Zig Zag Education

Economics AS and Level | Edexcel B | 8EB0 / 9EB0

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Edexcel Economics B Course Companion

Theme 1: Markets, Consumers and Firms

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Contents

Teacher's Introduction

Economic impact comes in all shapes and sizes and so, when studying the economy, it is important to look at the whole picture, from the largest market to the individual consumer.

This resource has been written to support the learning of Theme 1: Markets, Consumers and Firms, which forms part of the Edexcel Level 3 Advanced GCE in Economics B. It gives an in-depth view of the new qualification, presenting what specification points students need to know, plus extras along the way for extended learning.

At the beginning of this resource you will find a list of contents showing every specification point that is covered. There are also questions at the end of each topic, with answers at the end of the resource, to help students apply their knowledge to real-life economic contexts. Any key terms are revised as a glossary at the end of the resource.

Students get plenty of chance to practise their quantitative skills in this resource, including:

- Calculate, use and understand percentages and percentage changes (Sections 1.6.1. and 1.6.3.)
- Construct and interpret a range of graphical forms (Sections 1.1.2., 1.2.5., 1.3.2., 1.6.2. and 1.6.4.)
- Calculate cost, revenue and profit (Sections 1.6.1. to 1.6.3.)
- Interpret, apply and analyse information in written, graphical, tabular and numerical forms (all sections)

While extremely valuable to a student's revision, this resource should be treated as a companion to the many other textbooks and activity guides available. As with any subject, it is good to read as widely as possible!

The subjects covered in this resource include everything from business objectives and stakeholder conflicts to sources of finance, market failure and the price mechanism. The notes included in this resource can be given to students before a lesson as preparation for a topic, afterwards in order to help solidify their knowledge, or can be used by teachers as a supplement to in-class exercises and activities.

It is hoped that this resource, as well as offering support for teaching the essential elements of the AQA examination, will help students build on their research and dissemination skills. The world of economics is a constantly changing one full of fascinating stories. This resource attempts to utilise some of these stories as a basis for teaching in the most interesting way possible, meanwhile encouraging further study from the next generation of economic analysts!

Theme 1: Markets, Consume

Economic Terms

Consume	This means to use something, i.e. if you consume a good, th whether that good was an apple (in which case you have e case you have ridden it). In economics we often say 'to co bought it, because in order to use it, you will have had to h
Consumption	When a person buys a good or pays for a service
Consumer	An entity that buys goods
Goods	A product that is produced by firms or businesses
Economic Agent	An entity (person or organisation), who acts within the econom are an economic agent, and a corner shop or local business is
Utilise	To make use of something
Utility	The [illegible] of enjoyment an economic agent gains from

1.1 Scarcity, Choice and Potential Con

1.1.1 The Basic Economic Problem

The basic economic problem is that the resources are finite but the wants of people are infinite. This means the resources that are used to manufacture goods and provide services are fixed; there is only a set amount. However, there is no limit to our wants, whether that is our want of food, want of a new pair of shoes or want of emergency services, our wants are infinite. There are not enough resources available to 'satisfy' our wants; not enough resources to make all the things we want.

This is the problem of scarcity. Scarcity is the excess of want over what the resour

For example: *100 people want tickets to a show, but there are only 50 seats. There resources (seats) to satisfy the demand for the show – the tickets, therefore, are scar*

Choice exists because of scarcity. If there is a finite quantity of resources, then onl produced. Therefore, there must be a decision as to what the resources should pr shell; it is the study of how resources are allocated in order to satisfy the wants. It to answer the basic economic problem.

When a decision is made for one thing over another, a sacrifice has been made. In opportunity to have the other has been given up or forgone. This means there is a one option, the less you have of another

For example*: You have thre[illegible], you have to choose whether you will spen film with friends. Which do you sacrifice for the benefits of the other?*

Opportunity Cost
Opportunity cost is the cost of a choice; it is the opportunity forgone

This is where the idea of 'opportunity cost' comes fr choice in a world with scarce resources and trade-o every decision a sacrifice has been made. The oppo opportunity forgone. In other words, the unchosen order to have the other, chosen option. The forgon

For example*; you want a packet of crisps (worth 50p) and a chocolate bar (also wo and so you'd like both. However, your resources are finite; you only have 50p to spe choose? If you choose the chocolate bar, you have given up having the crisps; you h eat crisps in order to have the chocolate bar. The crisps are your 'opportunity cost'.*

Bear in mind that these ideas are seen throughout all of life, in an economic sense day-to-day life. The three examples above show choice, trade-off and opportunity tickets, you as a consumer and for you choosing how you spend your free time. C organisations and governments as well. The UK Government, for instance, needs t finite budget on reducing university fees, providing better pension schemes or im many other things.

1.1.1 Questions

1. What is the basic economic problem?

2. You have £10 to spend; you can either spend it on an economics a book, or you can go and see a film at the cinema.
    - a) Which do you choose?
    - b) What is the private benefit of this option?
    - c) What is the opportunity cost?

