a very small share of the market.

Physical and electronic markets

We have touched on these two categories already.

A physical market brings buyers and sellers together in the same location. We've already mentioned car boot sales and markets in town centres. Farmers' markets are another good example.

A much larger number of markets are now electronic. Businesses find their customers using a variety of electronic media, including the Internet, mobile telephony, digital television and via email. Transactions are completed electronically with the delivery method depending on the nature of the product sold.

Both physical and electronic markets are important to start-ups and small businesses. For example, Fraser Doherty started his Superjam business by selling his homemade jams at farmers markets and then promoting them in the aisles of supermarkets. By contrast, Nick Jenkins' specialist greetings card business Moonpig has always relied on using electronic markets, building sales by running a specialist website.

The key points to remember about electronic markets are that:

They provide an easier way for start-ups to enter a national market, particularly if the business has identified a small niche segment of that market

Electronic markets tend to be highly **price-competitive** since it is quite easy for customers to search for products from a variety of suppliers and to compare the best prices available (just about every consumer goods market has one or more price comparison website).

Setting up a new business in an electronic market tends to have lower start-up costs than entering a physical market.

Factors affecting demand

As we mentioned in the introduction, it is important that a start-up business understands the nature of demand for its products, and how demand can be affected by certain factors.

Many of the concepts covered in this section are drawn from the world of economics. However, don't worry if you are not studying economics. We can keep the theory quite simple!

The main factors that affect demand can be summarised as follows:

Price

The most important factor, particularly in any market when customers are **price-sensitive**. As the price of a product increases, the demand for it will usually fall. The extent to which this happens is known as the **price elasticity of demand** (which you will study in more detail in BUSS2). If the product has no close competitors or consumers find it hard to substitute it for other products, then an increase in price will have relatively little effect on demand.

Like all businesses, a start-up needs to remember that the price of a product or service is often seen as a signal of value for money or quality by customers. A higher price might put some customers off who don't perceive it as good value for money compared with cheaper alternatives. Conversely, a product priced too cheaply might deter customers who associate low prices with poor quality!

Setting prices is, therefore, a tough task for any start-up. There is no magic formula, although market research can quickly tell the business whether its prices are out of line with the competition.

Incomes

Demand for most products and services is closely related to the disposable incomes of customers. The more that households and businesses have to spend, the more they are likely to demand!

A key measure of incomes in the economy is Gross Domestic Product (GDP) which is the main measure of economic growth. As an economy grows (an increase in GDP), consumers have higher incomes and translate this into greater demand for products and services. In contrast, a weaker economy where GDP is falling, should lead to lower demand.

However, the link between GDP and demand is not quite as clear-cut as you might think. If consumer incomes are rising, they may decide to demand more luxury or higher-priced goods at the expense of basic or lower-priced goods. Alternatively, as the economy weakens, consumers may switch demand towards goods which have low or “value for money” prices, at the expense of more expensive products. We have seen this happening in the UK recently as consumers have moved spent more in the discount grocery chains such as Aldi and Lidl, as a result of the “credit crunch”.

Tastes and fashions

As a consumer, what you buy is often influenced by your tastes and interests and by what is fashionable. Consumer product markets are particularly influenced by changes in fashion.

The main issue for a start-up business is to consider whether demand in the target market is likely to be strong enough, for long enough! The danger is that investment in starting a new business in a fashionable market segment may be completed at a time when demand starts to fall as consumers move onto a different market. Fashionable products quickly attract new entrants which reduces the available sales and profits.

A good example would be the coffee bar market in the UK. Ten years ago there were relatively few coffee shops and a start-up would have a good chance of establishing itself in the market (either locally or nationally). However, the market is now saturated with competitors, making it very difficult for a start-up entering the industry now.

Competitor actions

It is rare that a business has a market all to itself! The demand for a product or service will be directly affected by the actions of competitors in the market. This is all part of the game of capturing market share.

A start-up entering a market should expect a hostile response from existing competitors. They may decide to lower their prices or offer other promotions in order to retain their customers. They may launch new and improved versions of their products to counter the new entrant. Alternatively, a competitor may copy the approach taken by the start-up, particularly if it is innovative and popular with customers.

The opposite is also true. A competitor may decide to leave a market segment in order to concentrate on other activities. This will increase the share of demand available to businesses that remain in the market.

Social and demographic factors

Social and demographic factors related to the changes that take place in society and the population which influence demand. Some examples will help make the point. In the UK recently we've seen:

- An increase in single-person households
- Growth in the number of affluent, retired people
- Increased awareness of, and interest in the environment
- Higher immigration into the UK, particularly from the enlarged European Union
- Greater consumer demand for organic products and for businesses based around social enterprise

There are many more social changes. The point is that each affects what and how much is demanded by customers.

Seasonal factors

In some markets, demand changes depending the time of the year.

Some markets traditionally experience peaks in demand during the summer - for example tour operators focusing on family holidays, ice-cream manufacturers and visitor attractions. Others see peak demand in the autumn and winter – e.g. distributors of heating supplies, retailers that rely on the Christmas trade.

The key point about seasonal factors is that the start-up or small business needs to understand which seasonal factors are relevant to the market they are in. There is little they can do to avoid seasonal peaks and troughs in demand, but knowledge of them certainly helps business planning (e.g. allowing for them in any monthly cash flow forecasts).

Government action

Changes in legislation and government regulation can certainly affect demand.

Some legislative changes have the effect of reducing demand in certain markets. A great example is the introduction of the ban on smoking in public places. This has reduced demand (spending) in traditional pubs, although it was expected to result in increased demand for eating out at pubs and restaurants. Actually, the evidence to-date is that there hasn't been an increase in customers visiting smoke-free pubs for a meal!

Some legislative changes are designed to de-regulate a market, which should have the effect of increasing demand. For example, the de-regulation of certain betting and gaming laws in the UK initially had the effect of increasing visitors to bingo clubs. However, the growth in online bingo has had an opposite effect, reducing demand (the number of people who come to the club and the average amount that they spend there).

A key point to remember about changes to demand caused by government action is that there is nothing a business can do about it! It is outside the control of the entrepreneur. The trick is for the entrepreneur to be aware of recent or pending changes and to have taken account of them in business planning.

Introduction to market segmentation

Market segmentation was mentioned in our section on how entrepreneurs conduct market research. We pointed out how important it is for a start-up to have a clear sense of its target market and how, ideally, the start-up should aim to establish the business in a **niche market segment.**

So what is segmentation all about?

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

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

As you can imagine, such markets (if they were not further divided) would be very broad.

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

- Benefits they want
- Amount they are able to or willing to pay
- Media (e.g. television, newspapers, and magazines) they see
- Quantities they buy
- Time and place that they buy

It therefore makes sense for businesses to divide (or "segment") the overall market and to target specific segments of a market so that they can design and deliver more relevant products and services

A market segment can be defined as follows:

A part of a market which exists to serve a group of customers with specific needs and wants.

The process of segmentation involves subdividing markets, channels or customers into groups with different needs, to deliver tailored propositions which meet these needs as precisely as possible.

Why use market segmentation?

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

Better matching of customer needs	Customer needs differ. Creating separate products for each segment makes sense and provides customers with a better solution

Enhanced profits for business	Customers have different disposable incomes. They are, therefore, different in how sensitive they are to price. By segmenting markets, businesses can raise average prices and subsequently enhance profits
Better opportunities for growth	Market segmentation can build sales. For example, customers can be encouraged to "trade-up" after being introduced to a particular product with an introductory, lower-priced product
Retain more customers	Customer circumstances change, for example they grow older, form families, change jobs or get promoted, change their buying patterns. By marketing products that appeal to customers at different stages of their life ("life-cycle"), a business can retain customers who might otherwise switch to competing products and brands.
Target marketing communications	Businesses need to deliver their marketing message to a relevant customer audience. If the target market is too broad, there is a strong risk that (1) the key customers are missed and (2) the cost of communicating to customers becomes too high / unprofitable. By segmenting markets, the target customer can be reached more often and at lower cost
Gain share of the market segment	Unless a business has a strong or leading share of a market, it is unlikely to be maximising its profitability. Minor brands suffer from lack of scale economies in production and marketing, pressures from distributors and limited space on the shelves. Through careful segmentation and targeting, businesses can often achieve competitive production and marketing costs and become the preferred choice of customers and distributors. In other words, segmentation offers the opportunity for smaller firms to compete with bigger ones.

Types of market segmentation

Whilst there are many ways to segment a market, the BUSS1 course only requires you to have an understanding of two of the main methods: **demographic and geographical** segmentation. We'll cover these two in some detail below, and then provide you with a quick insight into the other methods.

When looking at these two methods, please remember that segmentation is an art, not a science. There are no precise rules or formulae that help the entrepreneur split the market up. Market research can help, but much segmentation is done using gut instinct and experience of a market gained over time.

Demographic segmentation

Demographic segmentation consists of dividing the market into groups based on variables such as age, gender family size, income, occupation, education, religion, race and nationality.

As you might expect, demographic segmentation variables are amongst the most popular bases for segmenting customer groups.

This is partly because customer wants are closely linked to variables such as income and age. Also, for practical reasons, there is usually a lot more market research data available to help with the demographic segmentation process.

The main demographic segmentation variables are summarised below:

Age	Consumer needs and wants change with age although they may still wish to consumer the same types of product. So marketers design, package and promote products differently to meet the wants of different age groups. Good examples include the marketing of toothpaste (contrast the branding of toothpaste for children and adults) and toys (e.g. pre-school, 5-9, 10-12, teen, family).
Life-cycle stage	A consumer stage in the life-cycle is an important variable - particularly in markets such as leisure and tourism. For example, contrast the product and promotional approach of Club 18-30 holidays with the slightly more refined and sedate approach adopted by Saga Holidays!
Gender	Gender segmentation (that's men and women to you and me) is widely used in consumer marketing. Great examples include the clothing, hairdressing, magazine, toiletries and cosmetics markets.
Income	Many companies target affluent consumers with luxury goods and convenience services. Good examples include Lexus cars & Moet & Chandon champagne. By contrast, many companies focus on marketing products that appeal directly to consumers with relatively low incomes. Examples include Aldi and Lidl (discounted groceries) and fast-fashion clothing retailers such as TK Maxx.
Social class	Many marketers believe that a consumers "perceived" social class influences their preferences for cars, clothes, home furnishings, leisure activities and other products & services. There is a clear link here with income-based segmentation.
Lifestyle	Marketers are increasingly interested in the effect of consumer "lifestyles" on demand. Unfortunately, there are many different lifestyle categorisation systems, many of them designed by advertising and marketing agencies as a way of winning new marketing clients and campaigns!

Geographic segmentation

Geographic segmentation tries to divide markets into different geographical units: these units include:

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

Geographic segmentation is an important process - particularly for multi-national and global businesses and brands. Many such companies have regional and national marketing programmes which alter their products, advertising and promotion to meet the individual needs of geographic units. However, it is less relevant for the start-up or smaller business.

Limitations of market segmentation

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

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

Lack of information and data: some markets are poorly researched with little information about different customer needs and wants

Difficulty in measuring and predicting consumer behaviour: humans don't all behave in the same way all of the time. The way that they behave also changes over time! A good example is the "grey generation" (i.e. people aged over 50). The attitudes and lifestyles of the grey generation have changed dramatically in recent years.

Hard to reach customer segments once identified: it is one thing spotting a segment; it is another finding the right way to reach target customers with the right kind of marketing message

Analysing market data

Markets need to be measured in order to assess the size, growth and competitive shares of the market. Such data is key information for any business – large or small. It is important to know what the potential sales are from competing in a market and which competitors are winning the battle for the available customers.

This is an area of BUSS1 where you may be asked to perform calculations – the same kind of calculations that an entrepreneur may make. The key areas we'll cover are:

- Market size (volume and value measures)
- Market growth (percentage growth)
- Market shares (percentage of the market owned by each competitor)

A worked example

The market size is a measure of the total sales in a market. Total sales can be measured in terms of

Volume – i.e. the quantity of products sold

Value – i.e. the sales value of products sold. Remember that sales value = quantity x price

To take an example: imagine that Derek is planning to open a car valeting business in his home town of Worcester. His market research has provided the following data:

- Approximately 25,000 cars are valeted in the Worcester area each year
- The average price of a car valet service is £10
- Last year there were about 22,000 car valets performed

- Whilst there are many small car valeting businesses in the Worcester area, the three largest competitors currently achieve the following annual sales:

	Sales (£)
Cleanstyle	£65,000
WorcesterValet	£45,000
AutoFresh	£30,000

What analysis can be performed using this data?

Firstly, we can calculate **market size**, since we have a volume measure and an average price.

So the total value of valeting sales = number of valets per year (25,000) x average price (£10) = £250,000.

Secondly, we can also work out **market shares**. This is because we know the overall market size and the sales of the three largest competitors. The table below shows how this data can be calculated:

	Sales (£)	Share (%)
Cleanstyle	£65,000	26.0%
WorcesterValet	£45,000	18.0%
AutoFresh	£30,000	12.0%
Others	£110,000	44.0%
Total	£250,000	100.0%

You can see from the above table how market share is calculated. Take the example of Cleanstyle, which is the market leader with sales of £65,000. That means that Cleanstyle's share of the market size (£250,000) = £65,000 / £250,000.

Market share is calculated as a percentage, so the number is 26% (i.e. (65/250) x 100)

After calculating the individual market shares for the three largest competitors, you can see that the balance of all the other car valeting businesses must equal 44%. This is because the total market shares of a market = 100%.

From the information given, we can also calculate market growth. We are told that last year the total volume of car valets was 22,000. This year it is 25,000, which is an increase of 3,000 valets.

To calculate market growth, we express the change (3,000) as a percentage of the previous figure (22,000). So market growth is 3,000 / 22,000 = 13.6%

Exam tips

There is lots of opportunity to analyse a market in a way that helps a start-up: segments, growth, size, trends, customers etc. A start-up that is focused on really understanding its market has the best chance of success. Look out for evidence of this in your BUSS1 case study.

In the exam you will be expected to be able to calculate market share, market size and market growth, and to be able to interpret the calculations. Make sure you practice these calculations - don't shy away from them!

You should also appreciate that there are several factors that affect demand for a product, not just price. Some factors will be more important than others - it depends on the product and market!

Guided revision questions

Revision questions for Understanding Markets

(1) Define the term "market" (2 marks)

(2) Explain the meaning of the word "demand" (2 marks)

(3) Using an example of each, describe what is meant by geographic and demographic segmentation (4 marks)

(4) Define the term "market segment" (2 marks)

(5) Explain why segmentation is so important for a start-up wanting to target a niche market (4 marks)

(6) Why is age such a popular method of demographic segmentation? Support your answer with two real-life examples (6 marks)

(7) List three consumer markets in which gender is used as a way to segment the market (3 marks)

(8) Why might market segmentation be unhelpful to a start-up business? (4 marks)

(9) How might a grocery supermarket use socio-economic groups for market segmentation? (6 marks)

(10) Define the terms "market size", "market growth" and "market share" (6 marks)

(11) Explain why a market growth might be slowing even though the overall size of the market is rising (3 marks)

(12) List two reasons why the sales value of a market rise even if the size of the market in volume terms has fallen? (3 marks)

(13) What is the market share of a business that sells £12 million in a market whose size if £60 million (2 marks)

(14) A market was worth £150 million in 2006 and £165 million in 2007. What was the market growth rate in 2007?

Choosing a Legal Structure

Introduction

If there was a prize for the most boring part of any business course, this would win every time! BUSS1 is no different!

However, for a start-up, making the right choice of business structure is actually quite important. The choice made has significant implications for what happens if the business fails and also for how much finance the business can raise.

So it is worth concentrating reasonably hard on these notes – boring though the topic is!

The term "business structure" refers to the legal structure a business takes. The entrepreneur can basically choose from these options: (these are covered in a little more detail in the other study notes in this section)

Structure	Definition & overview
Sole trader	The most common type of business structure. A sole trader is just an individual owning the business on their own. Remember that a sole trader can also employ people – buy those employees don't share in the ownership of the business. The sole trader owns all the business assets personally and is personally responsible for the business debts. A sole trader has unlimited liability (see below).

