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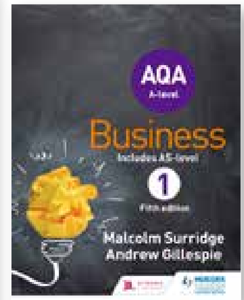

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Business

1 Fifth Edition

Malcolm Surridge and
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DYNAMIC LEARNING

HODDER EDUCATION
AN HACHETTE UK COMPANY

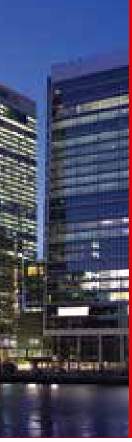
Contents

Unit 1

What is Business?

You should study business in a variety of contexts (e.g. large/small, UK focused/global, service/manufacturing) and consider:

- the importance of the context of business in relation to decision making
- the interrelated nature of business activities and how they affect competitiveness
- the competitive environment
- the ethical and environmental issues in decision making
- the influences on functional and strategic decisions and plans
- the factors that might determine whether a decision is successful, for example the quality of data
- how technology is changing the way decisions are made and how businesses operate and compete.



Chapter 1

Understanding the nature and purpose of business

Introduction

The purpose of this chapter is to introduce you to Business as a subject and to encourage you to think about the range of organisations that exist in modern economy. The UK has businesses of all sizes, from those employing just one person to those who employ many thousands. They also supply diverse products from high technology products such as military equipment to relatively simple services such as painting and decorating. This chapter also invites you to consider the targets that businesses attempt to achieve and how they might measure their achievements.

What you need to know by the end of this chapter:

- why businesses exist
- the relationship between a business's mission and its objectives
- the objectives that businesses commonly set themselves
- the reasons why businesses set objectives
- how businesses measure profit and why it is important.

Why businesses exist

1. What are businesses?

The word 'business' is derived from the idea of 'busy-ness'. This notion of 'busy-ness' is a good description of many business organisations. They are busy finding and buying resources, organising and using these resources in production, selling their products and making sure they supply what their customers want. This tells us that businesses are organisations that transform inputs or resources into outputs or **products** that are purchased by their customers.

Businesses are very diverse as well, and are present in many aspects of our lives. They supply an enormous range of **goods** and **services** that are demanded by individual consumers and other businesses. They supply essential products such as electricity, health care and education, as well as luxury products including jewellery, gourmet meals and designer clothes. Businesses supply goods and services. Goods have a physical existence and can be seen or held – examples include televisions and furniture. Services are products supplied by businesses which are intangible, such as cleaning, dental care or the provision of hotel accommodation.

Key terms

Good – a physical product such as a house or designer suit.

Service – an intangible item such as insurance or decorating.

Product – a more general term which includes goods and services.

Businesses are very important for the UK and bring a number of benefits to the country, its economy and its inhabitants.

- **Businesses create employment**. In March 2014 there were 30.43 million people working in the UK. This represented a rise of 722,000 compared with March 2013. Being in employment allows people to earn an income and therefore to benefit from being able to purchase a range of goods and services. The UK is an attractive location for many foreign businesses, for example Nissan, HSBC and Zara, and the employment that is created attracts many migrants.
- **Businesses create wealth**. Businesses in the UK have transformed resources into goods and services that have been in demand for many centuries. This process has created surpluses which have then been invested in a range of assets such as roads, bridges and hospitals and these in turn have brought significant benefits to the country. In recent years, for example, businesses have built the M6 toll motorway near Birmingham, increasing the country's wealth and bringing benefits to many people and other businesses. Businesses in the UK pay large amounts of taxation to the government. In 2012–13 UK businesses

paid taxes on their profits (called Corporation Tax) amounting to nearly £44 billion. The UK government is able to use this money in a variety of ways including building schools and power stations.

- **Businesses create new products**. Businesses can enrich the lives of people in the UK by creating new goods and services. Pharmaceutical businesses such as GlaxoSmithKline (GSK) research and develop medicines that can cure illnesses and extend the quantity and quality of people's lives. GSK created the anti-depressant drug 'Paxil' which has been highly successful and has generated sales of over £7.5 billion for the business.
- **Businesses can enhance a country's reputation**. Successful businesses can help to establish and maintain a country's reputation for being innovative and forward looking. The UK has a strong global reputation for producing top quality music and television programmes. Wall to Wall Television is a relatively small business which has an international reputation for producing well known programmes such as *The Voice* and *New Tricks*. These programmes sell in many countries and help to present the UK in a favourable light.

Businesses come in many types and sizes.

The size of businesses in the UK varies enormously. Figure 1.1 relates to businesses that are privately-owned, that is, not owned by the government. It shows that 99.2 per cent of the UK's businesses are small, having fewer than 50 employees. Small businesses provide a little under half the jobs in the UK but only earn 33 per cent of the revenue generated by selling goods and services. The UK has 4,682,000 small businesses.

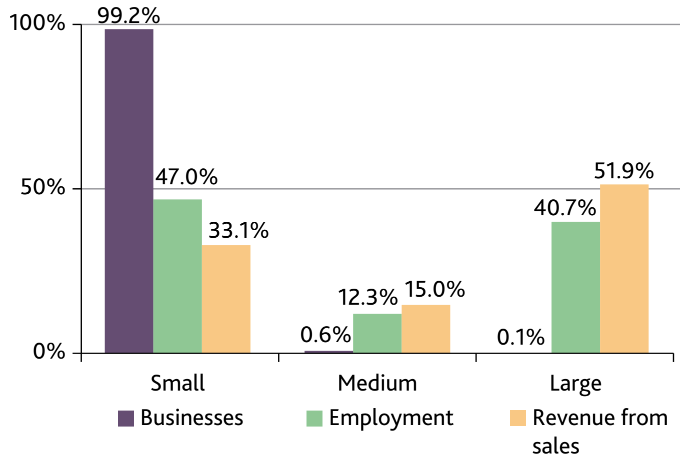


Figure 1.1 The proportions of the UK's businesses that are small, medium or large and their share of employment and sales revenue.

