Chapter 1

Unit 1.1 - What is a business?

"It does not take much strength to do things, but it requires a great deal of strength to decide what to do."
Elbert Green Hubbard (1856 – 1915), American author and philosopher

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1.1 What is a business?	
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The nature of business (AO1)

A **business** is a decision-making organization involved in the process of using inputs to produce goods and/or to provide services (see Figure 1.1). *Inputs* are the resources that a business uses in the production process, such as labour and raw materials. This process generates *outputs* (also known as products). Management guru Peter Drucker said that *"there is only one valid definition of business purpose: to create a customer"* by creating goods and services that meet the needs and wants of customers.

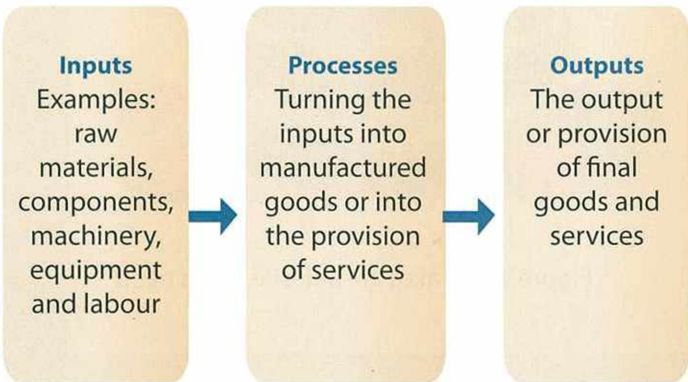

Figure 1.1. The production process

The term **product** can refer to both goods and services. **Goods** are physical products, such as smartphones, clothes, books and food. **Services** are intangible products, such as haircuts, public transport, education and healthcare. Businesses can also provide goods and services to other organizations, such as freight transportation, distribution and insurance.

An **entrepreneur** is the individual who plans, organizes and manages a business and its operations, taking on financial risks in doing so. The term was coined by Richard Cantillon (1680 - 1734) an Irish-French economist. Entrepreneurship describes the trait of business leaders who tend to be distinctive in their temperament, attitude and outlook who drive the business to achieve its organizational goals. Successful entrepreneurs tend to be creative, innovative and highly passionate. They search for and exploit business opportunities by forecasting and/or responding to changes in the marketplace.

The nature or purpose of business activity is to generate **added value**. This occurs when there is a positive difference between the selling price of a product and the cost of producing the good or service. Added value exists when products are appealing to customers, so they are willing to pay a higher price for such items.

Management guru Peter Drucker (1909 - 2005) famously said that the only purpose of a business is to create customers, i.e. the role of businesses is to combine human, physical and financial resources to create goods and services in order to satisfy the *needs* and *wants* of people, organizations and governments. **Needs** are the basic necessities that people must have to survive, such as food, water, warmth, shelter and clothing. **Wants** are people's desires, i.e. the things they would like to have, such as a larger home, a new smartphone, an overseas holiday or a birthday cake.

Figure 1.2 - Cakes are a desire, not a need

Case study 1.1 - Steve Jobs

Steve Jobs (1955 - 2011), the co-founder of Apple, did not graduate from university because his adopted parents could not afford the tuition fees. Instead, he took the risk of setting up Apple with two friends (Steve Wozniak and Ronald Wayne) in 1976. However, Ronald Wayne sold his share of the company within a couple of weeks for (just) $2,300. Jobs went on to reinvent computing, music and mobile phones, making Apple the highest valued company in the world, just two months before he died. *Forbes* estimated the wealth of Jobs to be over $8.3 billion.

Common mistake

The terms **customer** and **consumer** are often used interchangeably by students, although they have different meanings. Make sure you can distinguish between the two terms and use them in the right context - *customers* are the people or organizations that purchase a product whereas *consumers* are the ones who actually use the product. These may be the same entity (e.g. someone who buys and eats a meal), but not necessarily such as parents (customers) who buy presents for their children (consumers).

Box 1.1 - Types of products

- **Consumer goods** are products sold to the general public, rather than to other businesses. They can be further categorised as *consumer durables* (products that last a long time and can be used repeatedly, such as electronic devices, motor cars, jewellery, clothes and home furniture), or *non-durables* (those that need to be consumed shortly after their purchase as they do not last or cannot be reused, such as fresh food items, beverages, medicines and newspapers).
- **Capital goods** (or **producer goods**) are physical products bought by businesses to produce other goods and/or services. Examples include buildings (premises), computers, machinery, tools and specialist equipment.
- **Services** are intangible products provided by businesses. The service is not tangible, but the results or experiences are, such as healthcare, transportation, dining, sports (recreation), legal advice, financial guidance and education.