Ordinary partnership	Where a business is started and owner by more than one person. The legal Partnership Agreement sets out how the partnership is run, covering areas such as how profits are to be shared; what the partners have to invest into the business; how decisions are taken; what happens if a partner wants to leave or dies. The partners between them own all the business assets and owe all business liabilities. Partners, therefore, also have unlimited liability.
Limited liability partnership ("LLP")	Fairly new form of partnership in which the partnership is treated as a separate legal entity with its own assets and liabilities. Like a company, the LLP is registered at Companies House must file accounts. The partners continue to control and own the business – but the crucial different is that they are protected by limited liability.
Limited company	Limited companies differ from sole traders and ordinary partnerships in that they are **separate legal entities** to the founders. A legal entity can own things itself (assets), can sue and be sued. Companies are owned by their shareholders and run by directors. The shareholders appoint the directors (who in most cases are one and the same people!) who must then run the company in the interests of the shareholders. Now this is the important bit. Shareholders own a share of the company, but they do not own the assets of the company and they are not liable for the debts of the company. It is the company that is responsible for owning assets and paying debts. If the company becomes insolvent (i.e. it cannot pay its debts), then the company is closed. The shareholders are not liable for any debts owed by the company that cannot be settled. That is the importance of unlimited liability. By far the most common form of limited company is a private limited company. Private, in this case, means that the shares of the company are not traded publicly on a stock exchange. By contrast, a public limited company ("plc" after its name) tends to have a larger value of share capital invested and its shares may be traded publicly. Don't worry too much about plc's – they are very rare in the case of start-ups and small businesses – which is what you concentrate on in BUSS1.

Comparing the different structures

Given the range of business structures available, which one is best for a start-up? The answer is (as always) – it depends. The important thing is that an entrepreneur gets professional advice about the most relevant structure for their needs.

Here is a summary of the main advantages and disadvantages of the three main alternative business structures:

	Advantages	Disadvantages
Sole trader	Quick & easy to set up – the business can always be transferred to a limited company once launched Simple to run – owner has complete control over decision-making Minimal paperwork	Full personal liability – "unlimited liability" Harder to raise finance – sole traders often have limited funds of their own and security against which to raise loans The business is the owner – the business suffers if the owner becomes ill, loses interest etc Pay more tax than a company
Ordinary partnership	Quite simple – certainly the simplest way for two or more people to form a business together Minimal paperwork once Partnership agreement set up Business benefits from the expertise and efforts of more than one owner Partners can provide specialist skills Greater potential to raise finance – partners each provide the investment	Full personal liability – "unlimited liability" A poor decision by one partner damages the interests of the other partners Harder to raise finance than a company Partners are bound to honour decisions of others
Limited company	Limited liability – protects the personal wealth of the shareholders Easier to raise finance – both through the sale of shares and also easier to raise debt Stable form of structure – business continues to exist even when shareholders change Can pay less tax	Greater admin costs Public disclosure of company information Directors' legal duties

Social enterprises

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

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

Social enterprises are defined as:

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

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

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

A few things all social enterprises have in common are:

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

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

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

Exam tips

Getting the protection of limited liability is essential if the entrepreneur is investing significant capital into a start-up or if the business will have large debts.

Remember that BUSS1 is about start-ups and small businesses. These businesses almost never become public limited companies in the first 5-10 years of trading, so don't bother spending much time learning about stock market flotations.

Make sure you have a strong knowledge of the advantages and disadvantages of the various forms of business organisation.

Guided revision questions

Revision questions for Choosing a Legal Structure

(1) Define the term “sole trader” (2 marks)

(2) Explain why there are so many sole trader businesses in the UK (4 marks)

(3) List two advantages and two disadvantages of setting up in business as a partnership (4 marks)

(4) Who owns a partnership? (2 marks)

(5) Briefly outline the purpose of the partnership agreement (3 marks)

(6) What is the difference between “unlimited liability” and “limited liability” (4 marks)

(7) Do the members of a partnership enjoy limited liability? (2 marks)

(8) Identify the main advantages of using a private limited company for a business start-up (6 marks)

(9) Define the term “shareholder” (2 marks)

(10) List three examples of “not-for-profit” businesses (3 marks)

(11) Define the term “social enterprise” (2 marks)

Raising Finance for a Start-up

Introduction

Often the hardest part of starting a business is raising the money to get going. The entrepreneur might have a great idea and clear idea of how to turn it into a successful business. However, if sufficient finance can't be raised, it is unlikely that the business will get off the ground.

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

- How much finance is required?
- When and how long the finance is needed for?
- What security (if any) can be provided?
- Whether the entrepreneur is prepared to give up some control (ownership) of the start-up in return for investment?

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

- Set-up costs (the costs that are incurred before the business starts to trade)
- Starting investment in capacity (the fixed assets that the business needs before it can begin to trade)
- Working capital (the stocks needed by the business –e.g. r raw materials + allowance for amounts that will be owed by customers once sales begin)
- Growth and development (e.g. extra investment in capacity)

One way of categorising the sources of finance for a start-up is to divide them into sources which are from within the business (internal) and from outside providers (external). We'll use this approach to briefly describe the main sources of finance you need to know about for BUSS1.

Internal sources

The main internal sources of finance for a start-up are as follows:

Personal sources

These are the most important sources of finance for a start-up, and we deal with them in more detail in a later section.

Retained profits

This is the cash that is generated by the business when it trades profitably – another important source of finance for any business, large or small.

Note that retained profits can generate cash the moment trading has begun. For example, a start-up sells the first batch of stock for £5,000 cash which it had bought for £2,000. That means that retained profits are £3,000 which can be used to finance further expansion or to pay for other trading costs and expenses.

It is a mistake to believe (as one BUSS1 textbook does) that start-ups are not financed by retained profits. You don't have to wait for the business as a whole to make profits before you can start reinvesting profits earned on individual products.

Share capital – invested by the founder

The founding entrepreneur (/s) may decide to invest in the share capital of a company, founded for the purpose of forming the start-up. This is a common method of financing a start-up. The founder provides all the share capital of the company, retaining 100% control over the business.

The advantages of investing in share capital are covered in the section on business structure. The key point to note here is that the entrepreneur may be using a variety of personal sources to invest in the shares. Once the investment has been made, it is the company that owns the money provided. The shareholder obtains a return on this investment through **dividends** (payments out of profits) and/or the value of the business when it is eventually sold.

A start-up company can also raise finance by selling shares to **external investors** – this is covered further below.

External sources

Loan capital

This can take several forms, but the most common are a **bank loan** or **bank overdraft**.

A bank loan provides a **longer-term** kind of finance for a start-up, with the bank stating the fixed period over which the loan is provided (e.g. 5 years), the rate of interest and the timing and amount of repayments. The bank will usually require that the start-up provide some security for the loan, although this security normally comes in the form of personal guarantees provided by the entrepreneur. Bank loans are good for financing investment in fixed assets and are generally at a lower rate of interest that a bank overdraft. However, they don't provide much flexibility.

A bank overdraft is a more short-term kind of finance which is also widely used by start-ups and small businesses. An overdraft is really a loan facility – the bank lets the business "owe it money" when the bank balance goes below zero, in return for charging a high rate of interest. As a result, an overdraft is a flexible source of finance, in the sense that it is only used when needed. Bank overdrafts are excellent for helping a business handle seasonal fluctuations in cash flow or when the business runs into short-term cash flow problems (e.g. a major customer fails to pay on time).

Two further loan-related sources of finance are worth knowing about:

The **Small Firms Loan Guarantee Scheme** is a government-funded scheme that makes it easier for businesses to obtain a bank loan. In return for paying a slightly higher interest rate, loans of up to £250,000 made by banks under the SGLGS are backed by the Government. The scheme is a useful way of start-ups and small businesses getting bank loans when they are not able to offer the banks suitable security.

The **Princes Trust** is a well-known provider of start-up business finance for young and disadvantaged people. It provides low-interest loans of up to £4,000 together with the support of a business mentor.

Share capital – outside investors

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

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

You will also see **Venture Capital** mentioned as a source of finance for start-ups. You need to be careful here. Venture capital is a specific kind of share investment that is made by **funds managed by professional investors.** Venture capitalists rarely invest in genuine start-ups or small businesses (their minimum investment is usually over £1m, often much more). They prefer to invest in businesses which have established themselves. Another term you may here is "private equity" – this is just another term for venture capital.

A start-up is much more likely to receive investment from a business angel than a venture capitalist.

Personal sources

As mentioned earlier, most start-ups make use of the personal financial arrangements of the founder. This can be personal savings or other cash balances that have been accumulated. It can be personal debt facilities which are made available to the business. It can also simply be the found working for nothing! The following notes explain these in a little more detail.

Savings and other "nest-eggs"

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

Re-mortgaging is the most popular way of raising loan-related capital for a start-up. The way this works is simple. The entrepreneur takes out a second or larger mortgage on a private property and then invests some or all of this money into the business. The use of mortgaging like this provides access to relatively low-cost finance, although the risk is that, if the business fails, then the property will be lost too. The credit crunch in 2008 has reduced the availability and increased the cost of this kind of finance.

Borrowing from friends and family

This is also common. Friends and family who are supportive of the business idea provide money either directly to the entrepreneur or into the business. This can be quicker and cheaper to arrange (certainly compared with a standard bank loan) and the interest and repayment terms may be more flexible than a bank loan. However, borrowing in this way can add to the stress faced by an entrepreneur, particularly if the business gets into difficulties.

Credit cards

This is a surprisingly popular way of financing a start-up. In fact, the use of credit cards is the most common source of finance amongst small businesses. It works like this. Each month, the entrepreneur pays for various business-related expenses on a credit card. 15 days later the credit card statement is sent in the post and the balance is paid by the business within the credit-free period. The effect is that the business gets access to a free credit period of aroudn30-45 days!

Choosing the right source of finance

The following factors need to be considered when deciding on the best mix of finance for a start-up:

Control	Entrepreneurs are always best advised to hang onto as much control of their business as possible. Selling shares in the business to external investors (including friends and family) loosens that control. At the very least, an entrepreneur needs to have control over 51% of the shares in order to have the final say on key business decisions in a company
Cost	The basic rule of thumb is that finance provided by the founder (or reinvested from retained profits) is the cheapest. Somewhat more expensive is loan finance – typically priced at around 5-10 above the base interest rate, depending on the nature of the loan. If the entrepreneur can provide security for the loan, then the interest is usually cheaper than “unsecured” debt. This reflects that the security reduces the risk taken by the lender. The most expensive finance is generally from external investors. They will typically require a much higher return than a bank. Business angels look to achieve annual returns of around 30-50% from an investment – although they are prepared to wait for the business to be sold before all this return is realised.
Amount	The amount of finance required by a start-up varies depending on factors such as the length of the period before break-even is achieved and the investment required in fixed assets & product development. Smaller amounts (e.g. £1k-20k) are generally funded by a combination of

	personal sources, friends & family loans and perhaps a little help from a bank. Business angels might be interested once the amount goes above £10k. Much larger amounts than this are quite complicated to arrange. Banks and external investors will want to see the founding entrepreneur invest his/her money too, both as a sign of commitment to the idea and also to tie them into the business (give them something to lose!)
Timing	Remember that a start-up doesn't have to raise all is finance at once. One sensible approach is to go through a series of finance-raisings, obtaining money when the business actually needs it.
Flexibility	Some sources of finance are more flexible than others. The most flexible is the bank overdraft, which is a facility that a business uses as necessary. If the business goes overdrawn by £15,000, then it pays interest on that amount. If the cash comes in and the bank overdraft falls to £5,000, then interest is paid on the lower amount. Contrast this with a bank loan. Interest is paid on the whole amount loaned – whether or not the business has made use of the funds.

Exam tips

It is vital that a start-up chooses sources of finance that are appropriate and sufficient for its needs. Remember that too much finance of the wrong sort (e.g. an unnecessary large bank loan) can create huge problems for a start-up.

You must appreciate that many start-ups find it hard to raise finance until they have established a trading record. It is almost always up to the founder to invest funds to get things going.

Entrepreneurs are best-advised to retain as much control over their business as possible. That means not selling substantial proportions of the share capital to other investors.

A well run start-up uses its cash flow forecasts to identify when additional finance is required. This means that a start-up may choose to raise finance at several stages - not always right at the start of trading.

As always, make sure you can list the advantages and disadvantages of the various forms of finance.

Guided revision questions

Revision questions for Sources of Finance for a Start-up

(1) List three reasons why a start-up needs to raise finance (3 marks)

(2) Define the term "retained profits" (2 marks)

(3) List three personal sources of finance (3 marks)

(4) Explain why the founder of a start-up might want to own the entire ordinary share capital of the company (5 marks)

(5) Define the terms "bank loan" and "bank overdraft" (4 marks)

(6) Explain why a bank loan would be an appropriate source of finance for the purchase of plant and equipment for a new factory (4 marks)

(7) State two disadvantages of using a bank loan to finance a start-up (3 marks)

(8) Give two examples for each of internal and external sources of finance (4 marks)

(9) Explain why working capital is so important to a start-up (4 marks)

(10) Define the term "trade credit" (2 marks)

(11) Why might an entrepreneur use a personal credit card as a source of finance for a start-up? (3 marks)

(12) Using two examples of each, explain the difference between capital expenditure and revenue expenditure (6 marks)

(13) What is a business angel and why do they invest in small businesses? (4 marks)

(14) Explain why venture capitalists rarely invest in start-ups (4 marks)

(15) Outline the possible advantages and disadvantages of an entrepreneur financing a start-up with loans from friends and family (4 marks)

(16) Outline four factors that need to be considered in choosing the best sources of finance for a start-up (4 marks)

Choosing the Business Location

Introduction

Where to start a new business? It is a tough question that often leaves an entrepreneur agonising over the decision.

A small business starting up 10-15 years ago would soon be agonising over a key decision. Where can I find some premises? What kind of premises do I need and what will they cost?

Now in 2008, the decision about locating a start-up business is a very different one. It is possible to run a new business, even with several people, without ever having separate business premises.

The so-called "virtual business" is now a reality, made possible by easy communications and the enthusiasm of many people to work from home, as freelancers or consultants. Setting up a virtual business, often from home, is not without its problems. However, this is a very popular approach to locating a new business.

Not every kind of start-up can be based at home. When addressing the question of business location, the textbooks often use the example of a new retail business. For retailing, the search for a good location is vitally important.

In general, the most important consideration for a start-up is the **cost** of the business location. In your exam, it is best to assume (unless you are told otherwise) that a start-up has limited financial resources and that it will seek to minimise the start-up costs. Setting up in a new business location can add significantly to overheads – a business will incur rent, rates, insurance and many other ongoing costs simply from the decision to take some premises.

Factors affecting the choice of location

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

Communications	This includes transport facilities (road, rail, air) as well as information

	infrastructure. Transport links are particularly important if the business delivers products, sells direct using a sales force or is dependent on import and export. Information technology is less of an issue these days – most start-ups can quickly establish reliable broadband Internet connections.
Labour	When a start-up needs to hire employees, then access to a reliable pool of staff with relevant skills is important. Businesses that are labour-intensive often look to locate in areas of traditionally low wages.
Market - customers & population	A start-up may need to be located near particular centres of population. For example, if the product is a service targeted at affluent older-aged people, then it is important to be located where there is a sufficient population of such people. Franchise businesses often analyse the population characteristics of a potential new territory before setting up in a new location.
Suppliers	The business may be dependent on supplies of a particular raw material, so costs will be lower if the business is located near the source of supply (e.g. where the raw material is grown or where a distributor is based). This factor tends to be more important for manufacturing businesses rather than service businesses.
Government assistance	Government policy has often been designed to influence the locations of new businesses. If the start-up is "location-independent" (i.e. the other factors above don't really make a difference to the choice of location), then it may be that deals and incentives offered by Government can influence the choice. Some poorer areas of the UK are designated as "assisted areas". These include many parts of north-east England, Wales, East Yorkshire, Cornwall etc. Locating a new business in one of these areas potentially makes government grants and loans available. England, Scotland and Wales are also divided into regions each of which has a Regional Development Agency which targets government funding to focus economic regeneration and development on specific locations and industries. Many development agencies adopt what is known as a "cluster concept" – where investment is focused on a particular industry (e.g. IT) and the aim is to bring more businesses together in one location.

There is no magic formula which can be applied to decide the most important factors in choosing a location.

Where two possible locations have been identified, it might be that the availability of government grants or other incentives is the deciding factor.