Source: Business Population Estimates, 2013
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/254552/13-92-business-population-estimates-2013-stats-release-4.pdf

In contrast the UK has relatively few large businesses. Only 0.1 per cent of businesses in the UK are classified as large – that is having 250 or more employees. This means that in 2013 there were only 7,000 large businesses in the UK. However, these are the ones that are generally well known and they appear most frequently in the media.

2. What do businesses do?

Businesses exist to transform inputs or resources into goods and services that are in demand from individuals and other businesses. This transformation process is illustrated in Figure 1.2 below.

The transformation or production process undertaken by businesses adds value to the inputs that are used, as illustrated in Figure 1.2. This increase in value occurs because the products are demanded by certain groups of consumers who will receive benefits from having that product. Because of this, buyers are willing to pay a price that exceeds that paid for the inputs or resources used in production. Apple is expected to launch a new version of

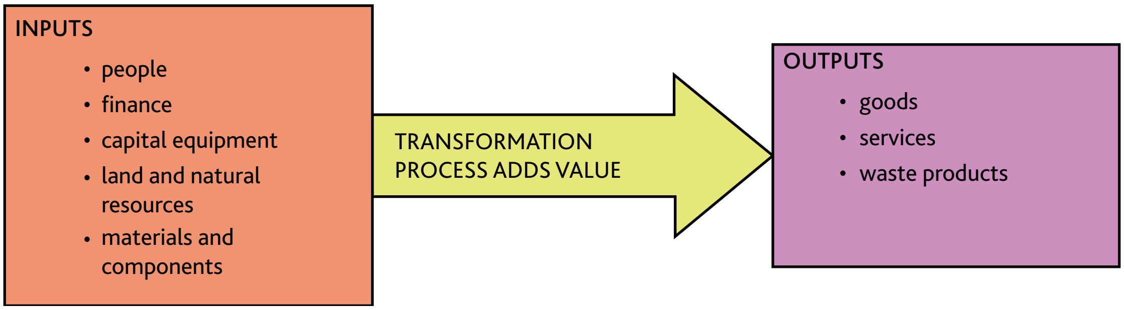


Figure 1.2 Adding value by transforming inputs or resources into goods and services

its iPhone soon. This will probably sell for between £600 and £900, far in excess of the cost of the resources used in it. Buyers will pay this price because the phone offers a range of benefits including the latest technology and status from owning a high fashion product.

Businesses interact with us throughout our daily lives. It is not necessary to visit a high street or a trading estate to see a business in operation. Modern methods of communication have brought businesses into our homes, our relationships and our leisure activities. We encounter them when buying goods and services, but also when engaging in everyday activities such as using the internet to research something or to communicate with friends. A business will have supplied the tablet, phone, laptop or other device you use to connect to the internet; a business will also provide the internet service and the webpages that you view. Finally, a business will have provided the energy to power your device and the telephone or satellite connection necessary to use the internet.

Businesses exist to satisfy our needs for a range of goods and services which we would be unable to provide for ourselves, either because we do not have the skills or time to supply them or because the costs of supplying them ourselves would be prohibitive. For example, without specialist businesses it is unlikely that we would be able to fly to other countries because we do not have the resources or skills to supply this service. Privately-owned businesses are an efficient means of supplying the wide variety of goods and services needed by modern economies. Other businesses that are owned and operated by the government may supply goods and services that would not otherwise be available. For example, it is common for governments to provide services such as street lighting and national defence.

Businesses also exist to satisfy other needs. They provide a means of satisfying people's desire to be creative or to make money. Some entrepreneurs establish businesses to allow them to express their creative talents. In 1993 Cath Kidston established a business selling distinctive fabric, wallpaper, china and clothing. Her design talents have created a successful business which operates internationally. Others have made vast fortunes from creating and expanding businesses. James Dyson, an inventor and founder of the Dyson business, has amassed net wealth estimated to be £3 billion in 2013.

People who create new businesses from an idea are often called entrepreneurs and they have to make many vital decisions early on in the life of the business. Once they have decided to start a business this will be followed by other decisions such as where to locate the business, how many products to produce and at what price they should be sold. The decision makers in larger businesses, normally managers, make decisions such as whether or not to produce a new product, to try and sell in a foreign market or to buy another business.

3. Types of businesses

It is possible to categorise businesses and the products they supply in different ways. Some businesses supply products directly to the final consumers and these are called business-to-consumers (or B2C) firms. Well known businesses such as McDonald's and Sony are examples of B2C businesses. In contrast, some other businesses supply their products to other business organisations and these are known as business-to-business (B2B) firms. For example, Tata Steel manufactures large amounts of steel in locations throughout the world. It sells its steel to other businesses, such as car manufacturers, to help them to supply their own products.

A business can also be categorised according to the sector of the economy in which it is based. Businesses are classified into one of three sectors according to

Business in focus: JCB

J.C. Bamford Excavators Limited, known as JCB, is a British multinational manufacturer of equipment used in the construction, agriculture, power generation, waste management and demolition industries. JCB produces a range of over 300 machines and maintains a reputation for excellent customer service. JCB is one of the world's top three manufacturers of equipment such as excavators, forklift trucks, power generators, dump trucks and lighting equipment. It employs around 11,000 people on four continents and sells products in 150 countries.

JCB produce many types of construction equipment

JCB's products are bought principally by businesses for use in their own production processes. Some of JCB's customers are large businesses themselves and can place substantial orders with the business.