1.1.2 Business Objectives

Firms can follow various business objectives. More often than not a firm will seek to maximise its profits, thereby have a profit-maximising objective. However, managers may be paid commission and, therefore, want to maximise the quantity of goods they sell. They would then follow a sales-maximising objective. This is where the principle agent problem may come into play.

Ex
W
su
ob

Profit Maximisation

Remember...

$Profit = Total\ Revenue - Total\ Costs$

A firm may follow a profit-maximising objective in order to make the most money
of the business. This is the most common and obvious objective of a firm. At this
quantity of goods where the revenue is the largest compared to the costs.

Formulae
The profit-maximising point is where: $Marginal\ Revenue = Marginal\ Cost$

Businesses may pursue other objectives for a variety of reasons. For example, a m
salaries, or having a large workforce to direct. If a business manager is motivated
sells, then they may wish to produce the highest number of goods possible. A firm
efficient and, therefore, aim to minimise costs.

Sales Maximisation

At the sales maximisation point, firms are producing as many goods as they can b
a few reasons why a firm might do this; charities and other not-for-profit organisa
because they are trying to maximise the amount they do and only need to break e
operation. Firms may wish to operate at this point in order to flood the market wi
power. By selling a lot of goods at a low price the firm can drive other competitor

Further Economic Knowledge
At the sales-maximisation point the average revenue of the goods produced is eq
all the goods produced and, therefore, just breaks even. Producing any more goo
making a loss and producing any less goods would mean the firm hasn't maximis

Formulae
The sales-maximisation point is when $Average\ Costs = Average\ Revenue$

Satisficing

While a firm can set itself the objective of profit or sales maximisation, it is unlikel
Businesses rarely reach these objecti[illegible] something which economist Herb

In economics, the term 'satisficing' is the idea of achieving the **minimally accepta**
solution. In terms of business objectives this refers to the idea that some firms ma
profit that the shareholders accept – perhaps just above normal profits – instead
way, firms are able to make enough profit in order to survive without constantly u
absolute maximum. They can then use these resources to support other aims, suc
branding or product development.

Survival: businesses need a positive cash flow (i.e. enough finances so that they a
to-month bills and other expenses). If a company is profitable overall, but does no
short-term expenses, it probably will not be able to survive.

Market share: this objective also supports profit maximisation. Businesses focus o order to promote themselves to more customers. As they introduce themselves to increase their sales and, therefore, profits.

Cost-efficiency: while other objectives help bring revenue up, cost-efficiency help supports profit maximisation as, with lower costs, businesses can earn more profits

Employee welfare: this is an important objective for businesses in order to maint the business, i.e. a business may be responsible for the quality of its products, but has control over this.

Customer satisfaction: this objective links back to profit maximisation and surviv profit, it must make sure it keeps its customers satisfied. This can lead to repeat sa which ultimately can convert into sales.

Social objectives: while many businesses start out with the primary aim of profit m objectives by supporting social causes (such as making charitable donations from with social objectives for many reasons, including the personal ethics of the busin more positive reputation for the business's brand, which can lead to higher sales (

Return on investment: also known as ROI, this objective focuses on the success o decisions. If, for example, a supermarket chain was to buy out a rival company for to make enough profit in future to justify having made the initial purchase (i.e. a g company loses money after buying out the rival firm, however, this would show a

Any business that sets itself objectives must make sure they are **'SMART'**:

- **S**pecific: to the business's aims
- **M**easurable: quantifiable to ensure that the objectives are achieved
- **A**chievable: agreeing that they are capable of being fully completed
- **R**ealistic: capable of being achieved using existing resources
- **T**ime-bound: given a realistic time for completion

1.1.2 Questions

3. Business objectives should be SMART. Identify what this acronym s

4. Copy out and complete the following three sentences with the phra

Sales Maximisation *Profit Maximisation*

a) At the point of ______________________, firms are prod they can before they make a loss.

b) The objective of ______________________ aims to gene possible for the shareholders and owners of a business.

c) When a firm aims to generate revenue between a minimum ar may say that it is concentrating on ______________________

1.1.3 Stakeholders (Economic Agents and Their Ob

Stakeholders come in all shapes and sizes. As a definition, stakeholders are any in have a direct influence on or interest in a business. This might include the owners customers, suppliers and employees, among many others.

Whenever a business makes a decision, it has to consider its stakeholders: their ne have on the business. Some decisions will work out better for different stakeholde most businesses.