Making a choice of location involves drawing up a list of criteria of what the start-up is looking for from business premises and then using qualitative judgement about what will work best.

Technology & home-based start-ups

The widespread adoption of low-cost, easy-to-use information technology solutions means that many entrepreneurs start their businesses at home.

In fact, pretty much everyone who starts a business does so from home, at least whilst they develop the business idea, conduct market research and decide whether or not to launch.

You might be surprised to learn that:

- In the UK, the home is the most popular location to start a business

- More than 60% of businesses are started from home; equal to more than 1,400 each week

- There are 2.1 million home based businesses in the UK contributing £364 billion in turnover to the UK economy (remember that, in total, there are about 4.5 million separate businesses in the UK)

- The highest growth in home business is coming from mums, young people and the over 50's

- The fastest growing sectors are business & professional services, personal services, online trading, food and domestic energy

- 86% of home business owners want to grow their business, without leaving home.

[source: adapted from Enterprise Nation www.enterprisenation.co.uk]

Running a business from home has various advantages and disadvantages:

Advantages	**Disadvantages**
Free (or minimal cost). This is the big advantage! Remember that most start-ups are short of cash!	Requires greater self-discipline – it is easy to get distracted!
Very little travelling, although customers and suppliers might still need to be visited	Work is often interrupted – e.g. by callers to the home or by family
Work can be combined with domestic tasks and responsibilities (e.g. child care). This can mean significant cost savings	Work never goes away – it is difficult to separate work from home life
Reduced risk and a lower break-even point for the new business – no commitments to rentals and lower overheads	Potentially lonely – lack of simulation from colleagues
Environmental benefits – lower carbon footprint	Working from home can give a poor impression to potential customers
You can wear what you like!	Some hidden costs – e.g. extra household insurance, potentially higher capital gains tax

	when the house is sold

Basing a start-up at home is not ideal for every kind of new business, though the statistics suggest that it is appropriate for most. There are several things a start-up can do which makes home-working more successful:

- Dedicating a separate room or area to work. A loft conversion, converted garage or other out-building is ideal
- Home-based entrepreneurs use quiet places such as libraries when they need to do creative tasks (such as writing)
- Coffee shops are increasingly used for meetings and work
- Informal and formal social networks of home-based entrepreneurs help alleviate the problem of loneliness and isolation

Exam tips

Most start-ups begin in the back bedroom, kitchen or garage - i.e. where costs are low. The rapid improvement in communication and collaboration technologies makes it possible to quite large businesses to operate without traditional business locations!

A start-up often changes location several times in the early years of trading, adding more space as required. Having too much paid-for space increases the fixed costs of a start-up and raises the break-even level of output.

Start-ups and small businesses often have a local geographical focus, particularly retailers and franchise operations. However, a start-up business that focuses on e-commerce might quickly find itself serving a national and international market.

In the BUSS1 exam, the location issues will very much be determined by the kind of business (product, customer, sector etc). The location issues tend to be more challenging for manufacturing and retail businesses.

Guided revision questions

Revision questions for Choosing a Business Location

(1) List two advantages and two disadvantages of setting up a new business from home (4 marks)

(2) Explain what is meant by a "virtual business" (4 marks)

(3) Give an example of a qualitative and quantitative location factor (2 marks)

(4) State three fixed costs that arise from the choice of a business location away from home (3 marks)

(5) Define the term "infrastructure (2 marks)

(6) Why might a start-up service business opt to locate in a shared office space? (3 marks)

(7) Explain why transport infrastructure might be a key factor in determining the location of a new food manufacturing business (5 marks)

(8) Describe three possible location factors that would be relevant to choosing a location for a new website design business (3 marks)

(9) Why is choosing a low-cost location usually important for a start-up? (4 marks)

(10) Explain why restaurants are often located close to each other in a town or city centre (4 marks)

(11) List three types of business where it is essential to be based close to the customer (3 marks)

(12) Why might a business want to locate near to its competitors? (3 marks)

Employing People

Introduction

As an introduction to the topic of employing people, it is important to remember that, in the UK, most small businesses are "one-man bands". There are approximately 4.5 million registered businesses in the UK, and of these 3.3m have no staff. Lots of entrepreneurs work for themselves, taking on the whole variety of jobs, from selling to bookkeeping and cleaning.

However, for the remainder of this section of BUSS1, we will assume that the start-up entrepreneur needs some other people to help him or her make the business work.

For most people starting a new business, the people employed by the entrepreneur will make or break the business. It is staff get things done, sell to customers, handle orders and deal with complaints.

Of course, people matter in every kind of business. However, in a small business the choice of employees matters more, especially because staff represent a much higher proportion of the business's costs. If an employee in a small business does not turn up for work, the business suffers. If an employee in a small business is able to multi-task, working with enthusiasm across a range of tasks, then the entrepreneur has a greater chance of making the start-up a success.

As a business grows, it will naturally require more people to carry out the work. New skills are required, a wider range of activities are undertaken and new technologies are used. If demand grows for the product or service, then capacity needs to increase. The workloads that were initially carried out by one or two people become too much, meaning that specific tasks need dedicated people to carry them out.

It is at this stage that the small business needs to take the plunge and employ people. So, what are the options?

Here are various employment options available to the start-up entrepreneur, which are covered in more detail in other study notes in this section. In summary, these are:

Employment option	Definition & Overview
Full-time	Permanently employed in the business; usually working over 30 hours per week. Full package of benefits & employment rights protected by law
Part-time	Works less than 30 hours per week; employed under a permanent contract of employment. Package of benefits likely to pro-rated based on hours; more limited employment.
Temporary workers	Employed for specific periods and/or tasks, often under contract from an employment agency
Consultants & advisers	Individuals and businesses external to the business which provide specific services and advice. E.g. accountants, lawyers, marketing specialists

Full-time employees

In the UK, there are about 30 million employees working in businesses, of which around three-quarters are in full-time employment.

Full-time is generally taken to mean an employee working 30 hours or more each week. In some textbooks you might see 35 hours mentioned. Don't worry. It is not the hours that matter; it is the fact that a full-time employee is fully committed to working for a business in return for the employment rights contained in the **contract of employment**.

The main plusses and minuses of employing full-timers are summarised below:

Advantages	Disadvantages
Maximises the output from each employee – particularly if they work overtime	Cost – the major disadvantage for a start-up business. Entrepreneur has to be sure that there is enough work to justify the cost of a full-time employee
Available full-time to handle peaks or unexpected increases in workload	
May work better with other employees, since they are at work for longer (no guarantee though!)	Reduced flexibility in terms of adding skills or capacity – part-time employees provide much more flexibility
Potentially better for customer service – customers are more likely to deal with the	Costly if there is a downturn in business activity – full-time employees still need to be

same people	paid, even if there is less for them to do
Easier to recruit people looking for the greater security and higher rewards of full-time work	
Better returns from training	

Part-time employees

Approximately 25% of employees in the UK are employed part-time. That means that they work “less than full-time”. Not a very helpful definition! What that means is that part-time employment is the term used to describe various methods of employing people who don’t work a full working week.

Part-timers might be employed on a:

- Weekly hours basis - e.g. 15 hours per week (5 hours on each of Monday, Wednesday & Friday)
- Zero hours contract – where there is no fixed number of hours, but the hours worked vary as the workload changes over time
- Job-sharing basis – where two or more employees share a single role, dividing up the time on an agreed basis

The main advantages and disadvantages of part-time employment for the start-up or small business are as follows:

Advantages	**Disadvantages**
Keeps costs down – reduces the breakeven point (lower overheads)	Potentially higher costs on training, induction
More flexible – part-timers can work overtime if there is sufficient work to do	Not always able to handle peaks in workload
Potentially more motivating & less stressful; can help retain good people	Less opportunity for training and promotion (though not too much of an issue for small businesses)
Can recruit a wider range of skills for the same total employment cost (e.g. part-time accountant + part-time designer)	Harder to communicate with employees if they spend less time in the business
Easier to recruit people who don’t want to, or cannot, work full-time (e.g. mothers with child care duties)	

Temporary contracts

Whether hired on fixed-term contracts or not, temporary employees are particularly useful if the business has seasonal peaks and troughs in workload. Temporary workers also enable a business to fill short-term gaps, for example caused by illness or maternity leave.

Temporary employees are often not directly employed by the business they work for. A common arrangement is for the "temp" to be employed by an employment agency ("temping agency") that then bills the business for whom the service is being provided.

The main upsides and downsides of using "temps" can be summarised as follows:

Advantages	**Disadvantages**
Flexibility – temps give the entrepreneur better control over the cost of staff, bringing in more people when required and releasing them when things get quiet	Higher cost per hour; temps are often charged out by an agency at a rate that is more than the employee would be paid if she/he was permanently employed by the business
Ideal for specific jobs, tasks and projects – e.g. installation of IT systems, website design, relocation, handling customer calls after a promotional campaign	Temps less likely to know and understand the business, or to fit in with its culture. This might be negative for customer service
Always the chance that a high quality temp can be persuaded to join the business on a permanent basis – so employing temps is a low-cost and low-risk way of recruiting people!	Potentially less motivated and productive; less interested in career progression

Consultants and advisers

Most entrepreneurs know that making a success of a new business requires hard work, the ability to multi-task, persistence and a decent amount of good luck.

One way in which a start-up can reduce the need for good luck is to ensure that weaknesses in specific skills required by the business are covered. Many start-ups find that there are some skills for which it is always best to seek outside professional help.

A good way to think about consultants and advisers is that they are **specialist suppliers of advice and guidance**. They don't tend to come cheap, but the good ones are worth it!

Professional advisers can play an important role in the planning stage for a start-up. A good adviser will help the entrepreneur avoid making the expensive mistakes and errors that can leave the business with a permanent disadvantage (or worse, failure).

Advisers and consultants for small businesses can assist in areas such as:

- Accounting and book-keeping
- Banking and finance-raising

- Legal (e.g. contracts, leases, protecting ideas via trademarks & patents)
- Design (marketing, websites etc)
- Branding & other marketing tasks
- IT (e.g. telecoms, customer systems, e-commerce)

The term consultant is generally taken to mean someone who provides a more specialist service than a business adviser and who works on specific projects. A consultancy project might last a few days, several weeks or longer. For the small business or start-up, consultancy tends to be on relatively short and inexpensive projects.

A summary of the advantages and disadvantages of using advisers and consultants is provided below:

Advantages	**Disadvantages**
Flexibility and lower costs - access specialist skills without having to employ someone on staff	Often expensive – but that it is the cost of getting specialist advice
Skills are provided for the business when needed	May not know or appreciate the culture of the business
Possible to get specialist advice for a start-up at relatively low cost whilst the business establishes itself	Potentially less committed to the business, since they don't work there
Over time, the adviser gets to know the business well	

Flexible working

Flexible working is an attractive option for many start-ups, since effective flexible working can bring many business benefits.

The term flexible working covers any kind of flexibility in terms of time (e.g. part-time work, shift work) and location (e.g. home-working) and includes the following:

- **Part-time working** - covered earlier
- **Flexi-time** - employees choose the hours they work outside a standard set of hours set by the employer
- **Job sharing** - two workers share a full-time job (i.e. two part-timers)
- **Term time working** - normal permanent contract, but the employee can take unpaid time off in school holidays
- **Zero-hours contracts** - workers work only the hours they are needed

Exam tips

For an entrepreneur, employing the first few people in a new business is fraught with risk. Make the wrong choices or pay someone too much, and the start-up's overheads soon increase significantly. The use of part-time or temporary staff is a popular way of handling increased workload.

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

Make sure you can describe the main advantages and disadvantages of the different kinds of employment.

Guided revision questions

Revision questions for Employing People

(1) State two legal issues that a start-up must consider when employing people (2 marks)

(2) Define what is meant by “full-time” and “part-time” employment (4 marks)

(3) Why might an entrepreneur investing in her first start-up be reluctant to employ full-time employees? (4 marks)

(4) Explain why a start-up business often requires staff to “multi-task” (4 marks)

(5) State three possible drawbacks of employing temporary workers (3 marks)

(6) Define what is meant by the term “freelance” (2 marks)

(7) What is meant by “job sharing” (2 marks)

(8) Outline two advantages of employing people on a temporary rather than permanent basis (4 marks)

(9) Outline the main benefits to a business from offering flexible working arrangements (5 marks)

(10) Give three examples of areas in which a start-up is likely to benefit from using the services of advisers and consultants (3 marks)

(11) What is the main difference between a consultant and an adviser? (3 marks)

(12) Explain, using two examples, what is meant by “outsourcing” (4 marks)

Section 2: Financial Planning

The second section of BUSS1 is really concerned with just two words:

(1) Cash, and

(2) Profit

As you work through the section you will come to understanding why we put cash ahead of profit.

Not every new business is started with the intention of earning high profits. However, every start-up needs enough cash to survive. A business can earn profits, but run out of cash and therefore fail. That's why cash comes first.

A start-up cannot succeed without sensible financial planning and this section guides you through how the entrepreneur makes sure the numbers stack-up.

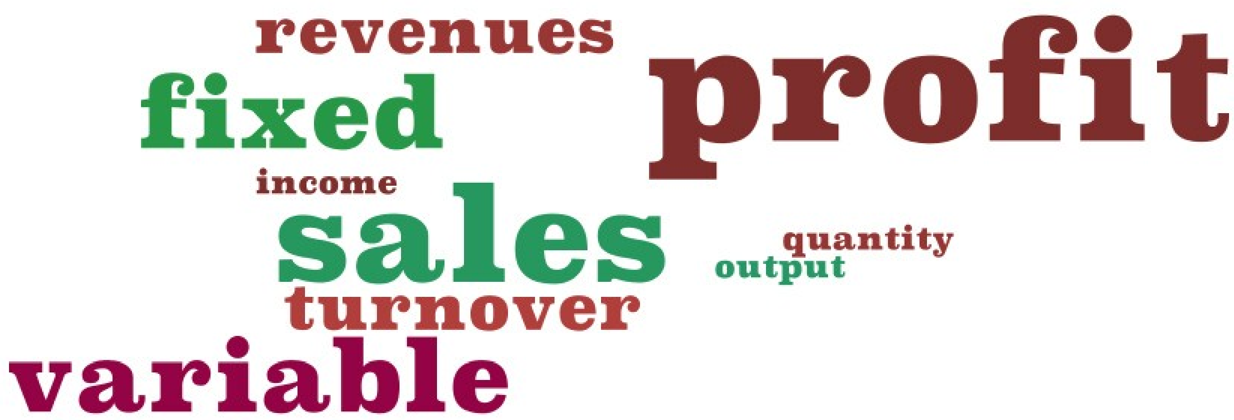
The key topics covered in this section are:

- Calculating sales, costs and profit - the basic building blocks of understanding basic accounts
- Break-even and decision-making - a really important series of calculations that focus on what level of output the business needs to achieve before it starts to make money
- Cash flow forecasting - the most important financial activity that any start-up can do
- Setting budgets - less important than cash flow forecasting, but still a useful management discipline

Since this section deals with numbers, there are some calculations that you will need to be able to do. Don't try to avoid the calculations - the exam is very likely to include them and you may need to practice them regularly as part of your revision!

The final part of BUSS1 is called "Assessing Business Start-ups". This is where you bring all the previous topics together (Section 1 + Section 2). In order to assess the success (or otherwise) of a start-up, you need to consider what the aims and objectives of the new business are. You'll look at the factors that can lead to success or failure, which you can then apply to the case study business that will be included in the BUSS1 exam paper!

Calculating Costs, Revenues and Profits



Meaning & importance of profit

In this section we cover some very important financial concepts for any business – but particularly any start-up business.

The word that will appear time and time again in this section is **profit**. A short word, but an extremely important word if you are the entrepreneur risking your investment in a new business venture.

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

Given that most entrepreneurs **invest** in order to make a return, the profit earned by a business can be used to measure the success of that investment.

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

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

Thanks to those wonderful accountants, profit can be measured and calculated. So here is the formula:

PROFIT = TOTAL SALES less TOTAL COSTS

When total costs are greater than total sales (or revenue), the business is said to make a **LOSS**.

That seems pretty simple. Unfortunately for you, the BUSS1 specification requires that you look a little closer at those sales and cost items and then to understand the relationship between cost, sales and profit. We'll guide you through what you need to know in the following notes.

