

AQA

A-level

BUSINESS

THIRD EDITION

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1 What is business?

Understanding the nature and purpose of business

Why businesses exist

REVISED 

Businesses exist in many shapes and sizes and for different purposes. The opportunity for making **profit** is an important reason why they exist, but it is not the only reason. Other reasons are:

- + to provide goods and services; this includes public services, such as the NHS and police and fire services
- + to develop a good idea (enterprise)
- + to provide help and support for others, most notably charities that raise funds in various ways to help and support the lives of others

Mission statements

REVISED 

A business **mission statement**, sometimes called a 'vision statement', defines what an organisation is and why it exists. It is a declaration of its core purpose and focus. Here are two examples:

To passionately create innovation for our stakeholders at the intersection of chemistry, biology and physics. (The Dow Chemical Company)

Bring inspiration and innovation to every athlete in the world. (NIKE, Inc.)

The purpose of the mission statement is to help bring focus and meaning to a business and act as a guide when making critical decisions that may affect the direction of a business.

A **mission statement** is a written declaration of a company's core purpose and focus and defines the reason for its existence.

Now test yourself

TESTED 

- 1 List three reasons why businesses exist.
- 2 Explain briefly why a business would write a mission statement.

Answers online

Common business objectives

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When looking at the **objectives** of a business, it is important to remember that they are quite complex and will vary according to circumstances and the type of organisation. A charity will have different objectives from a public limited company but even different public limited companies may have different objectives. Three key objectives of business are:

- + survival
- + growth
- + profit

Over recent years the global nature of business and the intense competition in many markets have meant that two other objectives have become increasingly important, namely:

- + customer service
- + corporate social responsibility (CSR)

CSR refers to the commitment of a business to behave ethically towards its workforce, the local community and society at large, i.e. companies take responsibility for their impact on society.

An **objective** is a goal to help a business achieve its mission.

When looking at business objectives, it is also important to recognise that each functional area of a business will set objectives that should contribute to the business achieving its overall objectives. This is illustrated in Figure 1.1.

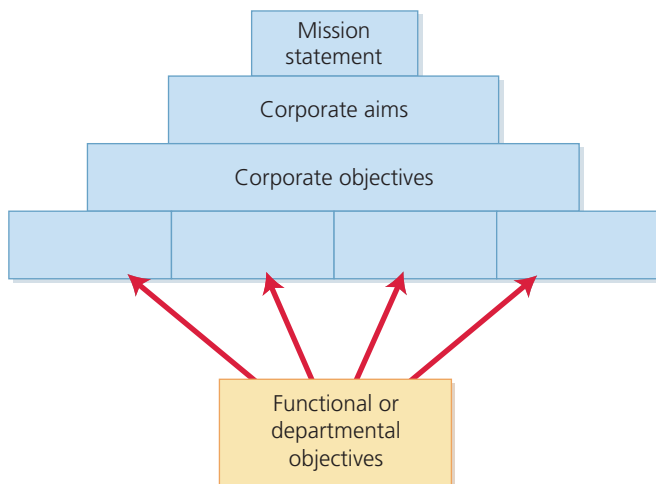


Figure 1.1 The hierarchy of objectives

Typical mistake

Do not assume that all businesses have the one objective of making a profit or that the objectives will always be the same for a particular business. They are likely to change over time.

The relationship between mission and objectives

REVISED

The mission statement of a business outlines the bigger picture and generally establishes the core values and principles that help guide the conduct and action of staff. **Objectives**, however, are goals that are set to achieve the overall mission of the business.

Objectives differ from the mission in that they are **actionable** and **measurable**. Without the mission statement, the objectives have no direction, but without the objectives, the mission is unachievable. Putting together the mission and objectives provides a balance that helps to shape a business's operation and service.

In addition to being actionable and measurable, objectives should have the following **SMART** characteristics. They should be:

- + **Specific:** objectives must be clear, precise and well defined.
- + **Measurable:** it must be possible to know when an objective has been completed.
- + **Achievable:** objectives must be within capabilities and have sufficient resources.
- + **Realistic:** an objective must be challenging but possible to achieve given the capabilities and resources.
- + **Time based:** there must be a deadline to work to.

As an example, an objective for a new coffee chain entering the UK market might be to increase market share by 2.5% a year for the next 5 years. This is a SMART objective as there is a clearly defined and measurable goal, whereas simply aiming to achieve growth in market share is not.

The relative importance of different objectives is likely to vary over time depending on circumstances. In difficult economic times, survival is likely to be more important than profit or environmental targets, whereas in a booming economy, profit, growth and social issues will take on a far more important role.

Why businesses set objectives

REVISED

There are a number of reasons why businesses set objectives:

- + The fact that objectives will be measurable and time based means that they can be used to evaluate performance.

- + If they are realistic and achievable, they can provide motivation for those who are responsible. However, they should not be too easily achievable and there should be an element of challenge.
- + Objectives should also be specific and, as a result, will give meaning to planning and ensure that a business remains focused on its mission.

Now test yourself

TESTED

- Outline how a mission statement differs from objectives.
- List five business objectives.
- Draw up a table to illustrate the likely objectives of the following: a public limited company; a public sector organisation; a charity.
- Outline why it is necessary for any business objective to be SMART.

Answers online

Making links

The mission and objectives of a business can be a driver of decision making and strategy, but their importance is likely to vary according to the opportunities and threats the business faces.

Exam tip

Objectives will not be the same for all companies and will change over time. Read any stimulus material you are given in the exam carefully to ascertain which objectives are important and why for the business in question.

The measurement and importance of profit

REVISED

Profit is the reward that owners or shareholders of a business receive for taking the risk of investing in the business. Profit therefore provides an incentive for setting up in business. When measuring the level of profit achieved, it is first necessary to understand what is meant by revenue and the various costs involved.

Revenue is the money received from sales and is calculated by multiplying the units sold by the price of each unit. When considering revenue, be aware that other terms might be used, such as **turnover**, **sales turnover** and **sales revenue** — they all mean the same thing.

Variable costs are the costs that are directly related to output and, as a result, vary directly with output. Examples include direct labour (workers who are directly involved in the production process) and raw materials.

Fixed costs, as the name suggests, are costs that are fixed and will not change in the short term. These costs will have to be paid whether or not any production takes place, and include rent, rates and director salaries.

Total costs are the fixed costs and variable costs added together and represent the total costs of production in a given time period.