Questions

1. Why is one of JCB's machines of more value than the inputs used by the business to create it?
2. JCB is a B2B firm and sells its products to a relatively small number of businesses. Do you think that it is easier for a B2B business to sell its products?

the types of goods and services they supply. The three sectors are:

- **Primary** – agriculture, forestry, fishing, mining and quarrying, oil and gas extraction.
- **Secondary** – manufacturing, construction and the supply of electricity, gas and water.
- **Tertiary** – the supply of services, for example hotels, catering, transport, education and health.

Some businesses may operate in more than one sector. For example, BP is one of the world's largest oil businesses. Its gas extraction activities place it in the primary sector, while processing the mineral oil into petrol and other products is a manufacturing process, making it part of the secondary sector. It also operates retail outlets that sell its products and these are part of the tertiary sector.

Over time the tertiary sector has supplied a greater proportion of production (measured by **gross domestic product** or **GDP**) in the UK, while manufacturing businesses have become relatively less important. One reason for this trend is that businesses overseas are able to supply manufactured products more cheaply. However, rising incomes in the UK have led to increased demand for services such as hotels, travel and catering. Figure 1.3 illustrates the changing importance of the three sectors in the UK since 1964.

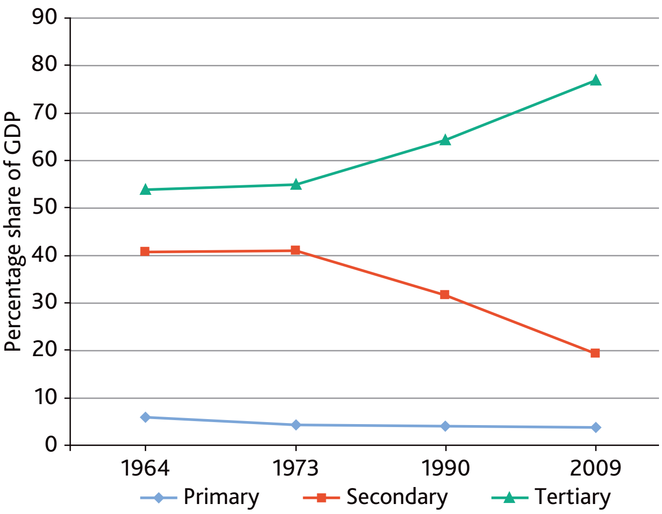


Figure 1.3 Percentage shares of GDP for primary, secondary and tertiary sectors in the UK, selected years

Source: ONS (2010e), United Kingdom National Accounts and previous issues

Key term

Gross domestic product (GDP) – measures the total value of the production of an economy (that is, all a country's businesses) over a period of time, normally one year.

What do you think?

Consider the following question with reference to Figure 1.3 above.

Does it matter if manufacturing businesses become less important in the UK over time?

Study tip

Being able to understand and interpret data is an important part of studying Business successfully. You should become familiar with the different ways in which data can be presented, ensure you understand what the data tells you (and what it doesn't) and consider how it might affect a range of businesses and the decisions they make.

The relationship between mission and objectives

Mission statements

A **mission statement** sets out what a firm is trying to achieve, i.e. the reason it exists. For example, a business may set out to be 'the lowest-cost producer in the industry' or to 'maximise the returns for our owners'. The mission may include a statement of what the firm believes it is, what it values, which markets it wants to compete in, and how it intends to compete. Mission statements commonly focus on:

- the organisation's values
- non-financial goals it may pursue
- the benefits of the business to the community
- how consumers are to be satisfied.

Key terms

Mission statement – sets out a business's overall purpose and is used to direct and stimulate the entire organisation.

Aims – long-term plans of the business from which its corporate objectives are derived.

Objectives – medium- to long-term goals established to coordinate the business.

By setting out a mission everyone within the business knows what they should ultimately be trying to do. All of their actions should be directed towards the same thing. This should make decision-making easier, for example when faced with a series of options managers can compare them in relation to the overall objective of the business. Mission statements can also motivate people – they know exactly why they are there and what the business is trying to achieve, and this can give them a sense of belonging and direction.

However, some mission statements are unrealistic, or simply public relations exercises, and so employees pay little attention to them. A mission statement will only have value if everyone within the firm supports it; in such circumstances a mission statement can be a powerful way of uniting people and developing a positive corporate spirit.

The list below sets out some mission statements used by well-known organisations:

- '… to provide the finest, most technologically advanced power systems. Whether our products are for use on land, at sea or in the air …' (Rolls Royce)
- 'To bring inspiration and innovation to every athlete in the world.' (Nike)
- '… to ensure the ability of Earth to nurture life in all its diversity.' (Greenpeace)
- '… to give people the power to share and make the world more open and connected.' (Facebook).

Aims and objectives

1. Aims

Aims are long-term plans from which a business's objectives are derived; these are often referred to as corporate aims, meaning they relate to the whole business. Businesses do not normally state aims as numerical targets, but rather in qualitative terms. For example, the house builder Taylor Woodrow states that its corporate aim is 'to make our homes environmentally sustainable to build and to live in'. Tesco's aim is to broaden the scope of the business to enable it to deliver strong, sustainable long-term growth. Although these are quite different, sustainability is becoming a major and growing influence on business thinking.

Corporate aims (and mission statements) are set by the senior employees within the business and are intended to provide guidance for setting other objectives and also to guide and assist more junior managers in their decision making. Thus, for example, managers throughout Tesco's stores will take decisions intended to achieve the organisation's aims of broadening the business's scope and delivering strong, sustainable growth. In this context, opting to open supermarkets in China and to sell electrical products and clothing are all important long-term decisions which the business has taken with the intention of meeting its corporate aims.

From its corporate aims (and its mission statement) a business can set quantifiable objectives, such as gaining a 35 per cent share of a particular market in Europe within three years.