For a business to operate effectively, tasks must be carried out by various functional areas (or departments). These interdependent functional areas are human resources, finance and accounts, marketing and operations management. The nature of business requires these main functional areas to work together in order to achieve the organization's goals.

1. **Human resource management** – The human resources (HR) department is responsible for managing the personnel of the organization. This includes roles such as human resource planning, organizational structures, management

and leadership, motivation and demotivation and dealing with industrial/employee relations (see Chapters 7 - 13).

2. **Finance and accounts** – The finance and accounts department is responsible for managing the organization's money, ensuring compliance with legal requirements (such as filing of corporate taxes) and informing those interested in the financial position of the business (such as shareholders and potential investors). Finance and accounts topics are covered in Chapters 14 - 22.

3. **Marketing** – The marketing department of a business is responsible for identifying and satisfying the needs and wants of customers. It is ultimately in charge of ensuring that the firm's products sell. This is done through a series of activities such as market research, promotion, pricing, branding and distribution. The nature of marketing as a business function is covered in Chapter 23 - 34.

4. **Operations management** – This functional area of a business is responsible for the process of converting raw materials and components into finished goods, ready for sale and delivery to customers. Examples of production include the extraction of crude oil, car manufacturing and the provision of travel and tourism services. Operations management topics are covered in Chapters 35 - 43.

A large organization is able to allocate resources to each of these four functional areas, making their roles easily identifiable. In a small business, owned by just one person, each function would need to be carried out by the same person. In practice, the interrelated nature of four functional areas of a business mean that the operations management department relies on effective marketers to promote and sell their products. Equally, marketers can only do their jobs if they have well-made products to sell and the necessary financial resources to do so.

Question 1.1 - The business of education

Education is big business. Schools can earn **revenue** from numerous sources, such as tuition fees (for fee-paying schools), grants from the government and fund-raising events. They might also lease out their facilities (such as classrooms, sports facilities, drama studios and swimming pools) during the evenings, weekends and school holidays.

Schools use these revenues to finance their **costs**, such as staff salaries, utility bills and the maintenance of the buildings. In addition to school fees, parents might also have to pay for items such as school uniform, textbooks, stationery, sports equipment and food.

(a) Distinguish between *revenue* and *costs*. *[4 marks]*

(b) Examine how business functions operate in an organization such as a school. *[6 marks]*

Primary, secondary, tertiary and quaternary sectors (AO2)

Businesses can be classified according to the stage of production (or chain or production) that they are engaged in. These stages are categorized as (i) primary, (ii) secondary, (iii) tertiary and (iv) quaternary sectors.

(i) Primary sector

Businesses operating in the primary sector are involved with the extraction, harvesting and conversion of natural resources. Examples include agriculture, fishing, mining, forestry and oil extraction. Primary sector business activities tend to account for a large percentage of output and employment in low-income countries. Businesses operating in the primary sector in high-income countries use mechanisation and automation, such as combine harvesters, tractors and automatic watering systems.

As countries achieve sustained economic growth and development, there is less reliance on the primary sector in terms of employment and national output, partly because there is little added value in primary sector production. For example, low-income countries can only sell tea leaves and coffee beans at relatively low prices. Nevertheless, the primary sector is important for all countries. For example, even though less than 4% of France's national output comes from the primary sector, the country benefits immensely from its agricultural exports sold all around the world.

Figure 1.3 - Agricultural farming is part of the primary sector

(ii) Secondary sector

Businesses that operate in the secondary sector are involved in manufacturing or construction. Examples include clothes manufacturers, publishing firms, breweries and bottlers, construction firms, electronics manufacturers and energy production companies. The output is then sold to customers, such as other businesses, governments, foreign buyers or domestic customers.

Medium-income countries tend to have a dominant secondary sector that accounts for a relatively large proportion of their country's national output. Economists argue that the secondary sector is the wealth creating sector because manufactured goods can be exported worldwide to earn income for the country. Value is added to the natural resources used during the production process. For example, the mass production and export of motor vehicles and consumer electronic products has helped economies such as Taiwan (China) and South Korea to prosper. However, automation and mechanisation in modern societies have caused a decline in many secondary (manufacturing) industries in terms of employment.