Armed with figures for revenue and costs, it is possible to calculate profit for a business using the formula:

$$\text{profit} = \text{total revenue} - \text{total cost}$$

Worked example

A business produces 10,000 units which it sells for £5 each. Its variable costs are £25,000 and its fixed costs £10,000. What is its profit?

$$\text{profit} = \text{total revenue} - \text{total costs}$$

$$\text{total revenue} = 10,000 \times £5 = £50,000$$

$$\text{total cost} = \text{variable costs} + \text{fixed costs} = 25,000 + 10,000 = £35,000$$

$$\text{profit} = £50,000 - £35,000 = £15,000$$

Profit is the amount of money remaining once all costs have been deducted from the revenue.

Revenue is money received from sales.

Variable costs are costs that vary as a direct result of changes in the level of output.

Fixed costs are costs that do not change as a result of changes in the level of output.

Typical mistake

Make sure your definitions are complete and your examples are accurate. When defining variable costs, it is not enough to say that they vary with output — they vary *directly* with output. In the same way, it is not labour that is the variable cost but labour *directly* involved with output.

- 7 From the figures below, calculate the expected profit of ABC Ltd.
- Output: 10,000 units
Price: £5 per unit
Fixed costs: £5,000
Variable costs: £3 per unit
- 8 Identify three advantages and three disadvantages of a business choosing to maximise profits rather than pursuing an alternative objective. You should consider the question from the point of view of different stakeholders, such as customers, workers, shareholders and so on.

Answers online

Understanding different business forms

Different forms of business

REVISED

Private sector businesses

Businesses in the **private sector** fall into two broad categories: corporate and non-corporate, as shown in Table 1.1.

Table 1.1 Types of business

Corporate businesses	Non-corporate businesses
Private limited companies	Sole traders (or sole proprietors)
Public limited companies	Partnerships

Corporate businesses

Corporate businesses have a legal identity that is separate from that of their owners. Their owners benefit from limited liability. **Limited liability** restricts the financial responsibility of shareholders for a company's debts to the amount they have individually invested. It means that a company can sue and be sued and can enter into contracts.

Limited liability has an important implication for the owners (shareholders) of corporate businesses because, in the event of such a business failing, the shareholders' private possessions are safe. Their liability is limited to the amount they have invested.

There are two methods by which the liability of shareholders can be limited:

- ✚ **By shares.** In this case, a shareholder's liability is limited to the value of the shares that they have purchased. There can be no further call on the shareholder's wealth.
- ✚ **By guarantee.** Each member's liability is restricted to the amount they have agreed to pay in the event of the business being wound up. This is more common with not-for-profit businesses.

There are two main types of corporate company:

- ✚ **Private limited companies.** These are normally much smaller than public limited companies. Share capital must not exceed £50,000 and 'Ltd' must be included after the company's name. The shares cannot be bought and sold without the agreement of other shareholders, and they cannot be sold on the Stock Exchange. Private limited companies are normally relatively small and are often family businesses.

The **private sector** is the part of the economy that is made up of private enterprises — businesses that are owned and controlled by individuals or groups of individuals.

Corporate businesses are businesses which have a legal identity that is separate from that of their owners.

Limited liability restricts the financial responsibility of shareholders for a company's debts to the amount they have individually invested.

- **Public limited companies.** Their shares can be traded on the Stock Exchange and bought by any business or individual. Public limited companies must have the term 'plc' after their name. They must have a minimum capital of £50,000 by law; in practice, this figure is likely to be far higher. They have to publish more details of their financial affairs than do private limited companies.

Those forming a company must send two main documents to the Registrar of Companies:

- **Memorandum of Association.** This sets out details of the company's name and address and its objectives in trading.
- **Articles of Association.** This details the internal arrangements of the company, including the frequency of shareholders' meetings.

Once these documents have been approved, the company receives a Certificate of Incorporation and can commence trading.

Non-corporate businesses

Non-corporate businesses and their owners are not treated as separate elements — an owner's private possessions are all at risk in the event of failure. Sole traders and partners are usually said to have unlimited liability. However, since 2000 it has been possible to establish limited liability partnerships (LLPs) which offer partners financial protection.

The different types of non-corporate business are:

- **Sole traders (or proprietors).** These are businesses owned by a single person, although the business may have a number of employees. Such one-person businesses are common in retailing and services, e.g. plumbing and hairdressing.
- **Partnerships.** These comprise between 2 and 20 people who contribute capital and expertise to a business. A partnership is usually based on a Deed of Partnership, which states how much capital each partner has contributed, the share of profits each shall receive and the rules for electing new partners. Some partners may be 'sleeping partners', contributing capital but taking no active part in the business. Partnerships are common in the professions, e.g. dentists and accountants.

The advantages and disadvantages of the various legal forms of business are shown in Table 1.2.

Table 1.2 The advantages and disadvantages of different legal forms of business

Type of business	Advantages	Disadvantages
Sole trader	<ul style="list-style-type: none"> ➤ Simple and cheap to establish with few legal formalities. ➤ The owner receives all the profits (if there are any). ➤ Able to respond quickly to changes in the market. ➤ Confidentiality is maintained as financial details do not have to be published. 	<ul style="list-style-type: none"> ➤ The owner is likely to be short of capital for investment and expansion. ➤ Few assets for collateral to support applications for loans. ➤ Unlimited liability. ➤ It can be difficult for sole traders to take holidays.
Partnership	<ul style="list-style-type: none"> ➤ Between them, partners may have a wide range of skills and knowledge. ➤ Partners are able to raise greater amounts of capital than sole traders. ➤ The pressure on owners is reduced as cover is available for holidays and there is support in making decisions. 	<ul style="list-style-type: none"> ➤ Control is shared between the partners. ➤ Arguments are common among partners. ➤ There is still an absolute shortage of capital — even 20 people can only raise so much. ➤ Unlimited liability.

Typical mistake

Do not propose starting a new business as a public limited company in response to an examination question. The huge costs involved mean that this is most unlikely to happen.

Typical mistake

Many students argue that it is expensive and complicated to set up a private limited company. This is not true and these are not valid reasons to argue against the use of this legal form of business.