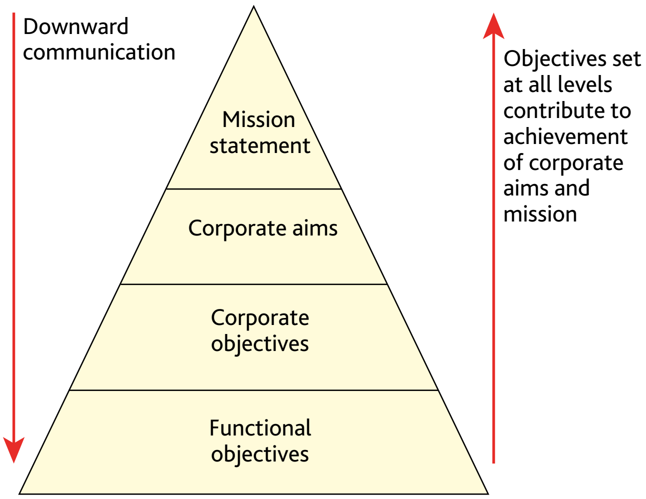


Figure 1.4 The hierarchy of objectives

2. Objectives

Once a firm has established its mission it can set its objectives. The objectives turn the mission statement into something which is more quantifiable. Rather than simply being a statement of intent, an objective sets out clearly what has to be achieved.

Objectives are medium- to long-term goals established to coordinate the business. Objectives should be quantified and have a stated timescale, such as to earn a 20 per cent return on capital next year.

To be effective objectives should be SMART. SMART objectives must be:

- **Specific** – they must define exactly what the firm is measuring, such as sales or profits.
- **Measurable** – they must include a quantifiable target, for example a 10 per cent increase.
- **Agreed** – if targets are simply imposed on people they are likely to resent them. If, however, targets are discussed and mutually agreed upon, people are more likely to be committed to them.
- **Realistic** – if the objectives are unrealistic (because they are too ambitious, for example) employees may not even bother to try and achieve them. To motivate people the targets must be seen as attainable.
- **Time specific** – employees need to know how long they have to achieve the target – is it two or three years?

Business in focus: Starbucks' mission statement

Our mission: to inspire and nurture the human spirit – one person, one cup and one neighbourhood at a time. Here are the principles of how we live that every day:

Our Coffee

It has always been, and will always be, about quality. We're passionate about ethically sourcing the finest coffee beans, roasting them with great care, and improving the lives of people who grow them.

Our Partners

We're called partners, because it's not just a job, it's our passion. Together, we embrace diversity to create a place where each of us can be ourselves. We always treat each other with respect and dignity. And we hold each other to that standard.

Our Customers

When we are fully engaged, we connect with, laugh with, and uplift the lives of our customers – even if just for a few moments. Of course, it starts with the promise of a perfectly made beverage, but our work goes far beyond that.

Our Stores

When our customers feel this sense of belonging, our stores become a haven, a break from the worries outside, a place where you can meet friends. It's about enjoyment at the speed of life – sometimes slow and savoured, sometimes faster.

Our Neighbourhood

Every store is part of a community, and we take our responsibility to be good neighbours seriously. We want to be invited in wherever we do business. We can be a force for positive action – bringing together our partners, customers, and the community to contribute every day.

Source: Adapted from Starbucks website
http://www.starbucks.co.uk/about/business-information/mission-statement

Questions

1. Explain how senior managers at Starbucks could use this information to set objectives for the business.
2. Why do many well-known businesses publicise their mission statement on their website?

An example of a good objective might be 'to increase profits by 25 per cent over the next four years'. By comparison, a bad objective would be 'to do much better' – it is not clear what 'doing better' actually means, how it will be measured or how much time is available to achieve the objective.

Common business objectives

1. Profits and profit maximisation

Profits are maximised when the difference between sales revenue and total costs is at its greatest. Some firms set objectives which involve achieving a minimum level of profit, allowing the business and its managers to focus on other objectives. This approach, known as satisficing, may be pursued by smaller family-owned organisations. It allows the owners of these businesses to achieve other targets such as entering new markets or increasing the size of the business.

Other businesses may seek to earn the greatest possible profits to satisfy their shareholders' desire for high dividends. This might be a shorter-term objective. Others may pursue the longer-term objective of providing acceptable levels of dividends, but also growth in the value of the business and therefore in the share price. This can provide shareholders with long-term financial benefits.

2. Growth

Many businesses pursue growth because their managers believe that the organisation will not survive otherwise. If a firm grows, it should be able to exploit its market position and earn higher profits. This benefits shareholders (in the long term) by providing greater dividends as well as offering better salaries and more job security to the employees and managers of the business. We saw earlier that Tesco has set itself the aim of strong sustainable growth and this will have been transferred into quantified objectives, possibly relating to sales figures or grocery market share in other countries.

3. Survival

This objective is for the business to continue to trade over a defined period of time, rather than to submit to some form of commercial pressure and be forced to cease trading. This is an important objective even for the largest of businesses at certain times. It may become a key objective during, for example:

- periods of recession or intense competition
- times of crisis, such as during a hostile takeover bid.

4. Cash flow

For most businesses cash flow is a vital element of success as it is essential to be able to pay debts on time. This is especially true of businesses that have long cash cycles. A cash cycle is the time that elapses between the outflow of cash to pay for the resources needed to produce a product and the receipt of cash following the sale of the product. Businesses in industries such as pharmaceuticals and construction may face long cash cycles. Walt Disney, the global entertainment business, has an objective to maximise its cash flow position. The failure to set an objective relating to cash flow could have dire consequences for a business if it is unable to pay its debts as they fall due. In the worst case a shortage of cash could result in a business having to cease trading.

5. Social and ethical objectives

Social objectives include targets that relate to matters such as providing employment for people or improving facilities for local people (for example building a play park for local children). Ethical objectives are those that are based on moral principles. Examples of ethical objectives include protecting the environment through the use of sustainable production techniques and ensuring that suppliers receive fair and prompt payment. Such objectives have received much attention in recent years. In part this is the result of increasing awareness on the part of many individuals and groups who have an interest in a business. Some investors will only invest in businesses that trade with ethical or social objectives. Importantly, a significant proportion of customers seek to purchase products from businesses with social and ethical objectives. Pursuing such objectives, and publicising the fact, can offer a business a distinctive and attractive image.