Figure 1.4 - Construction is part of the secondary sector

(iii) Tertiary sector

Businesses that operate in the tertiary sector specialize in providing services to the general population and other organizations. Examples of industries in the tertiary sector include retailing, transportation and distribution, banking, finance, insurance, healthcare, leisure and tourism and entertainment.

Note that physical goods can be transformed in the process of providing a service. This happens in a restaurant when the chef prepares a meal with fresh ingredients. Nevertheless, the focus is on the people who are providing the service - the chef and the waiting staff who serve the diners - rather than on the tangible product itself.

In high-income countries, the tertiary sector tends to be the most substantial sector in terms of both employment and output as a percentage of *gross domestic product* (the value of the country's output each year). For example, in the USA and UK, around 80% of the labour force work in the tertiary sector. The decline of the manufacturing sector in high-income countries also signifies their growing reliance on the tertiary sector.

Figure 1.5 - Public transportation is part of the tertiary sector

(iv) Quaternary sector

This is a sub-category of the tertiary sector. Businesses that operate in the quaternary sector are involved in intellectual and knowledge-based activities that generate and share information. Examples include information communications technology (ICT), research and development (R&D), consultancy services and scientific research. For example, pharmaceutical companies invest heavily in R&D to create innovative products, develop new production methods, improve efficiency and to tap into markets. The quaternary sector exists mainly in high-income countries as it requires a highly educated workforce. It is also the sector in which high-tech and e-commerce businesses invest for further growth and evolution.

Figure 1.6 - Information Communications Technology (ICT) is part of the quaternary sector

The four business sectors are linked through the **chain of production** which tracks the stages of an item's production, from the extraction of raw materials used to make the product all the way through to it being delivered to the consumer (see Figure 1.1).

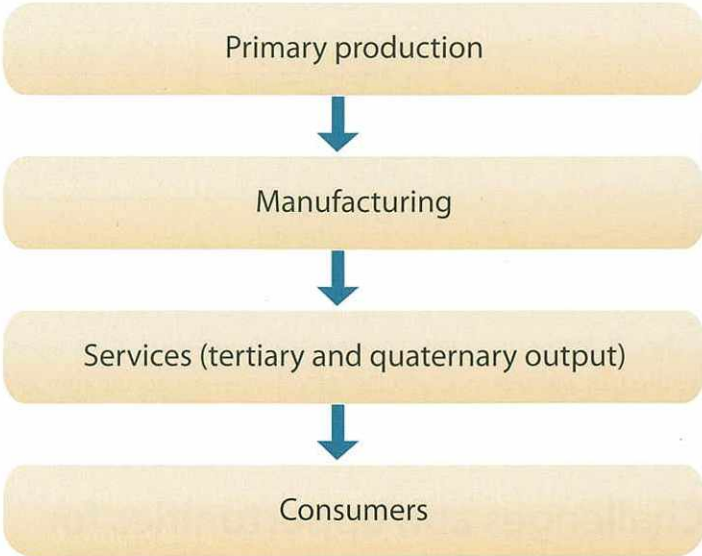

Figure 1.7 - The chain of production

All four business sectors are *interdependent* because each sector relies on the others to remain in existence. For example, raw materials such as crude oil, would not be extracted if there was no need for oil refinery whilst there would not be any need for oil refiners if there were no customers for the oil, such as motorists and airline companies in the tertiary sector. Likewise, firms in the secondary sector rely on their suppliers for stocks to ensure that their production targets are met. Businesses are also interdependent as they all need energy, ICT facilities, manufactured producer goods, financial services and management consultants.

High-income countries are able to exploit the tertiary and quaternary sectors as the main contributors to national output and employment. Businesses such as Apple and Samsung see themselves as operating in the services sector (they outsource production of their smartphones and computer hardware to manufacturers such as Foxconn). Apple realise that there is more added value in the tertiary and quaternary sectors - rather than receiving one-off payments from selling manufactured equipment, it can receive a flow of revenue from offering after-sales services such as maintenance and support services.

Question 1. 2 - Production Sectors

Study the data below and answer the questions that follow. A, B and C represent three countries: France, Bangladesh and the Philippines (although not necessarily in that order).