You should also remember that what we cover here is particularly relevant and useful to two other parts of the BUSS1 specification:

- Break-even analysis, and
- Using budgets

Measuring sales

First, a few words on the various terms that are used by businesses, AQA examiners and your teachers to describe what is actually the same thing!

Alternative terms for “sales” include:

- Revenues
- Income
- Sales turnover
- Takings

We’ll stick with the word “sales”, but look out for those alternatives terms in the BUSS1 exams.

Sales arise through the **trading activities** of a business. The value of sales achieved in a given period is a function of the quantity of product sold multiplied by the price that customers paid. So you see that total sales can be calculated by this formula:

Total sales = volume sold x average selling price

A business that wants to achieve higher sales needs to either:

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

Or (ideally) both of the above!

To see how this formula works, let’s look at an example.

Petra is a talented web designer and she plans to start a new web design business that will focus on designing effective e-commerce sites for niche retailers. Petra’s sales budget assumes that she will win the following volumes of design contracts in the four quarters of her first trading year:

Quarter	Number	Average Value per Contract	Total Sales
Jan-Mar	6	£2,500	£15,000
Apr-Jun	7	£2,500	£17,500
Jul-Sep	5	£3,000	£15,000
Oct-Dec	8	£2,750	£22,000
Total	**26**	**£2,673**	**£69,500**

In the example above, Petra is expecting to achieve total sales of £69,500 in the first year of trading. These sales come from a total of 26 contracts, with an average selling price per contract of £2,673.

How might Petra improve the total sales in year one?

Winning more web design contracts might help, although 26 contracts in the first year already looks like a lot of work. A fully-functioning e-commerce site for a retailer is likely to be a relatively complex and time-consuming project, so there seems little scope for Petra to increase volumes, unless she is able to raise capacity by employing extra designing or outsourcing elements of the work.

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

For example, if Petra did just 20 contracts in Year one (6 fewer than budget) at an average contract price of £4,000, then her total sales will be £80,000 (20 x £4,000), an increase over the existing sales budget of £10,500.

How to achieve higher average selling prices?

You might initially think that the answer is to **increase prices**. In Petra's case, she might price her contracts by reference to an hourly rate (e.g. £30 per hour). Increasing this rate would mean that the value of individual contracts would raise, but customers might not accept the new, higher price for the same work. It could be that a higher hourly rate will lead to Petra losing contracts that she would otherwise have won.

An alternative to increasing prices is to look for **higher value work** – for example contracts that involve more hours, but priced at the same rate.

Measuring costs

Successful entrepreneurs are usually obsessed with "costs". They want to know:

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

Why the obsession with costs? Because costs…

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

So let's examine costs in a little more detail.

Distinction between fixed and variable costs

An important part of understanding costs is to look at the way that costs change when the level of activity of the business changes. We'll use the term "**output**" to refer to changes in the quantities produced by a business.

In real business life, the following "textbook" distinction between types of cost is not straightforward. However, bear with us since the following topic is really important to your studies in BUSS1 and it links in closely with the topic of break-even analysis.

Costs which do not change when output changes are known as **"fixed costs"**

Costs which change when output changes are called **“variable costs”**

[Note: it is normally assumed that the percentage change in a variable cost is the same as the percentage change in output, but this doesn’t have to be the case].

Here is a summary of the main examples of fixed and variable costs in a typical start-up or small business:

Fixed Costs	**Variable Costs**
Rent & rates for the premises	Costs of raw materials and other inputs into the production process (e.g. components bought-in)
Wages & salaries of employees (those whose pay isn’t directly linked to output)	Wages of employees where pay is directly linked to output (e.g. pay per hour or pay per unit)
Marketing costs (e.g. research, advertising,	Marketing costs which vary based on how much is sold (e.g. salesman commission, promotional discounts)
Insurance, bank charges, accounting & legal fees	
Software and other IT-related costs (e.g. equipment leasing, website design)	
Consultant and adviser costs (includes activities that are outsourced – e.g. payroll)	
Product development costs (e.g. design, prototypes, consumer tests)	

There are some costs which are fixed for a certain level of output, but which then change once a higher level of output has been reached. These are known as “**semi-fixed costs**” (you will also see them referred to as “semi-variable costs”!

A good example is office space. Take the tutor2u business as an illustration. When the business first started, it operated from a loft conversion. Then, as volumes of orders increased, the business moved to one serviced office. Since then, as volumes have grown, the business has moved into three offices to handle the need for more employees. The fixed cost of office space might have been £10,000 (say) for a year, but then increased to £20,000 per year at the higher volume (output).

Exam tips

An entrepreneur starting a new business often finds it hard to forecast sales, costs and profits, especially if he/she has no experience of trading in the market. It is not unusual for the initial assumptions made in a business plan to prove inaccurate, so be careful about being too critical if this comes up in your BUSS1 case study.

Setting the price for a new product is particularly difficult. Many factors influence the price that customers are prepared to pay. A good piece of advice to offer in your answers is for the entrepreneur to experiment with different prices, promotions etc in order to find a profitable price which customers are happy to accept.

Start-ups often under-price their product because they fear too high a price will discourage demand when the business or product is launched. An increase in price will not necessarily result in lower quantity demanded.

Guided revision questions

Revision questions for Calculating Costs, Revenues and Profits

(1) Define the term “profit” (2 marks)

(2) State two reasons why an entrepreneur would want to forecast costs for a start-up (2 marks)

(3) State two purposes for which profits are used by a business (4 marks)

(4) In the first month of trading, a business sells 3,000 units of product A at a selling price of£10 and 2,500 units of product B at a selling price of £15. What was the total revenue in month 1? (4 marks)

(5) Explain why an entrepreneur might not be too concerned about a start-up business making a profit in the early period of trading (6 marks)

(6) Why might a start-up business set an aim of maximising sales revenue rather than profit? (4 marks)

(7) State two ways in which a business can increase its sales revenue (2 marks)

(8) When might a start-up be able to charge a high price for a new product? (4 marks)

(9) Explain why it is important for a business to know what the costs of production are (4 marks)

(10) How is total revenue calculated? (2 marks)

(11) Using an example of each, distinguish between fixed and variable costs (4 marks)

(12) What information is required to calculate the profit of a business? (4 marks)

(13) Explain why it might be difficult for a new business to set its prices effectively (4 marks)

(14) What is the relationship between variable costs and output? (2 marks)

(15) Using an example, explain why are some costs said to be "semi-fixed"? (4 marks)

(16) Explain why a start-up business is more likely to keep any profits earned in the business, rather than distribute them to the business owners (4 marks)

(17) Discuss whether profit is the most important objective for a typical start-up business (8 marks)

(18) Why might a new business only achieve relatively low sales from a product launched into a market? (4 marks)

Using Break-even Analysis in Decision-making

Introduction

Of all the sections in your BUSS1 course, this is definitely **one of the most important.** The concept of **contribution** is a crucial one in business. It focuses on how much profit a business makes from each unit of product sold and whether that profit is enough to allow the business to make money overall after taking account of its fixed costs.

In the previous section we looked at the important topics of sales, variable costs and fixed costs. These essential concepts come into play in break-even analysis, so we would recommend you look back at those ideas if you are still unsure what they mean.

Break-even analysis is a mathematical as well as business concept. You need to be able to perform the calculations on this area. If you are unsure of the calculations or a bit uneasy when it comes to anything to do with numbers, you should focus your revision on this topic.

However, break-even isn't just about numbers. You need to be able to understand the analysis and be able to **interpret** the results. You should also be able to describe the **limitations** of break-even analysis.

So what is "break-even"?

A business is said to "break-even" when it is earning **enough sales to cover all its costs.** The break-even point happens when **sales = total costs**. In other words, at the break-even point, the business isn't making a profit, but it isn't making a loss either!

It might help to use a football analogy to help explain break-even. If the business is making a profit, it is winning. If it is making a loss, then it is losing. If the business is breaking-even, then the score is a draw.

When we look at break-even, we are concerned with the following key issues:

- At what level of production (output) does break-even take place?
- What is the effect on break-even of changes in the business?
- What business decisions can be taken which affect break-even and which will help improve profits?

Contribution

Contribution looks at the profit made on individual products. It is used in calculating how many items need to be sold to cover all the business' costs (variable and fixed).

Let's start with a really important definition & formula (you really do need to know these!)

Definition:

Contribution is the difference between sales and variable costs of production

Formulae:

Contribution = total sales less total variable costs

Contribution per unit = selling price per unit less variable costs per unit

Total contribution can also be calculated as:

Contribution per unit x number of units sold

Let's look at a simple worked example of contribution. Here is some information about a business that just sells one product:

- Selling price per unit £30
- Variable cost per unit £18
- Contribution per unit £12 (i.e. £30 less £18)
- Units sold 15,000

Using the formulae, we can perform the following calculation:

Contribution = £180,000 (i.e. £12 x 15,000 units)

Looking at the contribution per unit above (£12), you should be able to see that it can be increased by:

- Increasing the selling price per unit - i.e. more than £30
- Lowering the variable cost per unit - i.e. less than £18

Note that the total contribution of £180,000 is **not the total profit** made by the business. Why? This is because we have not yet taken account of the **fixed costs** of the business. Let's do that now...

Imagine that, in the example above, the business has the following fixed costs:

Admin: £18,000

Marketing: £25,000

Payroll: £50,000

Other overheads: £23,000

Total: £116,000

The total fixed costs of the business are £116,000. If we take these away from the contribution (£180,000), then we can calculate the overall profit or loss of the business:

Total profit = contribution less fixed costs

Total profit = £180,000 - £116,000

= a profit of £64,000 (i.e. £180,000 less £116,000)

In the above example we calculated contribution per unit by subtracting variable cost per unit from selling price per unit.

Contribution per unit is a really useful number to have, and you find it used again and again in BUSS1 questions on break-even. Make sure you know the formula and are confident in calculating it!

Break-even level of output

In this section, we'll take you through the different methods of calculating the production output (volume, or number of units produced) at which the business achieves break-even.

We'll look at three approaches:

- A table (or spreadsheet) showing sales and costs over different levels of output
- A formula which you can use to calculate break-even output
- A graph which charts sales and costs

Each of these approaches basically does the same thing, but you need to be happy with them all – you never know which one the examiner might include in the exam!

For each approach, we have to make some important assumptions:

- Selling price per unit stays the same, regardless of the amount produced
- Variable costs vary in direct proportion to output – i.e. variable cost per unit is the same
- All output is sold
- Fixed costs do not vary with output – they stay the same

I known what you are thinking – those assumptions don't sound very realistic! Correct. However, you have to make these assumptions for the three approaches listed above to work! So bear with us. The unrealistic nature of the assumptions can be used when it comes to discussing the **limitations of break-even analysis** (which is also in the BUSS1 specification).

Using a table to calculate break-even output

Here is a table showing the sales, variable costs, fixed costs and profits from various levels of output for a one-product business:

The product is sold for £10 per unit. The variable cost per unit is £4. Fixed costs are £40,000 (the same at each level of output).

Output	Sales	Variable Costs	Fixed Costs	Total Costs	Profit
'000	£'000	£'000	£'000	£'000	£'000
0	0	0	40	40	-40
1	10	4	40	44	-34
2	20	8	40	48	-28
3	30	12	40	52	-22
4	40	16	40	56	-16
5	50	20	40	60	-10
6	60	24	40	64	-4
7	70	28	40	68	2
8	80	32	40	72	8
9	90	36	40	76	14
10	100	40	40	80	20

Using the table, you can see that the break-even output is somewhere between 6,000 and 7,000 units. At 6,000 units, the business makes a loss of £4,000. At 7,000 units, the business makes a profit of £2,000.

Using a formula to calculate break-even output

Let's use the same information as above to show how a formula can be used to quickly calculate the break-even output.

Remember contribution per unit? (Of course you do!)

Contribution per unit = selling price per unit less variable cost per unit

In this example, contribution per unit = £10 less £4 = £6 per unit

Here comes the clever bit – the formula

Break-even output (units) = Fixed costs (£) / Contribution per unit (£)

So, break-even output = £40,000 divided by £6 = 6,666

Note: break-even output is always expressed in terms of units

So break-even output = 6,666 units

If the information is available, it is always quicker and easier to use this formula rather than use a table or draw a chart.

Using a chart to calculate break-even output

Using graph paper, it is possible to chart the financial data that allows the break-even output to be measured. We'll use the same example data one last time!

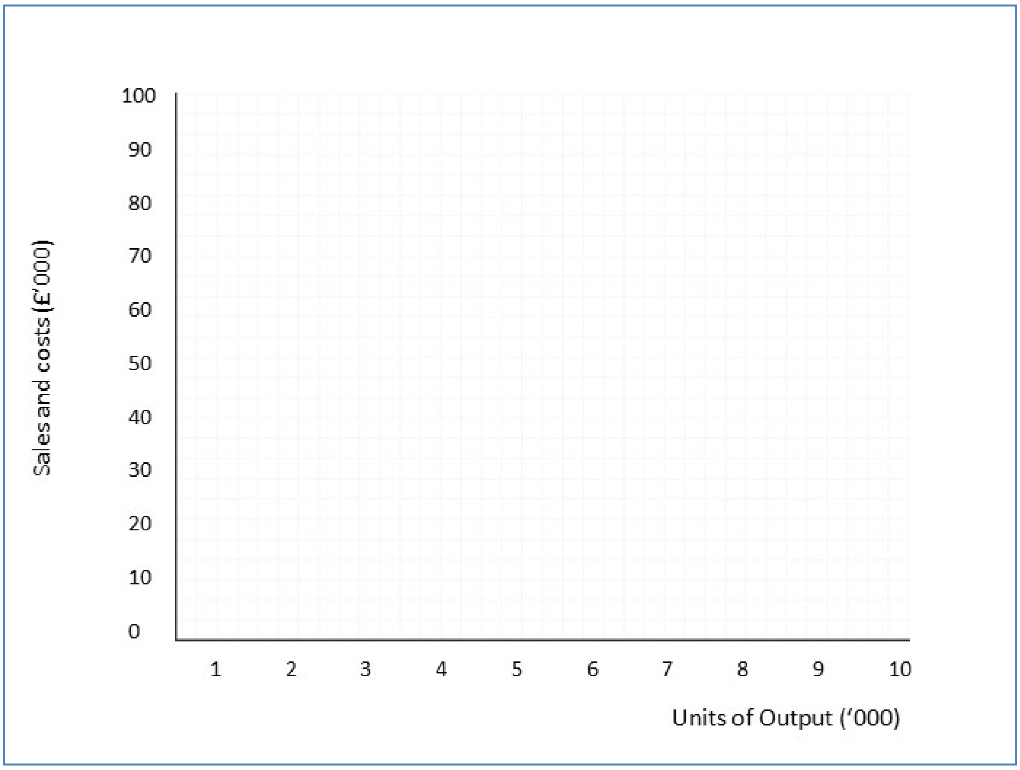
Step 1

The first step is to produce two axes:

The vertical axis shows the value of sales & costs

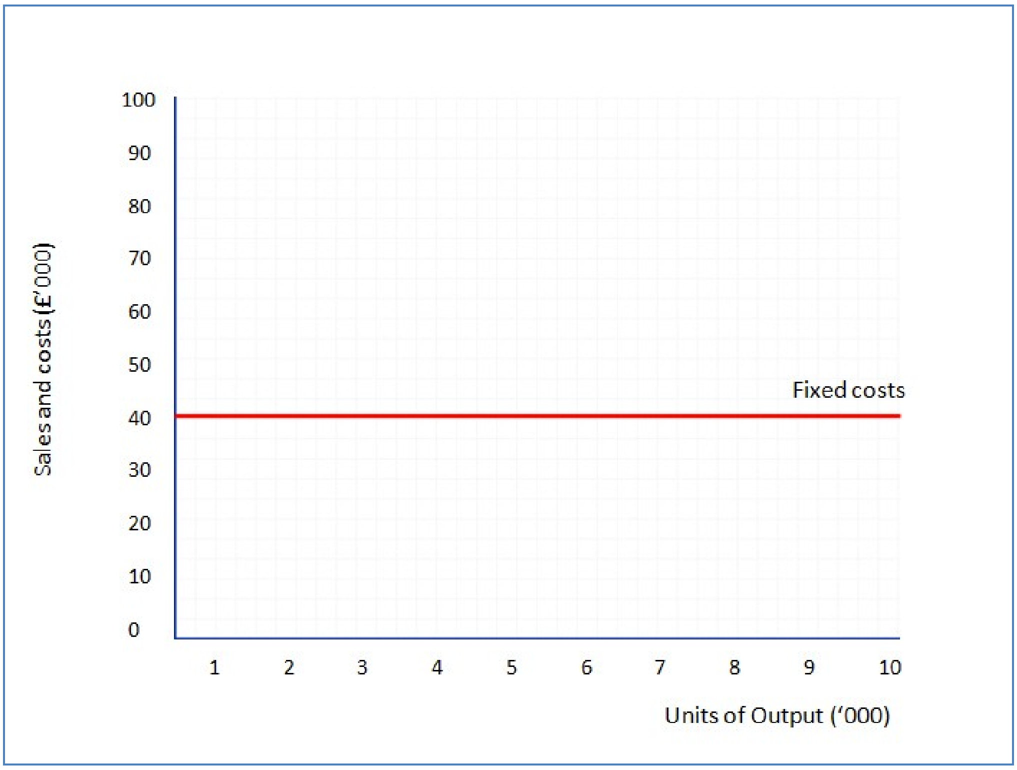
The horizontal axis shows the output

So here is what the blank chart would look like:



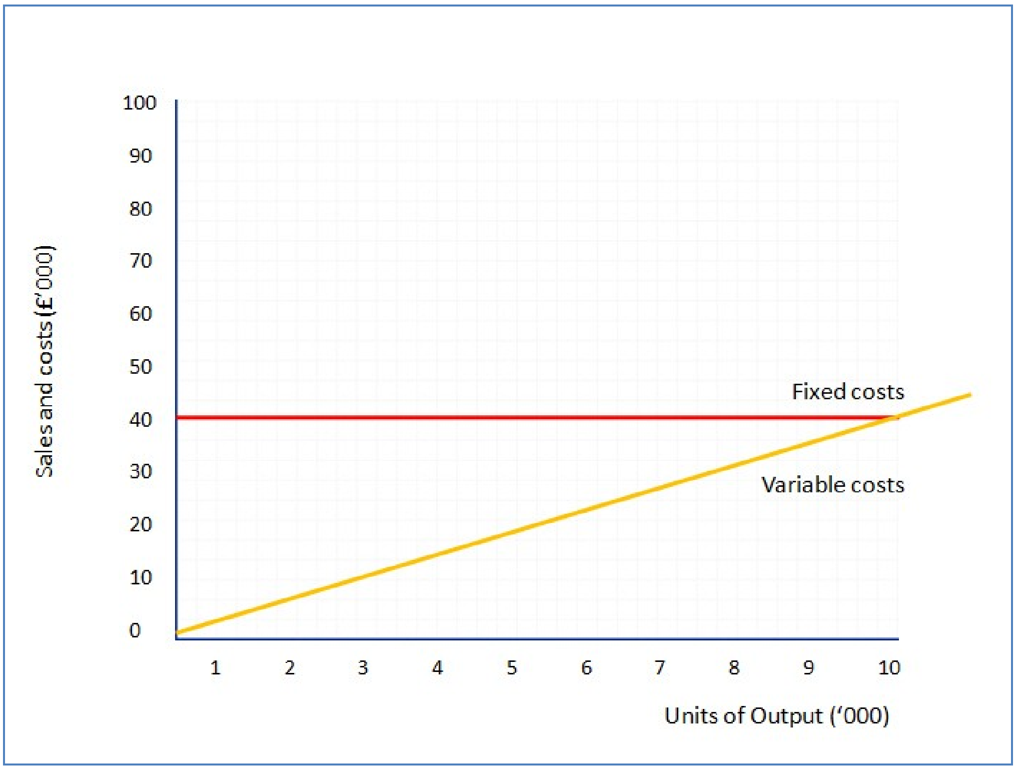
Step 2

The next step is to add the fixed cost line. Remember that we assume fixed costs don't change with the level of output. So the fixed cost line (in red below) is a horizontal line, showing £40,000.



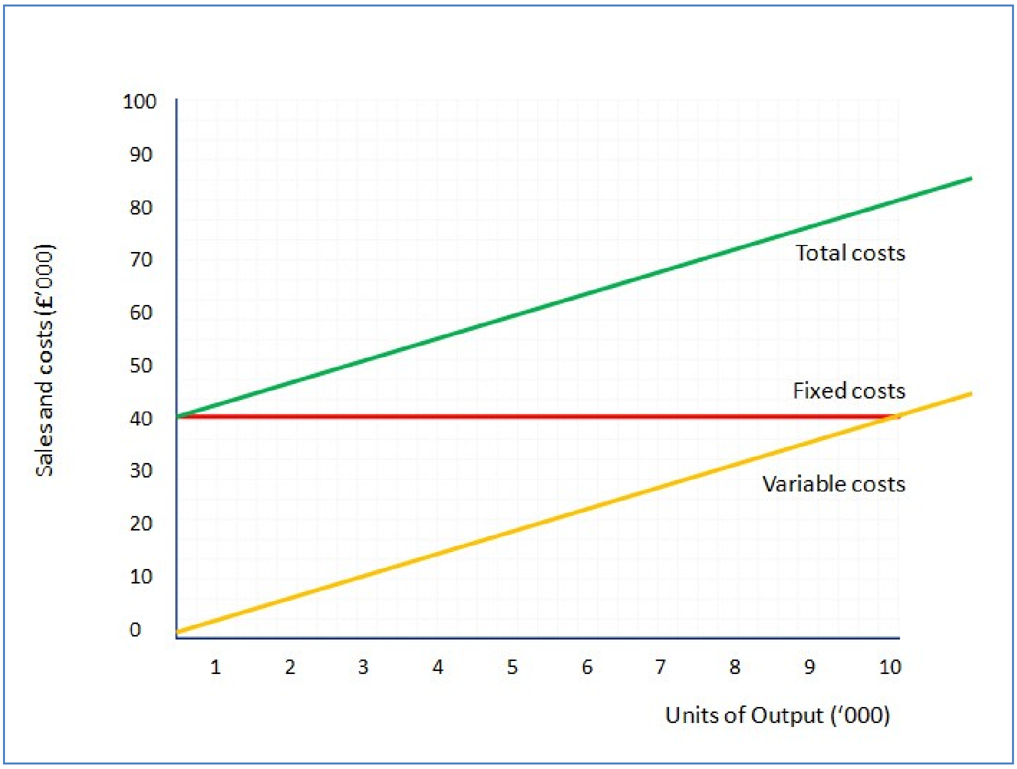
Step 3

Next we add the variable costs. We assume that variable costs vary directly with output. In our example, the variable cost per unit is £4. So variable costs for 1,000 units will be £4,000, and at 5,000 units they will be £20,000. Remember that you only need to plot a couple of points to be able to draw the straight line (in yellow below).



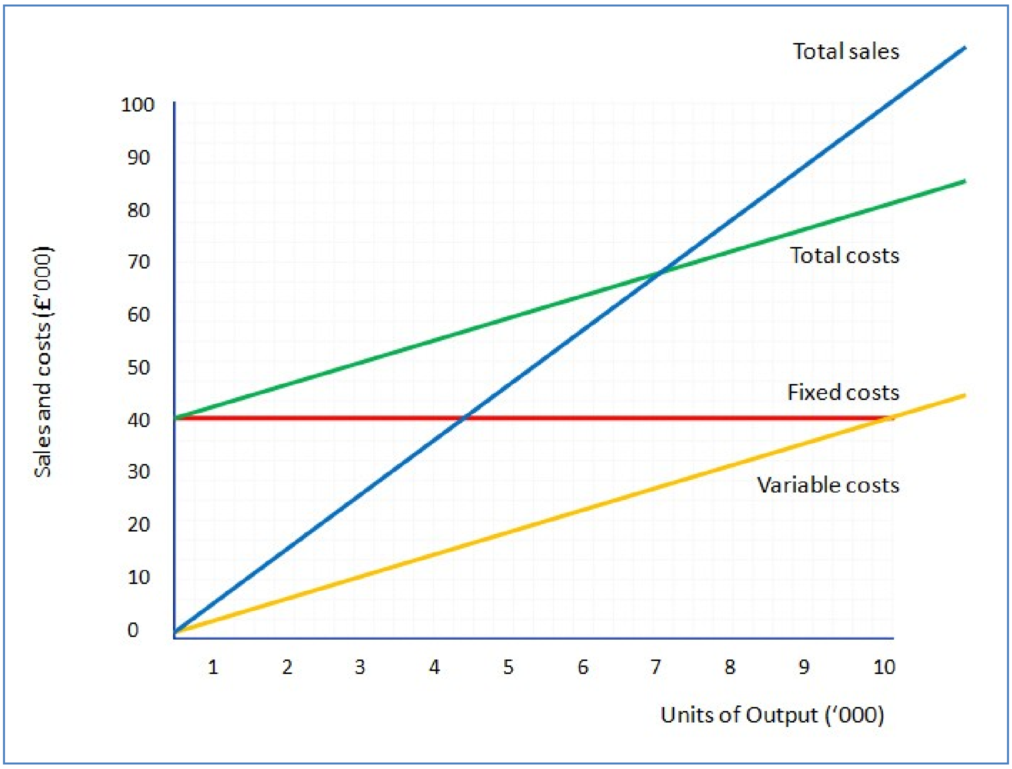
Step 4

Next step is to add the variable costs to the fixed costs for each level of output. This is important. Remember that to calculate break-even we need to know total costs. The total cost line is shown in green on the chart.



Step 5

Having dealt with costs, we can now draw the line for total sales. Remember that we assume that all output is sold for the same selling price (in this case - £10 per unit). So total sales for 2,000 units will be £20,000; 10,000 units will make £100,000 of sales. The total sales line is drawn in blue below.



Step 6

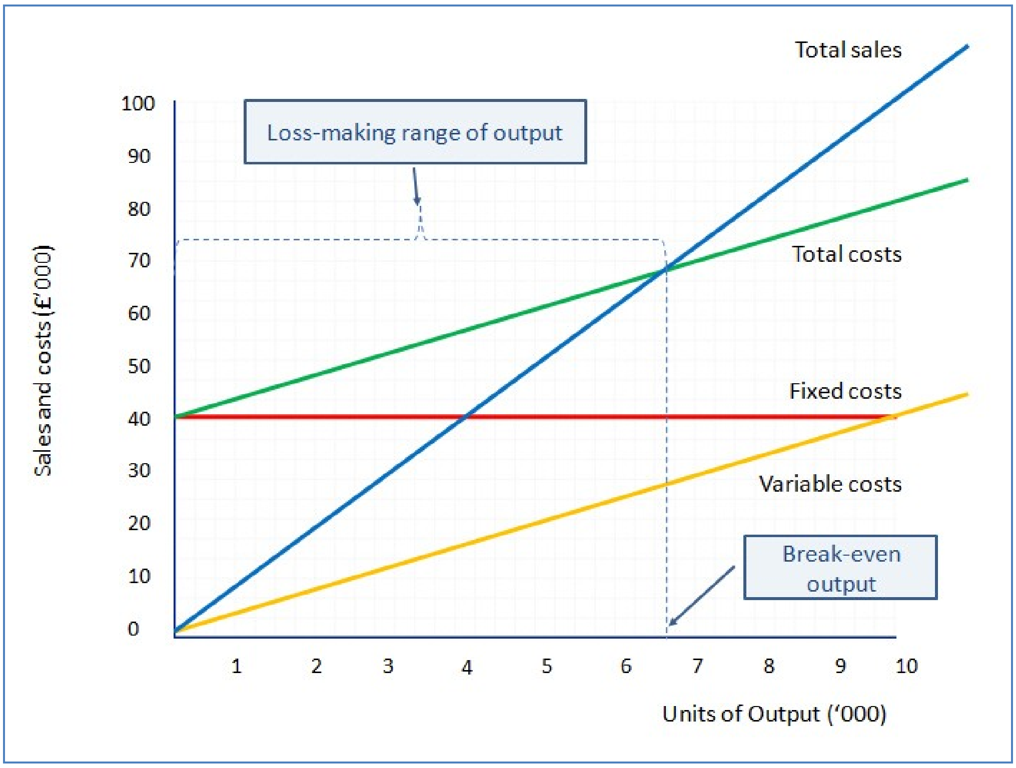
Almost there! The last step is to use these lines to identify certain information from the chart.

First, the break-even output. Remember this is the point where total sales = total costs. So the output is the point where the total sales line crosses the total costs line (e.g. where the blue line crosses the green line). Find this point on the chart and then follow a vertical line down to the output (horizontal) axis. You can see this brings us to 6,666 (approximately, since our chart isn't drawn perfectly to scale!).

Another thing you can notice from the chart is the over a range of output, total costs are higher than total sales (green line higher than the blue line). That means that in this range, the business is making losses. This is the **loss-making range of output**.

If the actual output is more than the break-even output, the business will be making a profit. In our example, any output more than 6,666 units will mean profits are earned.

The difference between the actual output and the break-even output is known as the "margin of safety". For example, if actual output were 8,000 units, then the margin of safety = 8,000 units less 6,666 units = 1,334 units.



Changes to break-even

We have looked at three approaches to calculating break-even output using the same information.

The next stage is to consider what happens to break-even if the data changes. The best way to see the effect of these changes is to work through some calculations, which you can do in our exercises. However, here is a simple summary which you might find helpful:

Change	Effect on Contribution per Unit	Effect on Break-even Output
Higher selling price	Higher	Lower
Lower selling price	Lower	Higher
Higher variable cost per unit	Lower	Higher
Lower variable cost per unit	Higher	Lower
Increase in fixed costs	No change	Higher
Decrease in fixed costs	No change	Lower

The purpose of looking at the effect of changes in assumptions is to understand what happens to profit as key data in the business changes. This is usually referred to as "**what-if analysis**".

What-if analysis can be done using any of the three methods. However, it is much easier and quicker to use the break-even formulae rather than drawing charts of new tables. We'll use the formulae for our worked example below.

Here is the starting data for our example:

Gordon's Seafood Restaurant

Gordon Romsey is planning to open a new seafood restaurant in the popular Cornish village of Padstow to compete with his good friend Rick Strain. His business plan makes the following assumptions:

Average selling price per meal	£40
Average variable cost per meal	£10
Monthly fixed costs	£9,300

Your task: calculate:

(1) The contribution per unit & current break-even output

(2) The current margin of safety assuming that Gordon sells 1,200 meals per month

(3) What would happen to break-even output if the average selling price per meal increased to £50

(4) What the margin of safety would be if monthly fixed costs were 20% higher but there was no change in the number of meals served per month and the average selling price stays at £40 per meal

So, using our break-even formulae, we can quickly get to the answers. Here's how:

Question (1)

Contribution per unit = £40 - £10 = £30

Break-even output = fixed costs / contribution per unit = £9,300 / £30 = 930 meals per month

Question (2)

Margin of safety = current output less break-even output = 1,200 meals – 930 meals = 270 meals

Question (3)

An increase of £10 in the average selling price per meal would increase the contribution per unit to £40 (i.e. £50 - £10).

So the break-even output will now be £9,300 / £40 = 744 meals per month

That means that the break-even output has fallen from 930 to 744 meals. Gordon's restaurant has to sell fewer meals before it breaks even. That's good news!

Question (4)

Fixed costs will be 20% higher: that means fixed costs will be £9,300 x 1.2 = £11,160

Break-even output will now be £11,160 / £30 = 1,116 meals per month

[note: the break-even output has risen (bad news) because fixed costs have gone up]

Margin of safety now = 1,200 meals – 1,116 meals = 84 meals per month

The margin of safety has fallen (bad news)

Strengths and limitations of break-even analysis

Break-even analysis is a practical and popular tool for many businesses, particularly start-ups. However, you also need to know about the limitations of the method. Here is a summary:

Strengths	**Limitations**
Focuses entrepreneur on how long it will take before a start-up reaches profitability – i.e. what output or total sales is required	Unrealistic assumptions – products are not sold at the same price at different levels of output; fixed costs **do** vary when output changes
Helps entrepreneur understand the viability of a business proposition, and also those who will lend money to, or invest in the business	Sales are unlikely to be the same as output – there may be some build up of stocks or wasted output too
Margin of safety calculation shows how much a sales forecast can prove over-optimistic before losses are incurred	Variable costs do not always stay the same. For example, as output rises, the business may benefit from being able to buy inputs at lower prices (buying power), which would

	reduce variable cost per unit.
Helps entrepreneur understand the level of risk involved in a start-up	Most businesses sell more than one product, so break-even for the business becomes harder to calculate
Illustrates the importance of a start-up keeping fixed costs down to a minimum (higher fixed costs = higher break-even output)	Break-even analysis should be seen as a planning aid rather than a decision-making tool
Calculations are quick and easy – great for giving quick estimates	

Exam tips

Focus your BUSS1 studies on understanding how various changes in the business can affect the break-even level of output. A break-even chart can help you illustrate this, but it is more important to understand why the changes affect break-even output, and what a business can do in response.