Key terms

Profit – measures the extent to which revenues from selling a product exceed the costs incurred in producing it over a time period.

Cash flow – the amount of money moving into and out of a business over a time period.

Ethics – moral principles that can shape the way a business behaves.

Stakeholders – individuals or groups (such as employees, customers and local residents) who have an interest in a business.

Business in focus: Marks & Spencer and its Plan A

Marks & Spencer's Plan A was launched in 2007

Plan A is all about doing the right thing.

Plan A has 180 commitments with the aim of making the business the most sustainable major retailer by 2015. We launched Plan A in January 2007, setting out 100 commitments to achieve in 5 years. We have extended Plan A to 180 commitments to achieve by 2015.

Through Plan A we are working with our customers and our suppliers to combat climate change, reduce waste, use sustainable raw materials, trade ethically and help our customers to lead healthier lifestyles.

We are doing this because it's what you want us to do. It's also the right thing to do. We're calling it Plan A because we believe it's now the only way to do business.

There is no Plan B.

Source: Adapted from Marks & Spencer's website http://plana.marksandspencer.com/about

Questions

1. Analyse the benefits that Marks & Spencer would expect to receive from the social and ethical objectives set out in its Plan A.
2. Do you think that any retailer can expect to succeed in the future without setting and publicising social and ethical objectives?

6. Diversification

Diversification is an objective where a firm produces an increased range of unrelated goods and services. Adopting this objective allows a business to spread its risk by selling a range of products (rather than one) or through trading in different markets. If one product becomes obsolete or a market becomes significantly more competitive, then the additional products or markets will provide a secure source of revenue for the business while it seeks new projects. Diversification avoids a business having 'all its eggs in one basket' and has been the principle behind the creation of conglomerate businesses. PepsiCo Inc., the multinational soft drink and snack producer, pursued the objective of diversification to extend its product range beyond soft drinks to help it to compete with its powerful rival Coca-Cola.

Short-run and long-run objectives

When deciding what it wants to achieve, a business can set both short-run and long-run objectives. If a business has a long-run growth objective it may want to invest in training for its employees to improve skills and performance, expand into new markets and invest in developing new products. All these activities may help to achieve the long-run growth objective. However, they will prove expensive and short-run profits may fall.

By comparison a business which wants to maximise its profits in the short run and is not concerned about the long term might cut back on all these activities. It would reduce expenditure on training and developing new products. In the short run profits may increase but in the long run this business may be in a much weaker position.

UK firms are often criticised for setting objectives which are too short term and do not involve long-term planning. Critics say that UK businesses fail to invest enough in ensuring they are strong enough over the long term. Currently investment by UK businesses is very low; instead they often go for short-term rewards. In their defence, UK managers often blame their investors for insisting on short-term rewards. Many shareholders in the UK are businesses such as pension funds and banks. These businesses need to make money for their own investors and often want these earnings quickly; if a business cannot deliver, pension funds and banks will simply move their investments elsewhere.

Why businesses set objectives

By setting objectives a business and the people who have an interest in it (known as its stakeholders) can gain a number of benefits.

By agreeing on objectives with other people within the business, managers can ensure that everyone is working towards the same overall goal. Without any clear objectives people are much more likely to do their own thing. Coordinating the efforts of all employees can improve organisational performance, especially in large businesses that may have people employed in different locations. For example, one of Tesco's objectives is to expand its retail services in all areas. This helps to encourage all its employees to seek ways to increase sales and can be supplemented with individual sales targets for specific stores.

Objectives can also be very motivating for employees because they set out exactly what the firm wants them to achieve. If an employee is set a target he or she knows precisely what they have to do. Without a target they may not be sure whether or not they are doing the right thing. Having a target also enables employees to measure their progress and to ascertain whether or not they (or the relevant part of the business) will achieve the target.

Objectives are also used to review the success of a business's plans. Managers can measure how much has been achieved compared to the target that was set. For example, the management team at Tesco can see if the sales or growth targets set for various parts of the business have been achieved. If an objective has not been achieved managers and employees can discuss why this has happened and what they can do differently to achieve the target next time. Tesco announced in April 2014 that its overall sales had fallen by 1.5 per cent. This is likely to mean that the business did not achieve its sales objective. The business's managers and employees can learn from this and look to improve Tesco's future performance.

The measurement and importance of profit

Costs and revenues

The relationship between profit, cost and revenue

Profit is a very important objective for many, but not all businesses. Achieving a certain level of profit, or the maximum possible, will be an important objective for many of the UK's largest and best known businesses such as Vodafone or Centrica, but not for others such as charities which pursue other objectives.

One of the most important relationships for a business is the formula:

profit = total revenue – total costs

This formula allows businesses to calculate whether they might make a profit and, if so, what that profit might be.

Key terms

Revenues – the earnings or income generated by a firm as a result of its trading activities.

Profit – the surplus of revenue over total costs for a business over a trading period.

Business costs

What is a cost? It is simply the expenditure a firm makes as part of its trading. Some of the expenses or costs firms face include payments for raw materials, fuel and components, as well as for labour (paid as wages and salaries).

The costs faced by a business can be classified in a number of ways, though the most common is to divide them into **fixed** and **variable costs**.

Key terms

Fixed costs – costs that do not alter when the business alters its level of output. Examples include rent and rates.

Variable costs – alter directly with the business's level of output, for example, fuel costs.

Total costs – fixed and variable costs added together.

Average costs – total costs of production divided by the level of production or output to give the cost of producing a single unit of output.

Fixed costs

Fixed costs do not change when a business alters its level of output. As an example, a business's rent will not vary if there is an increase or decrease in the level of production. Other examples of fixed costs include management salaries and interest payments made by the business.