Structure of employment (%)

	A	B	C
Agriculture	33	4	45
Manufacturing	15	24	30
Services	52	72	25

(a) Identify the countries A, B and C. *[3 marks]*

(b) With reference to the data above, explain your answer to Question 1.2 (a). *[6 marks]*

https://en.wikipedia.org/wiki/List_of_countries_by_sector_composition_of_the_labor_force

Challenges and opportunities for starting a business (AO2)

Results from around the world consistently show that around 20-25 per cent of new businesses fail to survive their first year. A new business is likely to face challenges which must be dealt with immediately to prevent them from escalating and threatening its survival. The challenges for starting up a business include any combination of the following:

- **Lack of finance** - All businesses need finance for the purchase of *fixed* assets, such as premises, buildings, machinery and equipment. However, start-up firms and most owners of new or small businesses do not have the credentials to secure sufficient funding without major challenges. Even if entrepreneurs are able to some borrow money, the funds may be insufficient or the relatively high interest charges might seriously affect the cash flow position of the business (see Chapter 20). Hence, new sole traders (see Chapter 2) often have to remortgage their own homes to raise the finance needed, thereby offering the lender more *collateral* (financial security) in case they fail to repay the loan).

- **Unestablished customer base** - A major challenge facing new businesses is attracting customers, i.e. building a broad and loyal customer base. The problem is intensified when there are well established competitors that already operate in the market. Customer loyalty is built over a long period of time, which may require marketing know-how and large amounts of money.

- **Cash flow problems** - Financing *working capital* (the money available for the daily running of a business) is a major challenge for many business start-ups. A business might have a lot of stock, such as raw materials, semi-finished output or finished goods that it cannot easily turn into cash. Customers might demand a lengthy credit period (typically between 30 to 60 days) enabling them to buy now and pay later, so the business will not receive the cash payment until the credit period is over. However, during this time, the business still needs to pay for its on-going costs such as wages, rent, utility bills, taxes and interest payments on bank loans.

- **Marketing problems** - Marketing challenges arise when businesses fail to meet customer needs, thereby resulting in poor sales and a lack of profitability. Supplying the right products to the right customers at the right price is especially crucial for new businesses. However, small and new businesses might lack the expertise to do this. Quite often, the key to small business success is to identify a *niche* (or gap) in the market and then fill it. For example, back in the 1990s, Amazon identified huge opportunities of using the Internet as a channel of distribution for books and other products. European airline carriers such as easyJet and Ryanair identified early on the niche market for no-frills (budget) air travel.

- **People management problems** - Business start-ups may lack experience in hiring the right staff with all the necessary skills. This can lead to poor levels of labour productivity and the need to retrain staff or to rehire people, all of which can be very expensive and time consuming. Moreover, new businesses might not know the ideal organizational structure (see Chapter 8) or the most practical methods of staff motivation (see Chapter 10) that best suits their organizational needs.

- **Production problems** - It can be challenging for business start-ups to accurately forecast levels of demand so they are more likely to either over produce or under produce. Overproduction tends to lead to stockpiling, wastage and increased costs (see Chapter 40). By contrast, underproduction leads to dissatisfied customers and a loss of potential sales.

- **Legalities** - It is necessary for businesses to comply with all necessary legislation, including business registration procedures, insurance cover for staff and buildings, consumer protection laws and rules about intellectual property such as copyrights, patents and trademarks (see Chapter 42). The paperwork and legal requirements of setting up a new business can be cumbersome, confusing, time consuming and expensive. Any oversight could result in the business having to pay compensation or financial penalties. This would obviously damage the already vulnerable cash flow position of business start-ups.

- **High production costs** - New businesses are likely to have high set-up costs (see Box 1.2) and running costs due to the large amount of money needed to purchase or pay for capital equipment, machinery, stocks (inventory), rent, advertising, insurance and so forth. Smaller businesses will also be at a cost disadvantage as they cannot benefit from economies of scale (see Chapter 5). By contrast, economies of scale allow larger and more established businesses to benefit from lower average costs of production due to the size of operations, such as being able to get discounts from their suppliers for large bulk purchases or being able to borrow money at a lower interest rate because of their larger size and financial collateral.

Box 1.2 - Examples of start-up costs for a new business

- Buildings, such as alterations, fixtures and fittings and insurance costs.
- Capital equipment, such as office furniture, telephones, computers, Wi-Fi, machinery, tools and motor vehicles.
- Human resources, such as recruitment, induction and training costs.
- Legal and professional fees, such as the costs of solicitors, licenses and permits.
- Marketing costs, such as market research, advertising and promotional campaigns.
- Premises, such as purchase costs, mortgage deposit payment or rental deposit costs.