Don't assume that break-even analysis is a proven, scientific method. It makes lots of assumptions about the ability of the business to identify which costs are variable and which are fixed - in reality this can be quite tough.

Break-even analysis is particularly useful for a new business or for any business which is loss-making or barely making profits.

In the exam, you are unlikely to be asked to draw a break-even chart from scratch. But you might have to complete the missing bits of a part-complete chart and/or identify the results of the chart.

Guided revision questions

Revision questions for Using Break-even in Decision-making

(1) What is meant by the term "break-even" (2 marks)

(2) Why is it important for a start-up to understand the break-even point? (4 marks)

(3) Define the formula for calculating "contribution" (2 marks)

(4) A computer games retailer buys 450 boxed games for £12 which will be sold for £40 each. What is the total contribution from these games? (3 marks)

(5) If the total contribution is £260,000 and fixed costs are £190,000, what is the profit? (2 marks)

(6) If the total contribution is £75,000 and variable costs are £360,000, what is the total revenue? (2 marks)

(7) State two ways in which contribution can be used by a business to help make decisions (3 marks)

(8) What happens to the break-even output if there is an increase in the rent paid on a business' factory? (2 marks)

(9) What is the effect on break-even output of a reduction in the contribution per unit? (2 marks)

(10) A hairdresser is concerned that she has to work 30 hours per week just to break-even. State three things she could do to reduce the break-even level of output (3 marks)

(11) An entrepreneur discovers that the actual break-even level of output for his start-up is much higher than he had assumed in his business plan. Analyse three possible reasons why this might be so (4 marks)

(12) Explain what is meant by the term "margin of safety" (3 marks)

(13) State three weaknesses or limitations in break-even analysis (3 marks)

Cash Flow Forecasting

Introduction

There is a phrase that successful entrepreneurs understand above all others. Here it is…

"cash is king"

Which means what? Why is cash king when businesses exist to make a profit?

The answer is that a start-up might make a loss, particularly in the early stages of trading. However, so long as the business has enough cash in the bank to pay the bills, it will be able to survive. For most new businesses, survival is what it is about whilst the entrepreneur works hard to get the business up and running properly.

In order to be sure that the business has enough cash to be able to pay the bills, an entrepreneur must have a cash flow forecast. The forecast is a prediction of the totals for each kind of cash flow into and out of the business, usually calculated on a monthly basis.

Cash flow forecasting is an essential discipline for a start-up business and it is quite likely to feature in your BUSS1 exams.

However, before we look at the mechanics of putting the cash flow forecast together, we need to consider first the nature of cash flow.

The nature of cash flow

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

In business, cash is always on the move…

Cash flows into the bank account when customers pay for their sales, when a loan is received from the bank, interest is received or when assets are sold.

Cash flows out of the bank account when suppliers are paid, employee wages and salaries are paid; interest is paid to the bank and so on.

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

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

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

It can be a while before the business makes its first sales – the **pre-trading period** often involves incurring costs without getting any revenue in return

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

A new business usually has to spend up-front on expenses such as marketing and product development.

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

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

How to forecast cash flow

Let's now look at how to put together a cash flow forecast for a start-up business. We'll use an imaginary case study business to illustrate the mechanics of how the forecast is put together.

For a start-up, working out the likely cash flows is a tricky task. The entrepreneur cannot rely on historical cash flow data. Instead the forecast needs to be built up by making assumptions about the likely amount and timing of each item in the forecast.

Some of these assumptions may be quite easy to make – the rent payment each quarter, the monthly wages for the part-time admin lady.

However, other assumptions are harder, particularly sales and cash receipts. How much will be sold each month? When will customers actually pay (assuming that they don't pay in cash at the time of sale)?

To illustrate the challenges, let's put together a three month cash flow forecast for the following start-up business:

Example – Sophie & Jack

Experienced interior designers Sophie and Jack decide to go into business together. They enter into a partnership, with each of them investing £5,000 into the business. Their "product" is a home-makeover service, modeled on the popular daytime television programmes where ordinary households are transformed through small building work and decoration.

Revenues:

Sophie and Jack expect to gain 2 projects per month for the first 6 months of trading; each project will generate £5,000 of sales. Customers will be expected to pay 25% of the price as a deposit with the balance on completion. Each project is expected to last one month.

The main costs associated with the start-up are:

- Equipment - £2,500 (month 1) & £2,500 in month 4), a total investment of £5,000
- Marketing - £500 per month
- Legal and accounting costs - £1,250 (month 1)
- Project materials – £1,500 per project (i.e. £3,000 per month). It is assumed that suppliers will allow Sophie & Jack 30 days to pay for these costs
- Sub-contracted labour (other tradesmen) - £4,000 per month. These will be paid in the month incurred.
- Sophie & Jack will pay themselves a salary of £1,000 each per month whilst the business is established.
- Other sundry costs of £500 per month have been assumed

Putting these assumptions into a cash flow forecast produces the following results:

	Jan	Feb	Mar	Apr	May	Jun	Total
CASH INFLOWS							
Investment	10,000						**10,000**
Credit sales	2,500	10,000	10,000	10,000	10,000	10,000	**52,500**
Total inflows	**12,500**	**10,000**	**10,000**	**10,000**	**10,000**	**10,000**	**62,500**
CASH OUTFLOWS							
Project materials		3,000	3,000	3,000	3,000	3,000	**15,000**
Sub-contract labour	4,000	4,000	4,000	4,000	4,000	4,000	**24,000**
Marketing	500	500	500	500	500	500	**3,000**
Legal and accounting	1,250	0	0	0	0	0	**1,250**
Equipment	2,500	0	0	2,500	0	0	**5,000**
Sophie & Jack salaries	1,000	1,000	1,000	1,000	1,000	1,000	**6,000**
Other costs	500	500	500	500	500	500	**3,000**
Total outflows	**9,750**	**9,000**	**9,000**	**11,500**	**9,000**	**9,000**	**57,250**
NET CASH FLOW	**2,750**	**1,000**	**1,000**	**-1,500**	**1,000**	**1,000**	**5,250**
Opening balance	0	2,750	3,750	4,750	3,250	4,250	
Closing balance	2,750	3,750	4,750	3,250	4,250	5,250	

The format of the cash flow forecast above is typical of the style used by most small businesses. You may come across different layouts and headings, but don't worry. The important thing is to understand the main information contained in the forecast and to be able to analyse what the figures show.

So, let's take a look around the structure of the cash flow forecast:

Cash inflows – these are the movements of cash into the business. The investment by Sophie and Jack into the partnership is a one-off cash inflow whereas the payments by customers are regular sources of cash. The challenge for Sophie and Jack is to ensure that customers pay on time. Delayed payments, for whatever reason, can seriously affect the cash flow of a small business.

In the forecast above, the monthly cash inflows are around £10,000 p/m and total £62,500 for the first six months of trading. Note that this total for cash inflow is not the same as sales. Those cash inflows include £10,000 of investment into the partnership.

Cash outflows – these are movements of cash out of the business. An important part of estimating cash outflows is to ensure that a prudent (or cautious) view is taken about both the size and timing of payments. Have all costs been taken into account? Will suppliers really offer 30 days credit before payment is required? A sensible cash flow forecast allows for what is known as "**contingencies**" – i.e. unexpected costs or higher than expected payments.

Looking at Sophie & Jack's cash flow forecast, the monthly cash outflows are typically around £9,000 except for a couple of months where some investment in equipment increase the amount of cash going out of the business.

Net cash flow – this is simply the difference between the total cash inflows and the total cash outflows. Net cash flow will vary by month. When looking at a cash flow forecast in the exam, always remember to look for months in which there is a net cash outflow (i.e. a reduction in the cash balance of the business). If there is a cash outflow, the questions you should ask are:

- Does the business have enough cash left after the outflow (look at the closing balance)
- If not, does the business have access to a bank overdraft

You can see from Sophie & Jack's cash flow forecast that there is a small **net cash inflow** each month except in April when there is a **net cash outflow** of £1,500.

Net cash outflows are often caused by one-off payments (e.g. buying equipment, paying tax such as VAT) or where seasonal falls in sales mean that cash inflows are not strong.

Opening balance – this is simply the balance in the bank at the start of a period. For a start-up, the opening balance is zero. As soon as investment funds are added to the bank, then the cash flows begin! Remember that the opening balance in any one month should equal the closing balance at the end of the previous month.

Closing balance – this is the amount in the bank at the end of the month. In the BUSS1 exam, you might be asked to calculate the closing balance. The formula for the closing balance is opening balance + net cash flow.

During your studies you should try to look at several different kinds of cash flow forecast like the one above. It is important to build your confidence looking at the numbers – seeing how they are calculated and then making some judgements about what the numbers mean!

Why cash flow forecasting is important

We said earlier that "cash is king". Cash flow is the life-blood of a small business. So you can probably seen that it makes sense for a start-up to forecast (predict) what is going to happen to cash flow to make sure it has enough to survive. If a business runs out of cash and fails, then it would be a shame if the entrepreneur hadn't at least seen it coming.

The AQA examiner wants you to know some “textbook reasons” about why businesses forecast cash flow, so here is a list of good reasons that you should learn!

Identify potential shortfalls in cash balances in advance – think of the cash flow forecast as an “early warning system”. This is, by far, the most important reason for a cash flow forecast.

Make sure that the business can afford to pay suppliers and employees

Spot problems with customer payments – preparing the forecast encourages the business to look at how quickly customers are paying their debts. Note – this is not really a problem for businesses (like retailers) that take most of their sales in cash/credit cards at the point of sale

As an important discipline of financial planning – the cash flow forecast is an important management process, similar to preparing business budgets.

External stakeholders such as banks may require a regular forecast. Certainly if the business has a bank loan, the bank will want to look at cash flow forecasts at regular intervals

Limitations of cash flow forecasting

It is important to remember the limitations of a cash flow forecast. They are not always reliable, largely because businesses need to make **assumptions** about the future. When commenting on any cash flow forecast in the exams, take a look at which figures are estimates and try to assess whether the entrepreneur has built in some contingency or safety margin.

Common reasons why cash flow forecasts prove unreliable include:

Sales prove lower than expected

It is too easy to make optimistic assumptions about sales, particularly before the business starts trading. Market research may help an entrepreneur estimate potential sales volumes and prices that customers will find acceptable. However, there is no substitute for actually starting to sell. Only by trading does the entrepreneur discover whether the product is attractive to customers, the price they will pay and what seasonal and other factors actually affect demand.

Customers do not pay up on time

This is an issue for businesses that allow customers a period of **credit** before paying for their purchases. Many small businesses suffer significantly from slow or delayed payment by customers. It is not unusual for a small business to have to wait 30-60 days before invoices are settled – sometimes much longer.

The cost of raw materials and other inputs prove higher than expected

This can happen in several ways. For example, the business may underestimate the price that has to be paid for each supply. Alternatively, the quantity of raw materials required may be under-estimated, perhaps because the production process doesn’t turn out to be as efficient as expected.

Certain costs are not included

A common problem for start-up, particularly if the entrepreneur does not have experience of the market in which is it launching. New entrepreneurs are often surprised by the type of costs that a small business incurs, often unexpectedly high.

Given the limitations of cash flow forecasting outlined above, how should an entrepreneur respond?

A good way is to create two different versions of the cash flow forecast:

(1) A "base case" version which is the expected or hoped-for version
(2) A "downside" or "worst case" version, which takes a pessimistic view of what might happen.

Which forecast should be used? It depends on who is reading it. The bank manager is probably best given the "downside" version so that his/her expectations are managed.

Sources of information for cash flow forecasts

The main sources for the assumptions used in the cash flow forecasts for a start-up will be:

Entrepreneur experience – there is no substitute for experience of running a small business. Some of the assumptions will be based on "gut feel" and instinct. A cash flow forecast produced by an inexperienced entrepreneur has to rely much more heavily on other sources.

Market research into key aspects of sales and costs – e.g. seasonal fluctuations in demand, average selling prices and quantities in the market, typical gross profit margins, the lead-time between marketing campaigns and orders etc

Suppliers – a great source of information on costs and also the timing of payments. What are the industry norms for paying suppliers in the market?

Advisers – it makes sense for start-ups to get help from advisers when putting the cash flow forecast together. The advisers might be from Business Link or other government-funded agency. It could also be the local bank manager or accountant – whose help is particularly useful when it comes to making sure the forecasts are complete & mathematically sound.

Exam tips

You cannot underestimate the importance of cash flow forecasting for a start-up. Think of the cash flow forecast as the "early warning system", which will show when the danger periods are and how viable the business is. A business neglects cash flow forecasting is either (1) hugely profitable and doesn't care, or (2) taking a huge risk.

Don't forget that cash flow forecasts are not perfect - they have their limitations, not the least because they are based on estimates and assumptions. It is important for the entrepreneur to think about the different scenarios that might arise - this is known as "what-if" analysis. The "worst-case" scenario is always worth assessing to see what might happen if things do go badly wrong!

It is really important to understand that cash flow is not the same as profit. A business can be profitable, but suffer from cash outflows if customers don't pay their debts or suppliers need paying early. Investment in fixed assets (cash outflows) will help profits in the medium-term, but is bad news for cash flow in the short term.

Don't forget to make the links with other parts of the BUSS1 course. For example, the use of market research can help improve the accuracy and reliability of cash flow assumptions. The cash flow forecast should also be consistent with the choices made about sources of finance. There is no point assuming the use of a bank overdraft if the bank will not provide the overdraft facility.

Guided revision questions

Revision questions for Cash Flow Forecasting

(1) *Define what is meant by the term "cash flow" (2 marks)*

(2) *Why is it important to manage cash flow? (4 marks)*

(3) *What is the difference between a cash flow forecast and a cash flow statement? (2 marks)*

(4) *L*ist three typical cash inflows for a small mail-order business (3 marks)

(5) Explain why a bank manager would want a start-up business to produce a cash flow forecast before agreeing to provide an bank overdraft (4 marks)

(6) List four typical cash outflows for a small retail business (4 marks)

(7) Identify two external organisations that might wish to see the cash flow forecasts of a business (2 marks)

(8) In a cash flow forecast, the opening balance of a particular period (e.g. month) is equal to what figure from the previous period? (2 marks)

(9) Explain why it is possible for a business to be profitable in a period but for the cash flow to be negative in the same period (4 marks)

(10) Explain why the use of forecasting scenarios is a useful discipline for a small business (4 marks)

(11) Why are spreadsheets so useful for producing a cash flow forecast? (4 marks)

(12) List three limitations of a cash flow forecast (3 marks)

(13) Describe why having a bank overdraft facility can help a small business manage its cash flows (4 marks)

(14) List three actions a small business could take to improve its cash flow (3 marks)

(15) How might a business benefit from delaying cash payments? (4 marks)

(16) Identify three cash flow difficulties that a start-up is likely to encounter in the first few months of trading (6 marks)

Setting Budgets

Introduction

When you hear the words "budgets" and "financial planning" you probably feel the urge to fall asleep. However, if you can stay awake whilst you work through this section of BUSS1, it will be worth it. For setting budgets is an important part of starting a new business and it is closely linked to the topics of:

- Cash flow forecasting, and
- Business plans

So what is a budget? A good definition of a budget is a "financial plan for the future concerning the revenues and costs of a business".

A "financial plan for the future" might sound a bit like the cash flow forecast – and you would be almost right! However, there are two key differences between a budget and cash flow forecast.

The first is that a budget is focused on the **trading profitability** of the business rather than the cash flows. When looking at budgets, you are really concerned with sales (revenues) and costs. In other words, a budget is an estimate of sales income together with the costs required to produce those sales.