The graph in Figure 1.5 relates to NTV plc, a business that researches, designs and manufactures televisions for sale throughout Europe. You can see that whether the business produces 1 million or 7 million televisions annually, the fixed costs faced by the business will remain the same – £250 million.

The reason that fixed costs do not alter is that NTV plc simply uses its existing facilities more intensively at times when it is receiving larger orders – this may be in the autumn months as Christmas approaches. As a further example, in the summer months an ice cream manufacturer may increase its output, thereby using existing production facilities more intensively. However, its rent, rates and other fixed costs will be unchanged.

Maths moment

$\frac{1+b}{c}=3$

The managers at NTV have calculated that if the business manufactures 2 million televisions in a year, the average fixed cost of producing one (that is the part of the business's fixed costs that has to be paid by a single television) will be £250 million divided by 2 million televisions which equals £125.

Calculate NTV Plc's average fixed cost of production if it produces:

1. 1 million televisions a year
2. 5 million television a year.

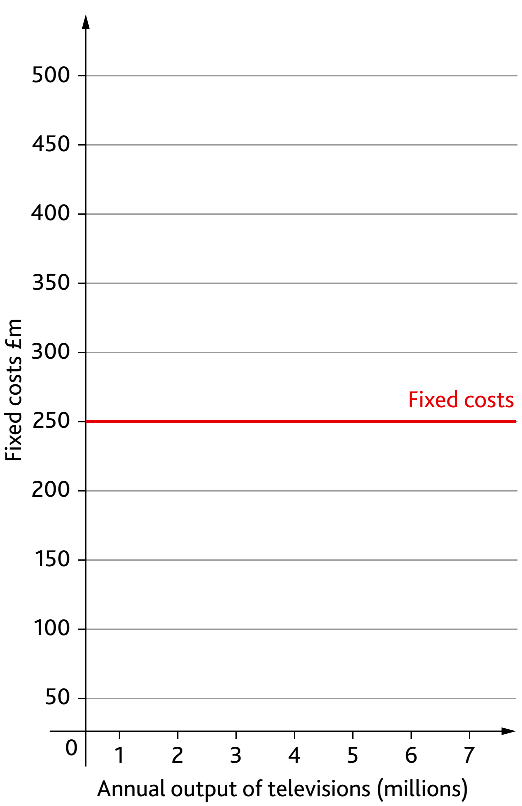


Figure 1.5 Fixed costs for NTV plc

Variable costs

In contrast to fixed costs, variable costs alter directly with the level of a firm's output. This means that a business which is increasing its output is likely to have to pay higher variable costs, whereas one reducing its output could expect variable costs to fall. Expenditure on fuel, raw materials and components are all examples of variable costs.

NTV faces variable costs of £350 for each television it manufactures (see Figure 1.6); this is required to pay for the components, fuel, packaging and labour involved in manufacturing the televisions. Thus, to produce 2 million televisions, the business faces variable costs of £700 million (2 000 000 x £350); to manufacture 5 million televisions results in variable costs of £1 750 million (5 000 000 x £350). This level of production is illustrated in Figure 1.6.

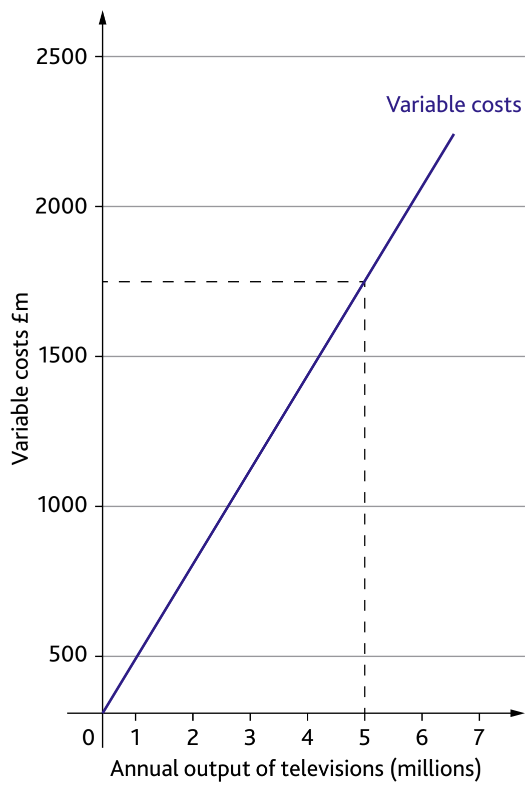


Figure 1.6 Variable costs for NTV plc

Figure 1.6 shows that expenditure on items such as fuel, labour, raw materials and other materials rises directly along with output. Variable costs are drawn as a straight line for simplicity. However, in the real world, the line may gradually flatten out as businesses frequently negotiate lower prices when placing large orders. For example, NTV is obviously a large business and would have a lot of power when negotiating with its suppliers. Thus NTV plc may be able to purchase materials more cheaply per unit if it places exceptionally large orders. This would reduce the variable costs for each unit of production (or average variable costs) as output increased, causing the variable cost line to flatten slightly. The variable costs associated with the production of 5 million televisions might, for example, be £1,600 million. If so, this would mean that the variable cost of one television is actually £320, not £350.

Semi-variable costs

Some firms face costs which are classified as semi-variable because they have fixed and variable elements.

Transport costs can be an example of a semi-variable cost. Most businesses pay a fixed, annual charge for renting vehicles and for insurance. However, they also have to pay costs such as fuel and the wages of drivers which are likely to increase if output rises and more products are transported. However, vehicle rental and insurance costs are fixed as they do not change as the firm increases or lowers its output levels. Taken together, these elements mean transport costs can be semi-variable.