Type of business	Advantages	Disadvantages
Private limited company	<ul style="list-style-type: none"> + Shareholders benefit from limited liability. + Companies have access to greater amounts of capital. + Private limited companies are only required to divulge a limited amount of financial information. + Companies have a separate legal identity. 	<ul style="list-style-type: none"> + Private limited companies cannot sell their shares on the Stock Exchange. + Requiring permission to sell shares limits potential for flexibility and growth. + Private limited companies have to conform to a number of expensive administrative formalities.
Public limited company	<ul style="list-style-type: none"> + Public limited companies can gain positive publicity as a result of trading on the Stock Exchange. + Stock Exchange quotation offers access to large amounts of capital. + Stock Exchange rules are strict and this encourages investors to part with their money. + Suppliers will be more willing to offer credit to public limited companies. 	<ul style="list-style-type: none"> + A Stock Exchange listing means emphasis is placed on short-term financial results, not long-term performance. + Public limited companies are required to publish a great deal of financial information. + Trading as a public limited company can result in significant administrative expenses.

Now test yourself

TESTED 

- 9** Identify three differences between a corporate business and a non-corporate business.
- 10** Explain the difference between a sole trader and a partnership.

Answers online

Not-for-profit businesses

Not all businesses aim to make profits. A **not-for-profit business** is any organisation, such as a charity, that has business objectives other than making a profit. These businesses are also called 'social enterprises'.

Social enterprises trade in a wide range of industries and operate with a number of non-profit objectives:

- + **To provide services to local communities.** Some social enterprises may remove graffiti or clean up beaches for the benefit of entire communities.
- + **To give people job-related skills.** The chef Jamie Oliver ran a chain of restaurants (called 'Fifteen') with the prime objective of providing training in a variety of catering skills for young people from disadvantaged backgrounds.
- + **Fair-trading activities.** Some businesses import products from less developed countries but pay above the market price for the products. They may also invest in facilities, such as education and healthcare, in the exporting communities.

A **not-for-profit business** is an organisation that has business objectives other than making a profit.

Exam tip

Remember that a social enterprise may have a financial target in the form of maximising income. This is true of many charities, which then use much of this income to support good causes.

Mutuals

Mutuals are generally private businesses whose ownership base is made up of their clients and policy holders. They are characterised by the fact that they are run for the benefit of their members, e.g. cooperatives. Insurance companies and building societies were traditionally organised in this way, but many of the biggest have changed to become public limited companies.

Now test yourself

TESTED 

- 11** Explain three objectives that a not-for-profit business may have. For each objective identified, give an example.
- 12** How does a mutual organisation differ from other incorporated business organisations?

Answers online

Public sector organisations

Some services and businesses in the UK are controlled and run by the government or local authorities and are referred to as being in the **public sector**. This includes services such as the police, fire service, the BBC and the NHS, as well as local council-run services such as rubbish collection.

The public sector used to include a number of key industries and utilities (such as coal, steel, water, telecommunications etc.) that were known as 'nationalised industries'. These have largely been sold off to the private sector through a **privatisation** process.

Now test yourself

TESTED

- 13 Using three examples, define the term 'private sector organisation'.
- 14 Using three examples, define the term 'public sector organisation'.
- 15 Explain how business objectives might differ for private sector and public sector organisations.

Answers online

The **public sector** is the part of the economy that is owned and controlled by the government or local authorities.

Privatisation is the process of converting government-owned and government-controlled industries or businesses to the private sector.

Reasons for choosing different forms of business

REVISED

The key choice in terms of business structure is between **unincorporated** and **incorporated** status. There are a number of factors that may be considered here:

- + **Formalities and expenses.** Sole traders and partnerships are relatively easy to set up, with few formalities. This is an ideal form for small businesses such as joiners, electricians and corner shops.
- + **Size and risk.** If a business is and intends to remain small and carries little in the way of risk, then a sole trader or partnership may be the most appropriate form of business. This is the reason many corner shops, joiners and electricians remain as sole traders.
- + **Objectives of the owners.** If the objectives of the owners involve growth, then forming an incorporated business might be more appropriate. This is likely to give greater access to capital and limited liability would reduce the risks involved for the owners.

Reasons for changing business form

REVISED

The main reasons for changing business form are as follows:

- + **Circumstances.** Due to changing circumstances, such as the growth of a business, the owner(s) may wish to become incorporated in order to benefit from limited liability.
- + **Capital.** The owner(s) of a business may find it easier to raise capital by becoming incorporated or by becoming a public limited company if it is a private limited company.
- + **Acquisition or takeover.** This may cause a change of structure, e.g. a private limited company may be taken over by a public limited company.

Although businesses generally change from private limited to public limited, it is also possible to move the other way, i.e. from public to private limited. A business may do this to escape the constant scrutiny of the City and the pressure of short-term shareholder objectives. A good example of this is Richard Branson's Virgin Group.

Making links

When assessing the most appropriate form of business organisation, think about factors such as the market, the objectives of the business and the risk involved.

Now test yourself

TESTED 

- 16 Why are most new businesses set up as sole traders?
- 17 List three reasons for changing the legal form of a business from sole trader to partnership.
- 18 List three reasons for changing the legal form of a business from private limited company to public limited company.

Answers online

Exam tip

When deciding on the most appropriate legal structure for a business, always base any recommendation on the circumstances of the individual business: its objectives, its size, the product or service offered and the risk involved.

REVISED 

The role of shareholders and why they invest

Ordinary share capital is the money invested in a company by **shareholders** entitling them to part-ownership of the company. This capital is permanent and will never have to be paid back to the owners by the company. If the owners wish to get their money back, they can sell their shares through the stock market.

Private individuals can invest in public limited companies, becoming shareholders and part-owners of the business, but private individuals will only ever own a small fraction of the shares of any one business. By far the biggest shareholders will be financial institutions such as pension funds and insurance companies.

Shareholders have certain rights and a role to play in the running of a business:

- + Major decisions that will have an impact on shareholders are required to be approved by the shareholders at a general meeting called by the directors.
- + The main role of shareholders therefore is to attend this meeting and discuss whatever is on the agenda and to ensure the directors do not go beyond their powers.
- + There are also certain actions that can only be done by shareholders, such as the removal of directors or changing the name of a company.

There are two reasons why private individuals and financial institutions invest in shares:

- + **Income.** Shareholders are entitled to a share of company profits known as a **dividend**. The total amount given to shareholders is decided by the board of directors and can vary, but investors hope that the return they get will increase over time.
- + **Capital growth.** Shareholders hope that the value of their shares will increase over time.

Now test yourself

TESTED 

- 19 Explain two reasons why someone might choose to buy shares in a plc like Facebook.
- 20 Explain two reasons why a plc like Facebook sells shares.