The other key difference is that a budget is a plan – it outlines what the business **wants to happen.** This is different from a forecast, which is what a business expects to happen.

Budgets are all about **setting targets** and **allocating resources**. In order for a budget process to be effective, a business needs to:

- Estimate sales reasonably accurately (sales budget), and

- Estimate costs precisely (expenditure budget)

Another important point to remember is that budgeting is part of **financial control.**

Financial control is different from **book-keeping** (which is about recording the financial transactions of a business). Book-keeping is, of course, important since any business needs accurate and up-to-date figures about its financial position. However, financial control is about using the figures to keep control over the business.

As we shall see, the use of budgets brings some important disciplines to the management of any business – large or small.

Why businesses use budgets

Here are the main reasons why businesses set up and use budgets:

Budgets are used to measure whether key business objectives and targets are being achieved. For example, if the budget has an objective of achieving sales of £150,000 in the first year of trading, then the actual sales can be compared with this budget to measure success.

Budgets play a key role in controlling expenditure. The budget sets out the costs that the business can afford to incur. When actual costs are measured, the entrepreneur can see whether the expected costs are likely to more or less than expected.

Budgets can provide a sense of direction for management and employees in the sense that they include targets that provide a focus. However, remember that most start-ups businesses will have few, if any, employees. So the direction-setting purpose of the budget is really for the entrepreneur.

For a small business or start-up, the process of creating a budget is relatively straightforward, although that doesn't mean it is easy.

Sales budget

The hard bit for a new business is to work out the projected sales for the budget period. The sales budget needs to take into account factors such as the size of the market, existing competitors and their response and the capacity of the business.

- What sales volumes will be achieved?
- What price can the product or service be sold at?
- When will the sales arise and through which distribution channels?

For the sales budget, it is important to be realistic. An overly-optimistic sales budget will probably give the impression that the business will generate more cash than it actually can.

Market research places a key role in the sales budget of a start-up. The assumptions made in the sales budget about selling prices, volumes and distribution channels (where products will be sold) need to be realistic and informed by what the business can find out about what really happens in the market.

Ideally, the sales budget will be based around assumptions made for individual products or product groups. The budget for each product is then added up to make the overall sales budget. A simple example is illustrated below:

Sales Budget Niche Children's Fashions Ltd

Product	***Qty*** ***000***	***Price*** ***£ / unit***	***Sales*** ***£'000***
Girls Jackets	3.0	£11.99	£36.0
Boys Jackets	4.5	£12.99	£58.5
Girls Blouses	2.5	£8.99	£22.5
Boys Shirts	5.0	£7.99	£40.0
Total	15.0		£156.9

Expenditure budget

The next step is to assess what the costs are of delivering the sales budget. This is the expenditure (or costs) budget and is concerned with question such as:

- What are the direct **costs of sales** – i.e. costs of raw materials, components or subcontractors to make the product or supply the service?
- What are the sales-related expenses, such as commissions?
- What are the fixed costs or overheads?

It is important that the expenditure budget is broken down into as much relevant detail as follows. For example, the budgeted fixed costs and overheads could be analysed by type, such as:

- Cost of premises, including rent, rates, office insurance etc
- Staff costs – wages and salaries (don't forget to allow for employer's national insurance)
- Utilities – e.g. lighting, heating,
- Communication costs –e.g. main telephone, mobile phones, internet and email access, web hosting
- Marketing and other printing, postage and stationery
- Vehicle expenses
- Equipment costs (including relevant software licences)
- Advertising and promotion
- Travel and subsistence expenses
- Legal and professional costs, including the costs of setting up the business structure

You can see from the list above that there are many items of expenditure that need to be considered by the start-up prior to trading. Most of the above cost categories will continue to be incurred by the business once it has started trading. However, the expenditure budget is particularly important for a start-up since it does not begin to generate income until its starts to trade with customers. Costs, on the other hand, are often incurred well before the first customer is served!

Market research also comes into play when creating the expenditure budget. It is particularly important if the entrepreneur has no previous experience of operating in the target market.

The overall aim of the expenditure budget is to ensure that it is **prudent** and **complete**. What do we mean by these two terms?

Prudent – the budget makes sensible, cautious assumptions about the value of costs to be incurred. For example, a prudent expenditure budget does not assume that the business will operate at maximum efficiency or that raw materials will be sourced at the best possible price. To do so would be to create unrealistic expectations about what the profitability of the business can be.

Complete – the expenditure budget does not miss out any significant items or categories of cost. For example, if the start-up plans to sell via e-commerce, the expenditure budget should include items such as web design, server hosting, transaction fees etc. There is nothing worse when a start-up begins trading to discover a bunch of costs that had simply been missed when the expenditure budget was put together!

Profit budget

The profit budget is simply the difference between the sales budget and the expenditure budget.

The profit budget shows what the budgeted net profit is for each of the budgeted periods (usually months).

In other words, having got budgeted figures for sales and expenditure, the start-up can work out how much profit it should earn as it begins life as a new business.

The profit budget isn't simply a mathematical calculation (performed by a spreadsheet). It enables the entrepreneur to look at costs and work out ways to reduce them. It can also help highlight potential cash flow problems, since periods where the business is budgeted to be loss-making are often associated with negative cash flow.

Methods of setting the budgets

In most established businesses, the budget-setting process is quite straightforward. Managers look at what actually happened last year, what has changed in the business and its markets, and then set a new budget that reflects the targets and objectives they want to achieve. In reality, this can be quite time-consuming (especially for a multi-location & complex business), but at least the budget-setters have the advantage of using real information on how the business trades.

However, remember that in BUSS1 we are mainly looking at a **new business** that is getting ready to trade. Management don't have the luxury of lots of historical sales and expenditure data. Time is short too – there are lots of other activities that need to be done rather than spending lots of effort on putting a budget together.

So, for the start-up entrepreneur, setting a sensible budget is a tough job. How does he or she do it? Here are some tips:

An entrepreneur with some experience of the market will make good use of "rules of thumb" to set key assumptions in the budget. For example, he/she may know that the average mark-up on cost is 60%, or that the average selling price is three times raw material costs. Using these guides, if accurate, helps make sensible assumptions. Rules of thumb are identified in several ways. One great method is to simply speak to suppliers!

Market research should be used wherever possible to fill in the gaps. We touched on this when describing how the sales budget can be prepared.

Good use of advisers and consultants helps too. For example, the main high street banks have detailed experience of most markets and industry sectors; they provide free guides to the main business planning issues in these markets. Good use of expert information, usually available for free, can help make the budgets realistic and reduce the time taken to complete them.

An experienced entrepreneur will accept that some elements of any start-up budget will simply be based on "guesstimates" or hunches. This is often the case for the sales budget. As long as the budget is revisited frequently and costs have been prudently estimated, then the use of guesstimates is fine.

Time spent working on the budget, and then periodically reviewing and amending the main assumptions, is time well spent. The budget-setting process need not take forever (a well designed spreadsheet can save dozens of hours).

Limitations of budgets

Whilst the budget-setting process is a useful management discipline, you need to be aware of the many limitations of budgets, particularly for start-ups and small businesses:

- Budgets are based on **estimates and assumptions**. By definition, actual results will vary from the budget (these are known as "variances" and you will cover these in BUSS2). The important point is that a business needs to know **why** actual results vary from budget.
- A start-up has no trading history which it can use to base the budget assumptions. For example, it would be nice to know about the seasonal profile of demand and to see what costs are actually incurred by the business idea. The first time the start-up budget is prepared, much of this information has to be guesswork (a similar problem exists when it comes to preparing the cash flow forecast).
- Setting and monitoring budgets takes time. We know that most start-up entrepreneurs are short of time. So a start-up budget (if it is produced at all) is often kept quite simple and brief so that the entrepreneur can focus efforts on other tasks.
- The motivational effect of setting budgets is limited if the start-up has no or few employees and managers.

Exam tips

Remember that, for the start-up entrepreneur, the time spent setting and monitoring budgets has an opportunity cost. Three days working on a budget spreadsheet could be spent instead on visiting customers, training staff or developing new product ideas. As a result, an effective budget system for a start-up is likely to be pretty simple - often nothing more than a single spreadsheet. Don't be too critical of a BUSS1 case study business that finds it hard to summon enthusiasm for a complex budgeting process!

Guided revision questions

Revision questions for Setting Budgets

(1) Define what is meant by the term "budget" (2 marks)

(2) List three advantages that a budgeting system brings to a business (3 marks)

(3) Why might a budgeting system help a start-up business to control expenses? (2 marks)

(4) List three different kinds of budget that might be created by a start-up business (4 marks)

(5) Identify five areas that a business should research so that it can produce realistic budgets (6 marks)

(6) What items might be included in the materials budget for a start-up manufacturer of processed foods? (3 marks)

(7) Explain why it is important for a start-up business to estimate with reasonable accuracy the level of future sales (4 marks)

(8) Why do small businesses traditionally find it harder to budget realistically for revenues? (2 marks)

(9) List three reasons why a new fast-food outlet may be unable to budget its sales accurately during the first year of trading (3 marks)

(10) Explain why costs are generally related to the level of a business's activity (4 marks)

(11) Explain the link between a business budget and the aims and objectives of a start-up business (4 marks)

(12) How often might a start-up business monitor actual results compared with a business? (4 marks)

(13) Explain three reasons why a start-up business might find the budgeting process difficult (6 marks)

(14) How might budgets motivate staff? (4 marks)

(15) Explain why a small business might benefit from setting budgets on areas such as advertising, travel and accommodation costs (4 marks)

Assessing Business Start-ups

Introduction

The final part of the BUSS1 course takes you beyond the start-up planning process and asks you to consider how a new business has performed after it has traded for a while.

We have already learned that most new businesses don't survive beyond 3-5 years of trading. Some go bust. Others are simply closed or are allowed to drift as a business shell" because the original entrepreneur has gone onto do other things. Some start-ups are eventually sold and integrated into larger businesses so that they no longer exist as a separate business.

Given this, how can we assess whether a start-up has been successful or not?

The trick is to consider why the business was set-up in the first place – to look at the **aims and objectives** of the entrepreneur.

When you take your BUSS1 paper, it is important to remember that businesses are started for a variety of reasons. Not every new business wants to grow rapidly and become a multi-million pound concern. Not every entrepreneur wants to build a business that will generate significant personal wealth. Not every business will end up employing dozens of employees and open locations around the country and overseas.

So a good place to start this section is to consider the main types of start-up business and think about how their aims and objectives vary.

We'll look at four key kinds of business:

- Part-time businesses
- Lifestyle businesses

- Social enterprises
- Ambitious businesses

Part-time businesses

Do you sell goods on eBay or other online auction sites? If so, then you run a part-time business.

Part-time businesses are a great way to start in business; a chance to learn what is involved without giving up the "day job" or whilst you complete a course. Part-time businesses are also ideal for people with significant other commitments (e.g. child-care).

You'll come across many part-time businesses. EBay, party-based products, consultancy and mail-order can all be sold successfully using this method.

The objectives of a part-time business tend to be quite modest. Most aim to supplement an existing living, or earn money to cover costs. For the business to grow to its full potential, it is almost always necessary to take the business on full-time.

Lifestyle businesses

These are businesses where the entrepreneur works full-time, but the main aim of the enterprise is to provide a satisfactory living. These entrepreneurs are not ambitious; they are happy to "tick over" with the business essentially producing the same performance each year.

The main advantages of lifestyle businesses are lower stress (usually) and a low financial investment.

The downside is that lifestyle businesses tend to generate low returns and they still have quite a high failure rate.

A quick search of a business-sale website, such as www.businessesforsale.com, will soon show you how many lifestyle businesses change hands every year. Take a look at the following link which will show you how many fish & chip shops are being sold on a particular website. These are all lifestyle businesses; they are being sold for various reasons (retirement, illness, financial need etc). A new owner will come along eventually and try to make a success of the fish & chip shop. But the chances are the business will be back on the market in the future!

The aims and objectives of a lifestyle business are also likely to be modest.

Social enterprises

Social enterprises are businesses that trade in goods or services for a social purpose. They have grown in number rapidly in recent years, with some very well known names establishing themselves against much larger competitors. Good examples include Divine Chocolate & Cafedirect.

Social enterprises have a different group of aims and objectives from a traditional profit-motivated business. They are usually said to focus on the "triple bottom line", where their objectives are measured in terms of:

(1) Financial surplus (surplus is similar to profit)

(2) Social responsibility and contribution

(3) Environmental impact

The surplus made by a social enterprise goes to one or more social aims. For example, Divine Chocolate pays a dividend from its annual surplus (profit) to the cocoa farmers who supply the raw materials. This in turn is reinvested in local infrastructure projects by the farmers.

Ambitious businesses

Our final category of business is, perhaps, the most obvious. The entrepreneur behind an ambitious business aims for significant growth – in sales, profits etc. These businesses tend to need higher investment, they take more risks, but the returns are potentially higher. Success takes great energy, careful planning and a bit of luck. Starting and running an ambitious business can dominate the life of the entrepreneur.

When we read about the success stories of fast-growing start-ups or famous entrepreneurs, we are normally looking at ambitious businesses.

The key point to remember in BUSS1 is that not all businesses are started with such ambitious aims and objectives.

The risks of business failure

In the previous section we pointed out that describing a business as a "failure" is potentially misleading, since it depends on what the aims and objectives are.

However, whatever the kind of business, all face risks that the business will not achieve what it aims to do. In some cases that means risks that lead to the financial failure of the business.

What are the reasons why a new business fails? Here are the main ones:

Poor management	Plain and simple. Poor decisions are taken; costs are not kept under control; management don't understand their market & customers well enough and offer a poor quality product. Bad management is at the heart of most business failures. A business idea or model that is a bad one is likely to fail, and this is a racing certainly if it is accompanied by poor management.
Sales lower than expected	It is very easy to over-estimate the sales that will be achieved by a start-up. The business plan can be over-optimistic about the price that customers will accept and the volumes they will buy.
Start-up costs too high	Another common weakness of start-up business planning. Sometimes costs are simply missed out of the cash flow forecast. Alternatively the amount is under-estimated. This is a big concern at the start-up stage, where finance is limited. A delayed product launch is often the cause of start-up cost overruns.
Unexpected shocks	These can come in various forms, although you have to be pretty unlucky to be caught by them. For example, you may have seen some businesses devastated by the floods in the UK during 2007 – those without suitable insurance may have failed. Businesses dependent on the UK housing market are suffering during 2008 as house prices fall and the number of transactions drops. However, for the vast majority of failed business, unexpected shocks **are not** the reason.

Overdependence on small number of customers	A start-up that is too reliant on one or more customers is at greater risk of failure than one which has a broader, more diverse customer base. If the customer relationship breaks down, or the customer itself fails, then the business is at risk. A good example – the component and other suppliers that were over-reliant on supplying Rover Cars, which failed in 2005.
Poor quality	This is linked to poor management. Persistent poor quality products or services will ultimately kill a business.
Overtrading	Sometimes a small business can grow too quickly and, as a result, it runs into serious cash flow problems. A business whose sales grow rapidly might find that customers take too long to pay their debts, whereas stocks build and suppliers demand payment on time. The result can be a business which appears to be successful and profitable, but which runs out of money.

Assessing the business plan

One way the AQA examiner might test this area is by asking you to assess the strengths and weaknesses of an entrepreneur's business plan. If we remember the main purposes of the start-up business plan, one was to provide a disciplined approach to working out how the business should be run. What things should you look for?

Imagine you are one of the five Dragons in the Dragon's Den and you are presented with an overview of a business idea and the supporting business plan. What questions would you ask the budding entrepreneur about the plan and the idea?

There are some fundamental questions that every plan (and business) should be able to answer confidently:

Is there a market in the gap?	Never mind a "gap in the market". Much more important is whether there is sufficient demand for the start-up's product or service. How many customers will buy, at what price, and when?
What competition will the business face?	Poor business plans tend to be complacent about the competition a new business will face. It is too easy to assume that entering a market will be plain-sailing and that existing operators in the market will not responds (e.g. by starting a price war or by launching a promotional campaign to retain customers).
Does the business have the right management skills and experience?	A good idea will not work unless the entrepreneur has the right skills and is able to build the right kind of team around her/him. It is worth knowing that experienced entrepreneurs tend to produce better business plans! They have made mistakes in setting up their previous businesses; they tend to be cautious about sales forecasts and prudent when it comes to forecasting costs and cash flows. In your BUSS1 exam, look for evidence that the featured entrepreneur(s) have set up and run businesses before – it could be significant.