- **Poor location** - Businesses face a dilemma in the location decision: busy areas offer the highest potential number of customers, but the premises in these areas will also cost the most (see Chapter 38). Fixed costs, such as rent or mortgage payments, account for a large percentage of total costs for many businesses. An aim for any new business is to reach break-even as soon as possible, by keeping fixed costs down. This is one reason why many entrepreneurs set up small businesses that operate initially from their own homes (which also has some tax advantages). Jeff Bezo, the founder of Amazon, started his online business in his garage. Of course, this option is not suitable for businesses where location (see Chapter 38) plays a key factor in business survival.

- **External influences** - All businesses, irrespective of size or how long they have been in operation, are prone to exogenous shocks (see Chapter 46) that create a challenging trading environment, such as a global financial crisis or the outbreak of a pandemic. However, larger and more established firms tend to be better resourced to handle these external influences. Hence, new businesses face the added challenge of being more vulnerable to external shocks which also means the potential for business failure is greater.

Figure 1.8 - The COVID-19 pandemic caused havoc for businesses across the world

However, there are many potential opportunities for starting up a business. These opportunities can be remembered by the mnemonic GET CASH©.

- **Growth** - Entrepreneurs tend to benefit personally when there is an appreciation in the value of their businesses, especially as property and land tend to increase in value over time. This is called *capital growth*. It is quite common for the capital growth of a business to be worth more than the value of the owners' salaries. Bill Gates, who co-founded Microsoft in 1975, made his fortunes mainly from the capital growth of Microsoft, the world's largest software maker.

- **Earnings** - The Chinese have a saying that "*You can never get rich earning money from working for someone else.*" That is because the potential returns from setting up your own business can easily outweigh the costs, even though the risks are high. It is common that entrepreneurs earn far in excess of salaries from any other occupation that they might otherwise pursue. Tim Cook, CEO of Apple, is reported to have an annual remuneration package of around $265 million whilst Elon Musk, Tesla's CEO, is paid around $595 million a year!

- **Transference and inheritance** - In many societies, it is the cultural norm to pass on assets, including businesses, to the next generation. Many self-employed entrepreneurs view their business as something that they are able to pass on (transference) to their children (inheritance) to give them a sense of financial security that might not be possible if they chose to work for someone else. The Walton family (the richest family in the world with an estimated wealth of over $215 billion) own over 50% of the shares in Walmart, the world's largest retailer. The Mars family is the second wealthiest family, with an estimated wealth of $120 billion. Mars Inc., a privately held company (see Chapter 2) that produces confectionary, processed foods and veterinary services is a multigenerational family business that was founded in 1911.

- **Challenge** - Some people might view setting up and running a business as a personal challenge. It is this challenge that drives them to perform and what gives them particular satisfaction. Being successful in business boosts self-esteem. This is perhaps one reason why multi-billionaires such as Warren Buffet, Carlos Slim and Li Ka-shing continued to work past the official retirement age.

- **Autonomy** - Working for someone else means exactly that. Employees have to follow the instructions and rules set by the organization that they work for, such as the conditions of employment, working hours, employment benefits and holiday entitlement. Conversely, being self-employed means that there is autonomy (independence, freedom of choice and flexibility) in how things are done within the organization. Essentially, this opportunity refers to the benefits of being your own boss.

- **Security** - Similarly, there could be a greater sense of job security for someone who is their own boss. By contrast, employees can be dismissed, made redundant or even replaced by technology. Although the risks are great, being self-employed also makes it potentially easier to accumulate personal wealth (financial security) to provide higher funds for (early) retirement.

- **Hobbies** - Some people might want to pursue their passion or to turn their hobby and interests into a business opportunity. Successful entrepreneurs have a passion for what they do and this is made easier if the nature of the work is directly related to their personal interests. Top selling author, J.K. Rowling is an example. Jamie Oliver, the celebrity chef, has set up several of his own restaurants. Internet entrepreneur Mark Zuckerberg became the world's youngest billionaire when he was just 23 years old, having co-founded Facebook and becoming the company's CEO.