Answers online

Shareholders are the owners of a limited company and include any person, company or other institution that owns at least one share.

A **dividend** is a share of the after-tax profit of a company distributed to its shareholders according to the number of shares held.

Typical mistake

Students often assume that when a shareholder sells shares they are sold back to the company. This is not true. Shares are sold through the Stock Exchange to a new shareholder who wishes to buy. This works in the same way as buying and selling used cars.

Influences on and the significance of share price changes

REVISED 

Both the level of dividend and the share price of a company can fluctuate, and it is important to recognise that they can go down in value as well as up. The price of an individual share is determined through the market. If demand is greater than supply, the price will go up; if there are more sellers than buyers, the price will fall.

There are a number of reasons why shares and dividends may fluctuate in value:

- + **Performance.** If there are worse than expected profits (e.g. if a retailer reports a poor performance during the Christmas period, a time when traditionally sales are good), shares will go down in value. If profits are higher, then share value will increase.
- + **Expectation of better or worse profit performance.** This might be as a result of a new product due to be launched on the market.
- + **Changes within the market or competitive environment.** For example, the move of consumers from the mainstream supermarkets such as Tesco to the discounters such as Lidl and Aldi will adversely affect the value of Tesco's shares.
- + **World uncertainty.** For example, conflict in the Middle East, a pandemic such as the Covid-19 one or an economic downturn will cause share prices to fluctuate.

Market capitalisation is calculated by taking the share price and multiplying it by the number of shares issued. This gives a valuation of a company. Changes in the share price will therefore affect the valuation of a business. A falling share price might provide an opportunity for investment or even takeover, or it might be an indication of a business in decline.

Worked example

Using the information below, calculate market capitalisation.

share capital	150m ordinary shares
share price	50p

market capitalisation = $150\text{m} \times 50\text{p} = \text{£}75\text{m}$

Exam tip

An economic downturn may be bad for some businesses, but for others it may be good (Tesco vs Aldi). The same can be said about conflict in the Middle East — this is bad for some businesses, but arms manufacturers are likely to benefit.

Market capitalisation is calculated as follows:

share price \times number of shares issued

The effects of ownership on mission, objectives, decisions and performance

REVISED

Profit is a key objective of many private sector businesses, and for some this may dominate the decision-making process.

Public limited companies are owned by shareholders who are often driven by profit, which can lead to a short-term approach to business. Decisions will be made on the basis of achieving profit, and the philosophy outlined in the mission statement may take a back seat.

The emphasis on profit has been demonstrated by Tesco. In 2014, Tesco saw falling profits and made mistakes in reporting profits as higher than they actually were. These failings led to a big fall in its share price and the resignation of its CEO.

Sole traders and private limited companies, however, will be less affected by this need to achieve profits and may be able to keep a closer focus on their mission statement and objectives.

Now test yourself

TESTED

21 List four reasons why share prices may fluctuate.

22 XYZ plc has a share price of 57p and 2,100 million shares. What is its market capitalisation?

Answers online

Understanding that businesses operate within an external environment

The world that businesses operate in is both unpredictable and uncertain, and changes in this external environment will have an impact on the demand for goods and services, costs and the way a business operates generally.

How the external environment can affect costs and demand

REVISED

The external environment refers to aspects that are out of the control of the business. These include:

- + competition
- + market conditions
- + economic factors (such as incomes and interest rates)
- + social and environmental issues
- + demographic factors

These factors not only affect demand for a product or service and the costs of operating a business but also impact on its ability to achieve its strategic goals and objectives.

Some influences in the external environment may be predictable in that trends can be spotted in a particular market, but others, such as the recession of 2008, are less predictable. Whether predictable or not, a business is likely to have to take action to prepare for or respond to the changing circumstances.

Competition

In a competitive environment, the strategies adopted by competitor firms will have an impact on a business. For example, we have seen the impact of competition on the grocery industry, with the big four of Tesco, Asda, Sainsbury's and Morrisons all suffering lower demand as a result of the rise of the discount retailers Aldi and Lidl. A business must try to differentiate its own products or services in order to encourage consumers to purchase them.

Furthermore, sometimes a competitor will come up with an innovative product or service that has a huge impact on the market it operates in. Examples are Apple, with the developments in the iPhone, and Nike, with the Vaporfly trainer.

Some businesses have also been quicker to use technology in their operations and have benefited, whereas others, such as Morrisons, were slow to adopt internet selling and suffered as a result.

Not only can competition have an impact on demand, but it can also have an impact on costs. In a competitive environment, firms are likely to compete on price, and this is likely to lead to pressure on costs, with individual firms looking to reduce costs wherever possible.

Market conditions

Market conditions refer to the characteristics of a particular market and might include its size, growth rate, any barriers to entry, seasonal factors and the amount and intensity of competition. All these factors will have an impact on a business in terms of demand and costs.

Exam tip

Do not always assume that any change in the external environment will be negative. Sometimes change can be positive for a business, and what is negative for one might be positive for another.

For instance, a market with high market growth and a low intensity of competitiveness is likely to present greater opportunities for higher demand than the opposite. A market with high barriers to entry, such as the aeronautical engine market, will protect operators in this market from new entrants.

Now test yourself

TESTED

- 23** Briefly explain why it is important for a business to differentiate its product or service in a competitive market.
- 24** Identify two barriers to entry for the aeronautical engine market.
- 25** Identify two reasons why the hairdressing industry is considered to have low barriers to entry.

Answers online

Economic factors

Economic factors include the stage of the economic cycle, interest rates, inflation and exchange rates. It is, however, interest rates and incomes that are the focus in Year 1.

Interest rates

Changes in interest rates can have a big impact both on the demand for goods and services provided by a business and on its costs. This impact may be positive for some businesses but negative for others:

- + Rising interest rates generally result in lower demand, as consumers are likely to have less disposable income due to higher borrowing costs for loans and mortgages. Other consumers might also be encouraged to save more as a result of rising interest rates.
- + Not all businesses will be affected negatively by rising interest rates, however. Discount retailers might actually benefit, for instance with consumers switching from traditional grocery stores such as Tesco to discount ones such as Lidl. Some restaurants, such as Pizza Hut, have also gained as consumers cut back on spending.
- + Costs will also be affected by changes in interest rates. A business with high levels of borrowing will be faced with higher costs when interest rates rise. This, coupled with any fall in demand, can be crippling for some businesses.
- + However, not all businesses will be affected in the same way with regard to costs — those with little in the way of borrowing will be less affected by interest rate rises.
- + Should interest rates fall, this is likely to have the opposite effect on both demand and costs.
- + Interest rates can also affect a business in terms of decision making: high or rising interest rates may lead to a business postponing new capital investment due to the costs involved. Low or falling interest rates will be more conducive to capital investment.
- + If a business has large cash reserves, it could benefit from rising interest rates due to the higher interest received.