Total costs

The calculation of **total costs** assumes that all the costs faced by a business are either fixed or variable. This means total costs can be calculated by using the following formula:

total costs = fixed costs + variable costs

Level of production (televisions, millions)	Fixed costs (£ million)	Variable costs (£ million)	Total costs (£ million)
0	250	0	250
1	250	350	600
2	250	700	950
3	250	1,050	1,300
4	250	1,400	1,650
5	250	1,750	2,000
6	250	2,100	2,350
7	250	2,450	2,700

Table 1.1 Cost information for NTV plc

Total costs can be used to calculate the average cost of producing a single unit of production. For example, in Table 1.1 we can see that the average cost of production is £600 per television if NTV plc manufactures 1 million televisions. However, this falls to £400 per television if it increases its production to 5 million televisions per year. This reduction takes place because the business's fixed costs are being spread over a higher level of production or output and therefore have a diminishing impact on average costs of production.

What do you think?

Why are televisions normally manufactured by large businesses, rather than small ones?

Costs and decision making

Total costs of production are an important piece of information for a business. Managers of a business can use this information when taking decisions on levels of output and prices to be charged. For example, firms that have very high levels of fixed costs, perhaps due to expensive equipment, will seek to produce large quantities of output. This reduces the effect of fixed costs on selling price by spreading them over a large quantity of sales.

Study tip

Always seek to identify and explore the many links that exist within the subjects that make up Business. We look more closely at the relationship between the scale of a business and its costs in the year 2 book.

Information relating to costs can be extremely helpful to managers when deciding on prices. It is unlikely that a business will want to set prices below the costs of production for any length of time. If a business knows the average cost of producing a product, then it can set a price that is higher which will ensure it makes a profit, so long as it is able to sell all that it produces. This is known as 'cost-plus pricing'.

Sometimes businesses are not able to control the price at which they sell their products – they might be a small firm in a very competitive market. In these circumstances it is important to know costs of production to decide whether it is possible to sell products at a profit. This will help the business's managers to make a decision on whether to enter a market.

In reality it can be difficult for businesses to calculate the average costs of production. Many businesses produce a range of products using the same production facilities. This means that its fixed costs may relate to a number of different products and it can be difficult to divide these fixed costs accurately between different products.

Business in focus: Easyjet

easyJet is one of the UK's most successful businesses. The airline was founded as recently as 1995 yet it had over 60 million passengers flying with it in 2013. One of the key reasons for the business's success is that its prices are attractive to its customers. A recent survey by Which? found that its average fare was £76.05. However, rival airline Ryanair was reported to have an average fare of £70.53.

One key element in offering low prices is that easyJet controls its costs strictly. Its website says:

> *By cutting out unnecessary frills and carefully controlling the cost of doing business, we are able to offer fares that represent great value for money – often at a fraction of the prices offered by other airlines.*

Sources: Adapted from *The Daily Telegraph*, 21 October 2013 & easyJet website

http://www.telegraph.co.uk/travel/travelnews/10393475/Ryanair-not-the-cheapest-airline.html

http://www.easyjet.com/en/aboutourfares

Questions

1. Explain why it is important for easyJet to control its costs.
2. Do businesses always benefit from controlling costs as tightly as possible?

Business revenues

A business's revenue is its income over a period of time. You may also encounter the terms sales revenue, sales income or turnover, which have the same meaning. Businesses calculate the revenue from the sale of a single product as well as from their entire product range. In either case the calculation is the same:

revenue = quantity sold x average selling price

In most circumstances, a firm can exercise some control over the quantity it sells and hence over the revenue it receives.

If a business reduces its selling price, it can normally expect to sell more. Whether this increases its revenue depends on the number of additional sales it makes as a result of reducing its price. If competitors also reduce their prices, then few extra sales will result and revenue is likely to be relatively unchanged. However, if the price reduction makes the product cheap compared to those of its competitors, and it offers similar benefits, then a price reduction might increase sales, significantly increasing the revenue received by the business.

Similarly, a rise in price can be expected to reduce sales. The size of the fall in sales will depend on many factors, including the loyalty of customers and the relative quality of the products. The amount by which sales fall will determine whether the firm receives more or less revenue following its price rise. Some businesses sell products that are unique or regarded as highly desirable, perhaps because they are fashionable. For example, some producers of fashion clothing, such as Gucci, can charge high prices and still enjoy relatively high sales.

Web link

To find out more about Gucci and its prices visit www.gucci.com/uk/home

What do you think?

Why is Gucci able to set high prices for its products and not suffer a large fall in sales and in sales revenue?

The relationship between price and sales revenue is explained by the concept of the price elasticity of demand.

Profits

A business makes a profit when, over a period of time, its revenue exceeds its total costs of production. The formula necessary to calculate profit is:

profit = total revenue + total costs

A business's profits depend upon two main factors: profit margins and the quantity (or volume) of sales.

A profit margin is the amount or percentage of the final selling price that is profit. If a business sells products where a large percentage (or margin) of the price is profit, then it is likely to make large profits.

However, the quantity a firm sells will also affect the amount of profits it earns. In general if a business sells a greater quantity of its products it will make more profit, so long as it does not have to reduce price (and therefore its profit margin) to achieve higher sales.

If a business's costs are greater than its revenues over an accounting period the enterprise will make a loss rather than a profit.

Why are profits important?

For many businesses, profits are very important and are often used as a measure of success. Many people who invest in enterprises do so in the hope and expectation of making a good return on their money. For such investors it is not simply profits that are important, but rather the size of the profit. A larger profit means a greater return for the investor.

Making a profit brings a range of benefits to a business and its owners and can influence a number of decisions.