In summary, people set up their own businesses due to the opportunities to satisfy their personal desires - such as to fulfil a personal vision, to have the opportunity to achieve success, to be their own boss or simply to live a more extravagant lifestyle (if and when the business becomes a 'success'). However, a significant number of new businesses fail to survive. There are three inter-related reasons or challenges behind this: a lack of cash in the business, poor cost control and substandard or weak management and leadership.

Key concept

How important is **creativity** for business success?

Theory of Knowledge (TOK)

Reflect on the opportunities for starting up a business. How do *reason* and *emotion* interact to affect the decision-making process? Is *emotion* or *reason* more important in this process?

Theory of Knowledge (TOK)

To what extent is luck an essential part of being successful in business? How does this impact the knowledge needed to succeed as an entrepreneur?

Business Management Toolkit

Discuss how the use of a business plan (see Chapter 48) can help entrepreneurs to tackle the challenges and opportunities of starting a business.

What is a business? and the key concepts

Business activity is the process of turning inputs (land, labour, capital and enterprise) into outputs (finished goods and services) in order to meet the needs and wants of different customers. Irrespective of the country or culture, all businesses strive to add value in the production and provision of goods and services as part of their sustainable business strategy.

The reasons for setting up a business can vary from one country and culture to another. For example, only a few legal procedures are needed to establish a business in Singapore, Hong Kong (China) and New Zealand, thus promoting an entrepreneurial culture where creative and innovative businesses can thrive. In other places, such as Chad, Libya and Myanmar, a risk-taking entrepreneurial culture is not so apparent, so there is relatively little change and sustainability is more of an issue.

Essentially, the nature of business activity is to satisfy the needs and desires of customers whilst fulfilling the organization's own objectives, such as profit, growth and corporate social responsibility (see Chapter 3). In the long run, all businesses must generate profit or surplus in order to survive, although there will be similarities and differences in how for-profit and not-for-profit organizations go about doing this (see Chapter 2). Complexities in the global corporate world mean that change, ethics and creativity are central to the sustainability of businesses.

Case study 1.2 - Paul Buchheit and Gmail

Creativity and the ability to adapt to change are crucial skills to compete successfully in the corporate world. Paul Buchheit, an employee of Google, is credited as the creator of Gmail. In 2001, he programmed the first working version of Gmail in just one day(!) and was the lead developer. He left Google in 2006 and worked at Facebook until 2010. In 2011, Buchheit won The Economist Innovation Award for the computing and telecommunications field.

Key concept

Discuss the extent to which **sustainable** business practices can enhance an organization's chances of financial success.

REVIEW QUESTIONS

1. What is a business?
2. How do goods and services differ from each other?
3. How do needs and wants of consumers differ from each other?
4. How do customers and consumers differ from each other?
5. What are the four functional areas of a business?
6. What are the four business sectors of the economy?
7. How does a business add value to its goods and services?
8. What is meant by the chain of production?
9. What are the main challenges for business start-ups?
10. What are the main opportunities for business start-ups?

KEY TERMS

Adding value is the practice of producing a good or service that is worth more than the cost of the resources used in the production process.

Businesses are organizations involved in the production of goods and/or the provision of services.

Consumers are the people or organizations that actually use a product.

Customers are the people or organizations that buy the product.

Entrepreneurs are the people who manage organize and plan the resources needed for business activity in pursuit of organizational objectives. They are risk takers who exploit business opportunities in return for profits.

Entrepreneurship refers to the collective knowledge, skills and experiences of entrepreneurs.

Goods are physical products produced and sold to customers, such as laptops, books, contact lenses, perfumes and children's toys.

Needs are the basic necessities that a person must have to survive, including food, water, warmth, shelter and clothing.

Primary sector refers to businesses involved in the cultivation or extraction of natural resources, such as farming, mining, quarrying, fishing, oil exploration and forestry.

Production is the process of creating goods and/or services, adding value in the process.

Quaternary sector is a sub-category of the tertiary sector, where businesses are involved in intellectual and knowledge-based activities that generate and share information, such as research organizations.

Secondary sector refers to businesses concerned with the construction and manufacturing of products.

Services are intangible products sold to customers, such as the services provided by airlines, restaurants, cinemas, banks, health and beauty spas, schools and hospitals.

Tertiary sector refers to businesses involved with the provision of services to customers.

Wants are people's desires, i.e. the things they would like to have, such as new clothes, smartphones, overseas holidays and jewellery.

Figure 1.9 - Holidays are common wants (desires)