Incomes

Demand in the economy will also be affected by the level of incomes. Falling incomes, as in the recession of 2008, saw falling demand, but as the economy picked up and incomes rose, demand increased. It should, however, be recognised that not all businesses will be affected to the same extent — demand for necessities will be less affected by changes in income than demand for luxuries. This is discussed in more detail in the section on income elasticity on pp. 41-43.

Exam tip

When looking at interest rates and income, be aware of the interrelationship between them. A rise in interest rates will indirectly cause a fall in the income available to consumers to spend (disposable income), whereas a fall will have the opposite effect.

- 26** How might a manufacturer of luxury products be affected by a rise in interest rates?
- 27** Explain why not all firms do badly in a recession.

Answers online

Demographic factors

Demography is the study of human populations based on factors such as age, gender, income and occupation, as well as birth and death rates, the level of public health and immigration. In the UK, the following factors are important:

- + The population is growing, with immigration making a large contribution to this growth.
- + The population is also an ageing one.

These factors affect the level of demand and the nature of the goods and services purchased. They also affect the structure of the working population itself. For example, workers are now facing the prospect of working longer before they receive the state pension.

It is important for businesses to recognise and anticipate the demographic changes taking place. Some businesses, such as B&Q, actively seek to recruit older workers, and the demand for holidays such as cruises has increased over recent years.

Environmental issues and fair trade

Businesses should not ignore environmental issues. The influence of the media and social media means that any misdemeanour in terms of pollution and exploitation of people in less developed countries is quickly brought to light. This can then have an impact on the reputation, sales and costs of a business.

In the UK, successive governments have introduced legislation to help protect the environment from pollution.

- + As a result, businesses have to spend large amounts on measures to ensure that water, air and the surrounding countryside are kept free of pollution.
- + Some businesses have located themselves overseas where legislation is less stringent, but even there they are not always free from the public gaze.

Concern for the environment is being driven by factors such as global warming. It is believed that carbon emissions are the major contributing factor to global warming and that not only businesses but also governments should be doing more to cut these emissions.

Sustainable development has also become an issue due to concerns that certain resources are running out and need to be conserved and sustained wherever possible. For example, the fishing industry is subject to quotas and some paper manufacturers now say they plant one new tree for every tree cut down.

Fair trade has also become a concern. This is about achieving better prices, decent working conditions and fair terms of trade for farmers and workers in less developed countries. This is likely to mean higher costs for a business but could also lead to greater demand and a better reputation and could act as a selling point.

Overview of external factors

The various external factors (see Figure 1.2) can have a significant impact on the demand for products and services, the costs incurred and profit. Although a business might sometimes be caught out by sudden changes in the external environment (e.g. the recession of 2008 and its depth), it should be able to anticipate and plan for some changes.

Making links

In the exam, always read the provided data or case very carefully as this will give you pointers towards the links you might make. For instance, for a business paying high regard to social responsibility there is likely to be a link to their mission.

For instance, demographic changes can be identified, changes in interest rates anticipated and new products and services provided in order to stay ahead of competitors. As a result, any negative impact on cost and demand may be minimised and any positive impact maximised.

POLITICAL	<ul style="list-style-type: none"> • Government type and policy • Funding, grants and initiatives
ECONOMIC	<ul style="list-style-type: none"> • Inflation and interest rates • Labour and energy costs
SOCIAL	<ul style="list-style-type: none"> • Population, education, media • Lifestyle, fashion, culture
TECHNOLOGICAL	<ul style="list-style-type: none"> • Emerging technologies, web • Information and communication
LEGAL	<ul style="list-style-type: none"> • Regulations and standards • Employment law
ENVIRONMENTAL	<ul style="list-style-type: none"> • Weather, green and ethical issues • Pollution, waste, recycling

Figure 1.2 External factors affecting businesses

Exam tip

The external factors affecting a business can be easily recalled using the acronym PESTLE: **P**olitical, **E**conomic, **S**ocial, **T**echnological, **L**egal and **E**nvironmental.

Now test yourself

TESTED 

- 28** List three reasons why a study of demographics might be important to a business.
- 29** What do you understand by the term 'fair trade'?
- 30** Identify one company that has received bad publicity as a result of its contribution to environmental damage.

Answers online

Summary

You should now have an understanding of all the points below.

Understanding the nature and purpose of business

- + why businesses exist
- + common business objectives and their purpose
- + the relationship between mission and objectives
- + the measurement and importance of profit, covering revenue, fixed costs, variable costs and total costs

Understanding different business forms

- + the reasons for choosing different forms of business and for changing business form, with the forms including sole traders, private and public limited companies, non-profit organisations and public sector organisations

- + limited and unlimited liability
- + ordinary share capital, market capitalisation and dividends
- + the role of shareholders and why they invest
- + influences on share price and the significance of share price changes
- + the effects of ownership on mission, objectives, decisions and performance

Understanding that businesses operate within an external environment

- + how the following external factors affect costs and demand: competition, market conditions, incomes, interest rates, demographic factors, environmental issues and fair trade

Exam practice

XYZ plc

XYZ develops, installs, owns and operates rapid electric vehicle (EV) charging stations in the UK. When XYZ plc converted to a public limited company 3 years ago, everything seemed promising. It had a mission of being 'the most recognisable brand in EV charging' and had the business objectives of both market growth and growth of market share.

The situation seemed very different 3 years later: customer complaints had increased and the company had failed to achieve its targets for market growth and share. Understandably, shareholders were very unhappy with the steadily declining share price and lack of dividends. For the most part, its problems had been caused by the changing external environment: the increased popularity of EV cars, low interest rates and a lack of government regulation meant that more firms had entered the market. As a result, EV charging had become an increasingly competitive market and the choice to float XYZ on the stock market was coming into question.