Does the business have sufficient cash before it reaches profitability?	Cash flow is a critical issue for nearly all start-ups. As an investor or lender, you would look very carefully to see if the cash flow forecast has been prepared carefully and is realistic.
What is the break-even position	Yes – real business people actually use a concept covered in your business studies course! For start-ups that exist in order to make a profit, it is vital to understand the break-even position and the relationship between sales, variable costs and fixed costs.

Exam tips

It is vital that you appreciate the different objectives that a start-up might have. Not every business wants to grow rapidly into a multi-million pound concern. Many small businesses simply want to earn a lifestyle return.

In the BUSS1 case study, you should expect the business to be facing risks, problems and the possibility of eventual failure. This is entirely normal for a start-up.

You should also expect reality to be different from the assumptions made in the original business plan.

Guided revision questions

Revision questions for Assessing Business Start-ups

(1) State three possible objectives of an entrepreneur starting a new business (3 marks)

(2) State three benefits of a start-up setting clear objectives for the business (3 marks)

(3) Explain what is meant by a "smart" objective (3 marks)

(4) Describe the main risks faced by a start-up high street fashion retailer (5 marks)

(5) What is meant by a "lifestyle business" (2 marks)

(6) Explain why a poorly-prepared business plan might lead to the failure of a start-up? (4 marks)

(7) Explain why an unexpected increase in demand might cause problems for a small business (4 marks)

(8) State three reasons why there may be a change in demand that is not anticipated by a new business (3 marks)

(9) Outline the steps a small business could take to deal with an unexpected increase in costs (4 marks)

(10) State two ways in which poor management might cause the failure of a start-up (2 marks)

(11) Explain why cash flow is often a major problem for a start-up (5 marks)

(12) Why might a franchise be less of a risk than an alternative form of start-up? (4 marks)

(13) Describe three ways in which an entrepreneur could assess the successful of a start-up after it has been trading for two years (4 marks)

Mini Case Studies

Moonpig.com

http://www.moonpig.com

Key areas:

Sources of business ideas

Business angels

Break-even

Back in 1997, Nick Jenkins got the idea for his online personalised greetings card business Moonpig.com whilst taking an MBA course. Nick was looking for a product idea that could be sold using the Internet but which could be personalised and delivered through the post.

Nick financed the start-up with £160,000 of his personal funds, and spent the cash on renting premises, hiring a web development company and a printing specialist. However, it some became clear that Nick need to invest significantly more in order for the business to break-even. He has since raised several million pounds from business angel investors, although he still has a significant stake in the company.

Looking back, Nick says that it was easier for him to raise money from business angels once he had established the business and could show them a trading record. It took five years for Moonpig to start making a profit.

Gear4.com

www.gear4.com

Key areas:

Sources of business ideas

Loans from family

Market size and growth

Tom Dutteridge looked long and hard for a successful idea he could turn into a business.

Frustrated by corporate life, Tom took the plunge in 2003 and decided to spend three months coming up with five business ideas. Armed with his savings and a loan of £23,000 from his father, Tom developed a plan to build a consumer electronics business that would sell direct to other retailers. He named it Gear4 and invested all the remaining finance in making a product that would allow car drivers to play their iPod using the car stereo.

The product was an immediate success and by offering a wider range of related iPod accessories, sales in the first year were £1m. These increased to £1.8m in year 2 and £4.8m in year three. In 2008, turnover is expected to be £18m.

Honeyrose Bakery

At the age of 33, Lise Madsen decided she wanted to start up a business of her own. She says “It was a combination of desire for independence and having enough professional confidence to do it.”

Lise formed her baking business Honeyrose with an idea of making "organic cakes full of sinful

www.honeyrosebakery.com

Key areas:

Reasons for becoming an entrepreneur

Limited company structure

Government assistance for entrepreneurs

Aims and objectives

Cash flow forecasts

ingredients". To finance the idea, Lise raised £70,000 and friends and her previous employer, in return for a 17.5% stake in the shares of the new company. Lise also got a £320,000 grant from the London Development Agency. She started production in 2001.

Turnover has grown to £3 million in 2008. However, profit is not the only objective of the business. Lise gives away 5% of annual profits to worthwhile causes through the charitable organisation she has set up, Yellow Flower Foundation.

Lise believes that she did not raise enough finance at the start-up stage. As a result, she says the first two years were a "nightmare with cash-flow issues".

Cult Pens

www.cultpens.com

Key areas:

Market segmentation

Sources of finance – retained profits

Simon and Amanda Walker invested start-up funds of £4,000 to establish their business Cult Pens.

They had become tired of their IT careers in London and decided to buy a small stationery shop in Dartmouth as a new challenge. The shop proved the ideal platform for launching an e-commerce business that targeted a niche in the pens market.

They focused on inexpensive pens, popular with offices. Cult Pens stocks 3,600 types of pen, about 40% of the total available.

Although the start-up investment was quite low, for the first couple of years they ploughed profits from the shop back into new stock, infrastructure and staff.

Sport Stars

www.sport-stars.co.uk

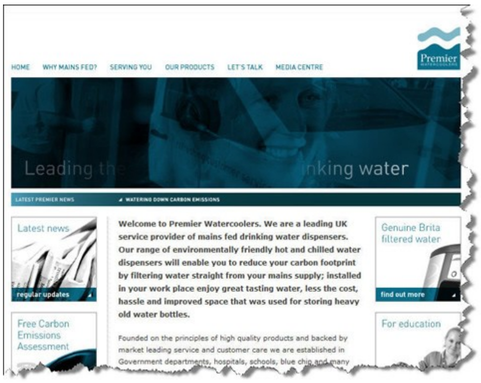
Key areas:

A change in government policy created the opportunity for James Taylor to grow his business providing sports coaching to schoolchildren.

The government ruled that teachers must spend 10% each day away from the classroom to prepare lessons. James recognised an opportunity and approached head teachers with the proposal that they employ Sport Stars coaches to cover this time

He secured five contracts and by the second year sales had risen to £500,000.

Where did the idea for Sports Coaches come from? James used his personal experience running sports clubs at boarding schools and his time as a sports

<table>
<tr><td>Sources of business ideas – personal experience</td><td>coach at LA Galaxy football club.</td></tr>
<tr><td>Premier Watercoolers

www.watercoolers.co.uk
Key areas:
Sources of business ideas – business experience
Sources of finance – bank loan & personal funds
Employing people</td><td>Phil Langley used his time working in the sales team of a bottled water firm to carry out market research for his own business. He identified an opportunity to supply mains-fed water coolers rather than the more traditional bottle-fed coolers.

Phil raised finance by taking out a £100,000 bank loan and investing £20,000 of his own funds (by selling his car).

After trading for a year, Phil realised he needed outside help to grow the business. He brought in James Cullum, an experienced engineer, in return for a 10% share of the company.

Annual turnover for Premier Watercoolers has now reached £3.5m. One of Phil's main problems has been recruiting and retaining the right people to help sustain the growth.</td></tr>
<tr><td>Everything Environmental

Key areas:
Sources of finance: business angels
Business planning
Market research
Market segmentations</td><td>Evan Lewis came up with the idea for his start-up, Everything Environmental, whilst working in a sales job for a corporate gift business. His idea? To set up his own corporate gift business acting as a wholesaler for gifts made from recycled materials.

Evan raised £150,000 from private investors and had begun trading within three months!

Producing a realistic business plan was important to Evan. The results for the first year of trading were within £1,000 of the budgeted profit. Evan's target market segment is undoubtedly a small niche in the much larger corporate gifts market.

Sales of eco-friendly items are only £10m p.a. out of a total market of £1 billion. However, the eco-friendly segment is growing fast. As a result, Evan's business is enjoying sales growth of over 100% per year.

Evan's advice to entrepreneurs is straightforward: "Do be clear where your market is, because that determines your product, the price, how you sell and your entire business strategy.</td></tr>
</table>

Take Note  www.takenotetyping.com ***Key areas:*** Business planning Economic sectors Outsourcing / employing people Characteristics of successful entrepreneurs	Here is an example of a start-up that required zero start-up finding. It simply required the time and effort of the founders to get the business running. Rebecca Procter and Vanessa Rogers did a business studies degree together. But when they started their transcription service business Take Note, they didn't bother with a business plan or financial projections. Perhaps they just didn't have time! Take Note offer transcription and meeting note-taking services, so the business is firmly in the tertiary sector. With no funding for the start-up, Rebecca and Vanessa have used outsourcing as the main way of keeping costs down (and lowering the break-even output). The company now sub-contracts around a hundred people working at home, transcribing from audio files or copy typing. Finding good workers is no problem, says Vanessa, as there are plenty of highly skilled new mothers, retired secretaries and people who've been made redundant. Like most entrepreneurs, says Rebecca, they turn their hand to everything. "We do all the admin., accounts, marketing, design, personnel and emergency cover. We also like to meet clients personally, which is very important for an internet business."
Fruitful Office  www.fruitfuloffice.com ***Key areas:*** Business structure – partnership Employing people	Daniel Ernst and Vasco de Castro started Fruitful Office to take advantage of an opportunity to help employers make their workplaces healthier. Their business supplies baskets of fresh fruit to offices. David and Vasco decided to form a partnership. The set-up costs were £16,000, but turnover is already projected to rise to £1m per year. Growing the business in the early days has not been without its problems. Hiring suitable staff has been a problem, since the fruit packing work has to be done during unsociable hours. Buying cheap equipment also proved to be a false economy - it kept on breaking down. One of the lessons that Daniel and Vasco have learned is the importance of the entrepreneur delegating tasks. As they say, "every hour spent doing a job you could delegate is an hour lost in growing the business".

Examination Technique

Introduction to BUSS1

The BUSS1 exam is based on a short, unseen case study which describes the planning process of a start-up. The format of the paper will change between exam sittings. However some things will stay the same:

- It is likely to include some numerical data and you should prepare to perform calculations on areas such as break-even, market share, cash flow totals etc.
- The case study will focus on a new business and the planning process it has undertaken (note – the type of business featured will vary)
- The whole of the Unit 1 specification can be examined
- There will be 60 marks available and the exam will last for 75 minutes

The questions are contained in two sections.

Section A	Shorter questions, offering lower marks, focusing on definitions, explanations, calculations etc
Section B	Longer questions, offering higher marks, which focus on analysis and evaluation

35% of the marks for Unit 1 are given for demonstrating knowledge. So it is vital that you learn definitions for all the key terms in the specification. The glossary included in this tutor2u course companion contains all the terms you need to know. You also need to know the various formulae for making calculations. There aren't too many of these – but make sure you know them and have practiced calculations many times before the exam.

In the following sections, we provide more detail about the different ways in which you are assessed in the BUSS1 exam and some tips for success in the exam hall.

How you are assessed

Your BUSS1 exam will test your ability to show certain exam skills which are known as **"assessment objectives" ("AO").**

There are four assessment objectives. You need to understand what they are, how to meet them and produce answers which allow the examiners to award marks for your script.

The four assessment objectives are summarised further below.

How do you know what you are being required to do in each part of the exam? There are always two key **clues** to look for:

(1) **Mark allocation** – if a part of a question only offers 2 marks, then you only need to demonstrate knowledge (e.g. provide a short definition). A task that has more than more than 10 marks available requires you to show all the exam skills – knowledge, application, analysis and evaluation.

(2) **Trigger words** – these are the words that start each question (your teacher may also refer to them as "command" words. They provide a strong guide as to the nature of the task.

AO1	**Knowledge** **35% of marks**	**Demonstrate knowledge** and **understanding** of the subject content. This might include giving a definition of a term or providing a list of relevant items. An example of a knowledge-only question would be: "What is meant by market segmentation?", or "State two items that would be included in cash outflows in a cash flow forecast" The mark allocation in a question is the best guide to spotting questions where you need to demonstrate knowledge and understanding. Look out for 2 or 3 mark questions starting with trigger words like "define", "state", "identify" or "what is meant by?"
AO2	**Application** **28% of marks**	**Apply knowledge** and **understanding** to problems and issues arising in the case study business. Look out for the following trigger words for questions requiring application: "calculate", "explain", "outline", "distinguish between" As you can see, calculations come into application. Make sure you practice them! Questions offering 3-7 marks will normally require both knowledge and application.
AO3	**Analysis** **20% of marks**	**Analyse** problems, issues and situations Your answers to questions that require analysis require much more depth. Often you will be asked to look at the advantages and disadvantages of a situation faced by the case study business. A well-reasoned description of both sides of the argument, using properly structured paragraphs, and a conclusion bringing the answer together is the key. If you see parts of questions offering more than six marks, then that should alert you to the need to include proper analysis in your answers. Key trigger words for analysis include: "Examine"; "Consider"; "Analyse", "Explain why" You will almost certainly have to practice writing in this structured way if you are to do well in BUSS1.
AO4	**Evaluation** **18% of marks**	**Evaluate, distinguish between** and **assess** appropriateness of fact and opinion, and judge information from a variety of sources Evaluation is the toughest skill to demonstrate and one which students often feel uncomfortable with. Evaluative questions ask you to reach a judgement. After looking at both sides of an argument or after analysing one or more options, you need to state your view on the best way forward. You might also be required to

		offer a reasoned opinion on the most important factors affecting an option. Whatever the task, it is vital that you express an opinion that is supported by your **analysis** of the issue – at all times making sure you **apply** business studies theory to the case study business. Questions requiring evaluation carry the highest marks. Common trigger words for evaluation include: "Evaluate"; "Discuss"; "To what extent?"; "Justify your view"; "Do you think that?"

Top tips for exam success

During your BUSS1 course you may come across a lot of advice about how to well in the exams. Depending on the source of the advice, some will be great, some sensible and some downright misleading. Tutor2u's AQA team has spent many years teaching AQA AS Business Studies. So, for what it is worth, here are our suggestions:

Before the exams

Keep up-to-date with business. Reading textbooks and this Companion is fine. However, there is no substitute for keeping an eye on business news stories and seeing how real businesses act.

Tutor2u's Business Studies Blog is a great source of news, resources and links for AQA AS Business Unit 1. In fact, we have a dedicated BUSS1 channel with its own RSS feed and Facebook-friendly widget. Make sure you access this blog as often as possible so that you get an advantage over other students.

Keep practicing key term definitions. Remember that 35% of the marks in BUSS1 are for knowledge. You can save time in the exam by knowing your definitions off by heart. Use the glossary included in this Companion.

Practice the numerical aspects of BUSS1 until you can handle all the calculations and interpret the data with your eyes closed (well – almost). You must be able to calculate percentages, percentage changes, and be able to interpret tables, charts & graphs etc. It might take a while for you to get comfortable with the numbers-bit, but it will be worth it.

Build lists of advantages and disadvantages for the main topics in BUSS1. Your Companion gives you a head start on these. As a minimum, make sure you know the advantages and disadvantages of the different:

- Sources of finance (e.g. internal/external, shares/debt)
- Business structures (sole trader, partnership, limited company)
- Methods of primary & secondary research (main methods of each)
- Options for locating a business (e.g. home-based, virtual)
- Types of employment (e.g. full-time, part-time, flexible working)
- Sources of business idea (e.g. business experience, franchises)

You should, of course, practice as many exam-style questions as possible in the run-up to the exam day. This is a great way of highlighting gaps in your knowledge and understanding. It also allows you to practice those high mark-scoring exam skills.

On the day

Be prepared. It might sound daft, but you know you will have to do some calculations, so take a calculator. Someone in the exam hall will not have remembered to do this

Read the paper carefully so you can see what kind of business is featured and the kind of questions you are being asked to answer. Underline the trigger words & circle the mark allocations. Make a note of how much time you can afford to spend on each element – don't go over this limit.

Read the questions carefully and only answer in the ways that examiner asks you to do. Make sure you use separate paragraphs to demonstrate that you are moving onto a new point or that you are moving onto some analysis or evaluation. Leave at least two lines between each paragraph so that there is a little space if you need to add an extra point later on.

Make sure your paper includes any workings that you've done for the numerical questions.

Don't use non-business studies terminology or street jargon.