- Profitable business may be attractive to customers. The financial performance of many of the UK's better-known businesses is reported in the media. Customers may believe that profitable businesses are selling desirable products and may be willing to make long-term arrangements with a business that they consider to be financially secure.
- A business that makes a profit, especially one which exceeds expectations, is likely to be able to persuade individuals and institutions such as banks to invest in it. This can make it cheaper to raise finance and may encourage and support expansion decisions.
- A profitable business may be bought by a larger rival. A profitable business is attractive in itself and may own valuable brands or be popular in a market which the larger business would like to enter. This can earn the original owners large sums of money. In 2014 Equifax, a multinational American finance business, bought TDX, a profitable Nottingham-based business offering similar services in a £200 million deal. This purchase offered Equifax a stronger foothold in the UK market.
- A profitable business is more likely to have the confidence of its suppliers and they may be more willing to allow the business time between the delivery of suppliers and payment. This is effectively an interest-free loan.

Study tip

Profit can often be judged better when it is compared to something else. We compare profits to the business's revenue from sales in Chapter 17.

For some businesses, earning a profit may not be at all important. A number of businesses are not established and operated with the aim of making profits. Charities, for example, do not seek to make profits. This type of business seeks to raise the maximum amount of income possible, or to provide a high-class product, while earning enough to cover its costs. In 2013, the RSPB, the UK's largest wildlife charity, announced it had generated a surplus of £90.1 million. This figure was recorded in the charity's accounts as 'net income available for charitable purposes' and will be reinvested in a range of ways including buying new wildlife sites.

Business in focus: Prezzo's expansion plans

Pasta and pizza chain Prezzo has announced it is to add up to 30 new restaurants to its estate this year after serving up another healthy rise in profits.

The group, which trades as Prezzo, Chimichanga Tex-Mex and Cleaver, opened 28 new sites during the financial year to December 2013 as it expanded to 237 outlets and increased its profits by 11% to £20.4 million. This stage of the business's growth provided its first presence in major cities such as Belfast and Leeds, as well as additional sites in Bath, Oxford and Glasgow.

It has opened one new restaurant in Ripon so far this year and is on site in a further six locations as it looks to add another 25 to 30 new outlets in 2014.

Source: Adapted from an article in *The Herald Scotland*, 9 April 2014
http://www.heraldscotland.com/business/business-news/prezzo-plans-further-expansion-as-profits-rise.1397044858

Questions

1. Prezzo is expanding very quickly. Why might this make it more challenging for the business to increase its profits rapidly?
2. Do you think that all of a business's owners would be in favour of a decision to use increased profits to finance expansion?

Assessment activities

Sections (a), (b) and (c) of these assessment activities are relevant for students taking AS and A level examinations. The questions in section (d) are for A level students only.

(a) Knowledge check questions

1 What is the difference between a service and a product?

2 State two reasons why businesses exist.

3 List two inputs used by a business to make goods or services.

4 State two features of a business's operations that may be reflected in its mission statement.

5 Is the following statement true or false? 'When drawn on a graph, variable costs always start at the origin (where the two axes intersect.)'

6 State two features of a good objective.

7 Complete the following formula:
revenue = …………… x average selling price.

8 A business has total costs of £12.5 million for producing 500,000 items. The variable cost per unit of producing an item is constant at £20. What are the business's fixed costs for the following?

(i) £12 million
(ii) £2.5 million
(iii) £1.5 million
(iv) £3.5 million

9 A business sold 37,000 garden sheds last year at an average price of £250. This year it plans to reduce its price to £225 and expects its sales to rise by 15%. How much revenue can it expect to receive this year?

(i) £9,573,750
(ii) £8,325,000
(iii) £10,637,500
(iv) £9,775,750.

10 A business has gathered the following information in relation to its most recent year of trading:
- it produced and sold 75,000 items
- the average selling price was £150
- its fixed costs were £4.5 million
- its average cost per unit of production was £85.

How much profit or loss did the business make during the year?

(i) £375,000 profit
(ii) £6,750,000 profit
(iii) £375,000 loss
(iv) £4,875,000.

(b) Short answer questions

1 Explain one benefit to a rapidly expanding business of setting clear business objectives. (4 marks)

2 The following data applies to a recently established business:
- selling price = £500
- variable costs = £255,000
- fixed costs per unit of output = £120
- sales = 1,000 units.

Calculate the business's profits. Show your workings. (5 marks)

3 Merlin plc constructs bridges and tunnels throughout the EU. Explain why the business considers setting cash flow objectives to be important. (5 marks)

4 Explain one reason why it is important for a business that is expanding into new markets to record a profit. (6 marks)

(c) Data response question

LEVI STRAUSS & CO

Levi Strauss & Co has just been voted one of the world's most ethical businesses and operates with many ethical objectives. It is known for selling high quality clothing, but has not received much publicity for its ethical objectives.

The business is developing a new product: a Dockers line of clothes called Wellthread. The line brings together the best practices in materials sourcing and garment manufacturing, providing social benefits and fair levels of pay to factory workers in Bangladesh and delivering durable khakis, jackets and T-shirts to consumers.

These clothes, of course, don't come cheap. Trousers cost $140, T-shirts $50 and jackets $250. Levi Strauss faces a big challenge of finding ways to sell Wellthread to mainstream consumers so that the principles involved in its design can be deployed throughout the business.

Beyond that, the business must figure out how to reconcile a commitment to long-lasting clothes with a desire to grow revenue by selling more stuff. Levi Strauss is a private business, albeit a big one, with $4.6bn in revenues in 2012.

Source: Adapted from an article in The Guardian, 6th November 2013

http://www.theguardian.com/sustainable-business/live-strauss-antidote-fast-fashion

1 Explain why Levi Strauss & Co might face a big challenge in selling its Wellthread range to mainstream consumers. (6 marks)

2 Analyse the reasons why Levi Strauss & Co sells its products at high prices. (9 marks)

3 To what extent do the benefits of operating with ethical objectives outweigh the drawbacks for Levi Strauss & Co? (15 marks)

(d) Essays

1 Is maximising profit always the most important objective for large well known businesses whose activities are reported regularly in the media? (25 marks)

2 To what extent are mission statements only of value to large businesses? (25 marks)

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Business For A-level Year 1 and AS

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