Key data of XYZ plc

	At flotation	Present
Sales	£25m	£27.5m
Market share	5.3%	5.2%
Share price	50p	35p
Number of shares	100m	100m

Questions

- a** Calculate the change in market capitalisation of XYZ plc. [4]
- b** Explain why XYZ plc's market share has decreased although sales have increased. [6]
- c** Analyse the factors shareholders may have considered before investing in XYZ plc. [9]
- d** To what extent do you believe XYZ plc was correct in its decision to convert to a public limited company? [16]

Answers and quick quizzes online

Exam skills

This chapter covers the traditional models of business types, business objectives and the challenges imposed on those businesses by the external environment. You should ensure that you can recall all of this content because it will act as a solid platform for more complex content later on.

Your Business A-level exam is likely to test your understanding of the concepts from this chapter in an *applied* sense. For example, you should be prepared to comment on the likely external challenges to the objectives of any business, whether a chocolate manufacturer or an airline — the answer will not be the same.

In addition, even though a particular exam question may not ask directly about the form of the business or its

objectives, it is likely that these will have some influence on the business's future behaviour, e.g.:

- ✚ A plc may find it hard to reinvest all its profit because it has profit-oriented shareholders. A sole trader may find it difficult to raise capital. In these scenarios, the structure of the business is acting as a constraint.
- ✚ By contrast, a business with an effective mission statement might find it easier to recruit and to motivate its workforce. A sole trader can be more decisive because there is only one person at the helm. In these examples, the business is likely to be more effective at achieving its aim.

Therefore, you should try to view the concepts in this chapter as enablers of or obstacles to business behaviour.

2 Managers, leadership and decision making

Understanding management, leadership and decision making

What managers do

REVISED 

Peter Drucker, seen by some as the creator of the modern study of management, outlined five basic tasks of a manager:

- 1 **Set objectives.** The manager sets goals for a group and decides what work needs to be done.
- 2 **Organise.** The manager divides the work into manageable activities and selects the people to undertake them.
- 3 **Motivate and communicate.** The manager creates a team of people who work together.
- 4 **Measure.** The manager not only sets targets but also analyses and appraises performance.
- 5 **Develop people.** It is up to the manager to develop people, who may be looked upon as the most important asset of a business.

Henri Fayol also outlined five elements of management: planning, organising, commanding, coordinating and controlling.

The role of a manager, then, is varied, but can be summed up in four key tasks: they **plan**, **organise**, **direct** and **control**.

Types of management and leadership styles

REVISED 

Leadership style is the way in which a leader approaches his or her role of planning, organising, directing and controlling. There are three basic styles of leadership:

- + **Autocratic leaders** make decisions without consulting others. (Another term used for this style is 'authoritarian')
- + **Democratic leaders** make the final decision but include others in the process.
- + **Laissez-faire leaders** allow team members freedom if they do their work and meet deadlines.

Other styles of leadership include **charismatic leaders**, who believe they can do no wrong, **paternalistic leaders**, who consult and try to make decisions in the best interest of all, and **bureaucratic leaders**, who do everything exactly by the rules.

Now test yourself

TESTED 

- 1 List four key leadership responsibilities.
- 2 Define the three traditional forms of leadership: autocratic, democratic and laissez-faire.

Answers online

This range of leadership styles is illustrated by Tannenbaum and Schmidt's continuum (see Figure 2.1). This classifies the style according to how much a leader tells or listens to his or her staff.

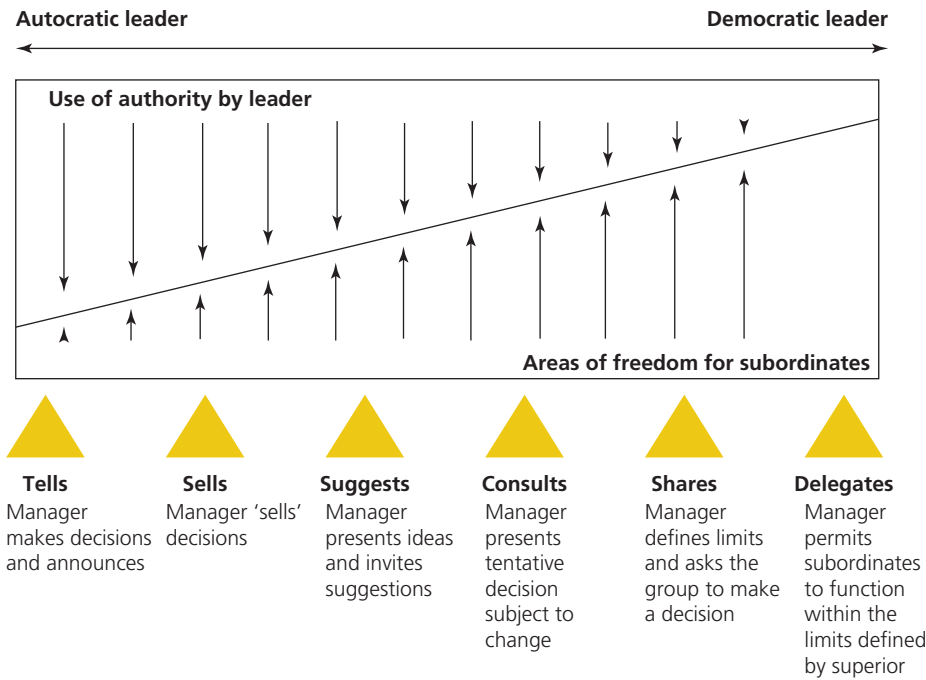


Figure 2.1 Tannenbaum and Schmidt's continuum of leadership behaviour

The figure shows the relationship between the level of freedom in decision making that a manager gives to a team of workers and the level of authority retained by the manager. As the workers' freedom increases, so the manager's authority decreases.

A further study of leadership by Blake and Mouton portrays leadership through a grid depicting concern for people on the y-axis and concern for production on the x-axis, with each dimension ranging from 1 to 9. This results in five leadership styles, as shown in Figure 2.2 and outlined below.

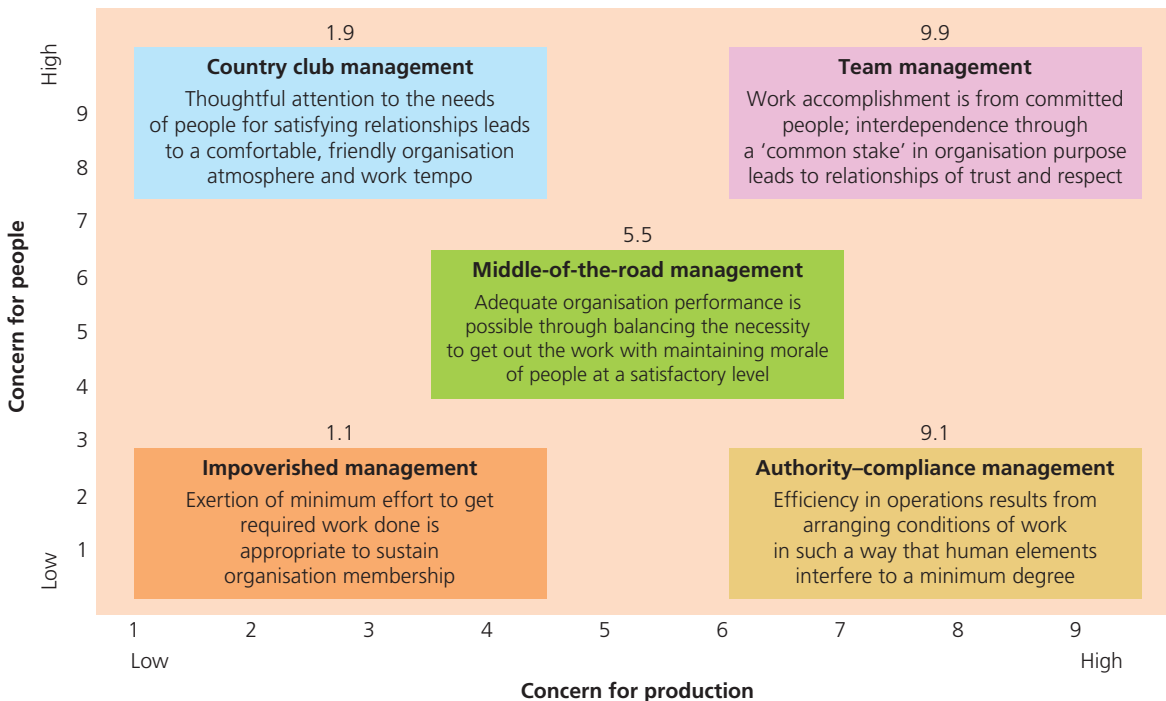


Figure 2.2 Blake and Mouton's leadership grid

- + **Country club management.** The emphasis is on people, with little concern for the task. This style may hamper production as it relies on workers being motivated.
- + **Authority-compliance management.** Leadership here is autocratic, with a clear emphasis on the task and little concern for people. It may increase production, but employees are likely to be unhappy.

- + **Impoverished management (produce or perish).** Leadership will be ineffective, with little concern for either the task or the people.
- + **Middle-of-the-road management.** There is a compromise here, with some focus on people and some on the task, but it is likely to lead to average performance.
- + **Team management.** This style focuses on both the task and the people. It is likely to be the most effective, with emphasis on empowerment, trust and team working.

Now test yourself

TESTED

- 3 Explain the difference between the types of leadership at either end of Tannenbaum and Schmidt's continuum.
- 4 Explain the difference, according to the Blake and Mouton theory, between country club management and impoverished management.

Answers online

The effectiveness of different styles of leadership and management, and influences on these

REVISED

The effectiveness of different styles of leadership is summarised in Table 2.1.

Table 2.1 Leadership styles

	Democratic	Autocratic	Laissez-faire
Description	Democratic leadership entails running a business on the basis of decisions agreed by the majority.	An autocratic leadership style keeps information and decision making among the senior managers.	Laissez-faire leadership means the leader has a peripheral role, leaving staff to manage the business.
Key features	Encourages participation and makes use of delegation.	Sets objectives and allocates tasks. Leader retains control throughout.	Leader evades duties of management and uncoordinated delegation occurs.
Communication	Extensive, two-way. Encourages contributions from subordinates.	One-way communication downwards from leader to subordinates.	Mainly horizontal communication, though little communication occurs.
Uses	Useful when complex decisions are made requiring a range of specialist skills.	Useful when quick decisions are required.	Can encourage production of highly creative work by subordinates.
Advantages	Commitment to business, satisfaction and quality of work may all improve.	Decisions and direction of business will be consistent. May project image of confident, well-managed business.	May bring the best out of highly professional or creative groups.
Disadvantages	Slow decision making and need for consensus may make it hard to take 'best' decisions.	Lack of information, so subordinates are highly dependent on leaders; supervision needed.	May not be deliberate, but bad management — staff lack of focus and sense of direction. Much dissatisfaction.

Different leaders adopt different styles of leadership, and the style adopted will vary according to the individual and the circumstances involved. Key influences might be:

- + **The individual.** Some leaders feel they always have to be in control and may lean more towards an autocratic approach, whereas others may feel more comfortable discussing decisions and will be more democratic in their approach. In other words, the style adopted will depend on the leader's personality and skills.

Typical mistake

Do not assume that a democratic style of leadership is always the best style to adopt — it will depend on the circumstances of the individual business.

- ✚ **Nature of the industry.** Some industries require a high degree of creativity, whereas with others safety might be paramount. The leadership style adopted is likely to reflect this, with a more laissez-faire approach adopted where creativity is needed and a more autocratic approach where safety is of concern.
- ✚ **Business culture.** If a business has a tradition of doing things in a particular way, then this might determine the style adopted. It may have always operated with a more laissez-faire or autocratic approach that might prove difficult to change.

Making links

When looking at management theory and styles, ask yourself why one style of management might be better suited to a business than another. Is it because of the nature of the product, the market operated in, the culture of the business or the circumstances it finds itself in?

Now test yourself

TESTED 

- Identify three influences on leadership style.
- Draw a table to show how an autocratic leader, a democratic leader and a laissez-faire leader would conduct the following activities:
 - setting objectives
 - communicating with staff
- Explain what type of leadership might be more effective in the following situations:
 - a private security firm
 - a research and development laboratory
 - a business with a reputation for empowering its workers

Answers online

Exam tip

Do not assume that there is one best style of leadership, as the style adopted is likely to depend on and evolve with the circumstances a business finds itself in.

Understanding management decision making

The value of decision making based on data (scientific decision making) and on intuition

REVISED 

Scientific decision making is the systematic approach of collecting facts and applying logical decision-making techniques, such as decision trees, to the decision-making process. The alternative to this approach is trial and error and intuition (gut feeling).

Since all decisions involve risk and uncertainty (due to external factors and sometimes also internal factors), a scientific approach is likely to be adopted. This involves the collection and analysis of data and the use of analytical tools such as:

- ✚ the Boston matrix
- ✚ the product life cycle
- ✚ investment appraisal
- ✚ ratio analysis
- ✚ decision trees

Scientific decision making

is decision making that is based on data and uses a logical and rational approach.

Opportunity cost is the cost of the next best alternative foregone.

Opportunity cost

Managers may also consider the **opportunity cost** when making a decision. This is the cost of the next best alternative that will be missed by making a particular decision. Business resources, particularly finance, are limited and, as a result, a business will not be able to undertake everything it would like

to: it will have to make a choice. For example, by investing in a new fleet of vehicles it may miss out on a new computer system — the computer system represents the opportunity cost.

Intuition

Intuition refers to decisions that are made based on a gut feeling rather than on evidence and rational processes. Data are not always correct. For example, the decision by Coca-Cola to change its recipe in response to taste tests proved to be a marketing disaster.

For innovative products, it may be impossible to judge consumer reaction if they have never seen the product. If an analytical approach had been adopted, the Sony Walkman and probably the MP3 player would never have been introduced to the market. Intuition, then, will always be an important factor in decision making.

Intuition is making decisions based on gut feeling rather than on data and rational analysis.

Now test yourself

TESTED

- 8 Outline two advantages of using a scientific approach to decision making.
- 9 Outline two advantages of using intuition in decision making.

Answers online

The use and value of decision trees in decision making

REVISED

Decision trees are tree-like diagrams that can be used to determine the optimum course of action in situations where several possible alternatives with uncertain outcomes exist. They are a visual representation of the various risks, rewards and potential values of each option.

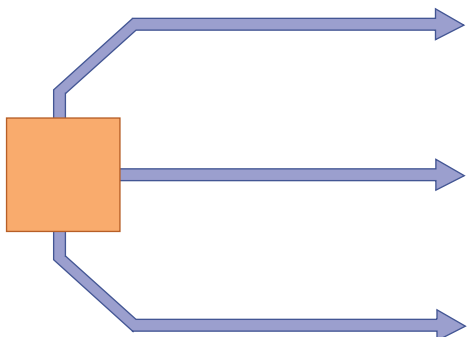
Decision trees are tree-like diagrams showing various options, their probabilities and financial outcomes.

Drawing and evaluating a decision tree

Every decision tree begins with a square. This represents the decision to be made:

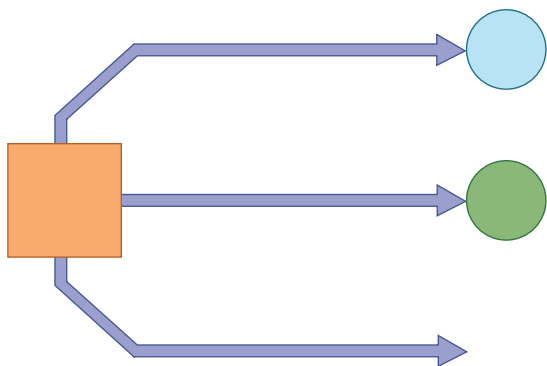


At least two lines will come out of the square representing the possible options. There will often be a third line — the do-nothing option:

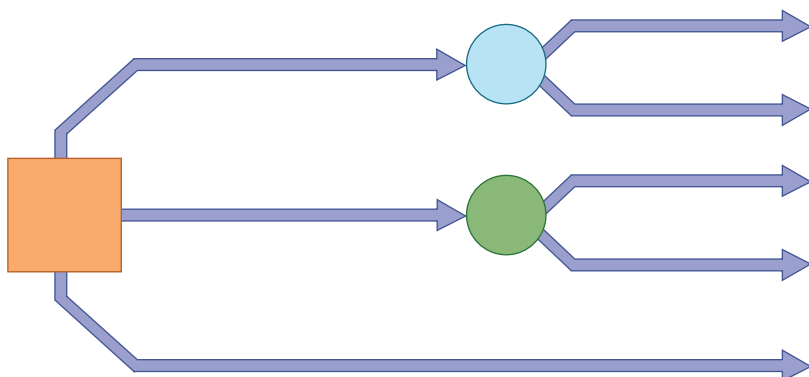


Taking each line in turn, it is now necessary to decide whether it is a result, it is uncertain, or another decision has to be made.

For a result there is no more to do, while uncertainty is represented by a circle and a decision by another square. The do-nothing line is a result and for our purposes we will assume there are no further decisions (note that more complicated decision trees are likely to have further decisions). The resulting decision tree will be as follows:



From each circle, lines will be drawn showing the possible outcomes:



In order to evaluate the decision tree, all lines need to be fully labelled. This means indicating the following information on the decision tree:

- + the cost of each option
- + the potential outcomes
- + the probabilities

This is shown in Figure 2.3. XYZ plc is considering whether to relaunch an existing product that has been failing or whether to undertake the development and launch of a completely new product. The data in Table 2.2 relate to each.

Table 2.2 XYZ plc relaunch and new product data

	Relaunch existing product	New product
Cost	£2.5m	£6m
Outcome success	£8.5m	£12m
Outcome failure	£0.5m	£2m
Probability success	0.7	0.6
Probability failure	0.3	0.4

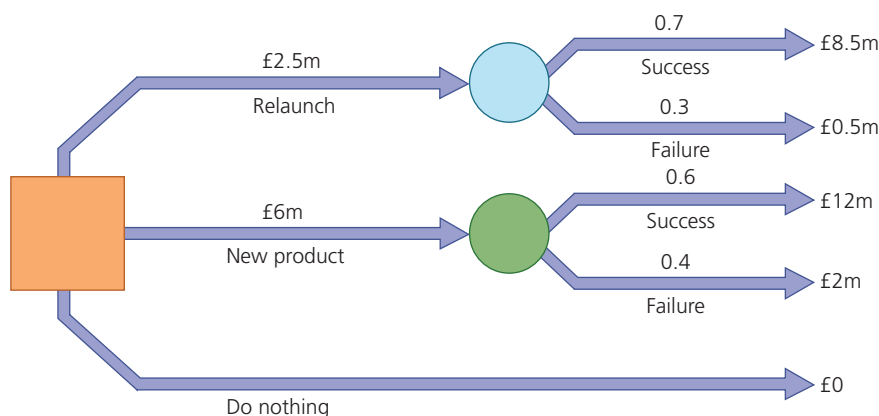


Figure 2.3 Decision tree for XYZ plc

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