> *US President Abraham Lincoln perhaps said it best:*
> *'You can please some of the people all of the time, you can please all of the p*
> *you can't please all of the people all of the time.'*

The majority of businesses are no longer just interested in what their shareholders bigger picture, which shows [illegible] different individuals and groups inflicting po Some stakeholders have more power than others and they all influence the busine below shows [illegible] of stakeholders, their key interests and what power and influen

Stakeholder	Key Interests	
Shareholders	Survival, growth and profit maximisation	Elect dire
Owners	Survival, growth, positive reputation and acclaimed prestige	Direct mi
Management	Efficiency, low labour turnover, good industrial relations and status	Enforce o corporate
Suppliers	High sales, steady growth, good liquidity and positive reputation	Availabilit
Government	Growth, high turnover, high profits, increased tax revenue and environmental awareness	Legislatio practices
Financial institutes (banks, etc.)	Repayment of loans/interest, etc.	Removal
Customers	Low prices, quality product, green credentials and reliable service	Spending awarenes
Employees	Salary, job security, career progression, motivation	Productiv quality of
Local community	Safe place to live, low noise, disruption and pollution	Complain

Table: Stakeholders, their key inte

The power of stakeholders can be broken down into four categories:

- **Low power, low interest**, e.g. unaffected members of the local community
- **Low power, high interest**, e.g. non-management [illegible]
- **High power, low interest**, e.g. suppliers to the company
- **High power, high interest**, e.g. local council

We can draw these stakeholders as a stakeholder map:

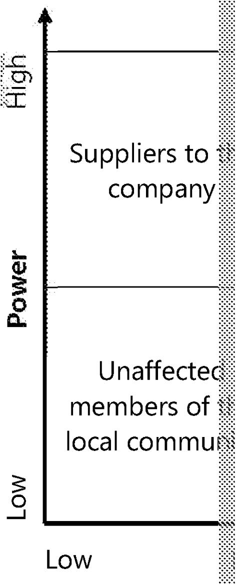


Diagram: An

Stakeholder Needs and Conflict

Naturally, when it comes to stakeholder needs and power, there can be a conflict such as shareholders, may be extremely interested in high sales and profit maximi such as the local community, may want to ensure their home town is safe and free If a company wishes to expand its operations in order to produce more goods, ge increase profits, it will also consider the possible effects to the local community. If community could react by filing complaints with their local council, holding demo and ruining the reputation of the company through word of mouth. This issue rep

More examples of stakeholder conflict include:

- **Management vs Employees:** the management of the company wishes to company by producing more goods while the employees are not prepare salaries improve.
- **Government vs Owners:** new sustainability legislation means that a com equipment in order to reduce its levels of carbon dioxide. While importan expenditure eats into the potential profits of the company.
- **Sup[illegible] v[illegible]:** this conflict occurs as the business needs to keep a p acc[illegible]t also make large payments to its suppliers – if raw materials a company will have less flexibility in setting future payment deadlines, or it ordering supplies in bulk.

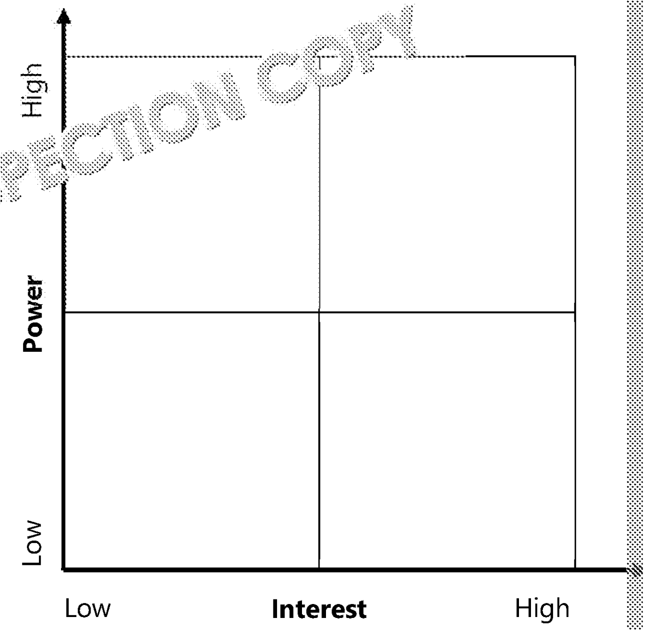
Corporate Social Responsibility

This no longer only applies to firms that care about reducing the damage they cau firms today have some sort of corporate social responsibility (CSR) that they follow government or by the average consumer who now expects it. Seen by many as ex firms save money (by reducing waste and lowering their bills) and creates the ima consumers feel good about supporting. Many businesses have increased their ma environmentally-friendly practices and continue to reap the benefits of a growing

1.1.3 Questions

5. The sports equipment manufacturer, Tennis Elbow, wishes to crea stakeholders. The company has 30 employees, most of whom are workers. The firm purchases all its materials from one main suppli to a select few consumers in the UK. Tennis Elbow is based in a sn company does not have much impact on the local residents.

Using the information above, copy the following stakeholder map a inserting one stakeholder in each section.



6. Below are three pairs of stakeholders for Tennis Elbow. Explain wh stakeholders have a conflict of interest.

a) Shareholders and Employees
b) Suppliers and Consumers
c) Business Owners and Local Community

1.1 Keywords

Opportunity Cost	The next best alternative that is forgone when making a dec
Profit Maximisation	An objective of most firms: to [illegible] as much profit as po quantity of output and price
Satisficing	The idea of [illegible] the minimally acceptable result rathe terms of business objectives this refers to the idea that some [illegible] level of profit that their shareholders accept – per instead of trying to maximise profits.
Marginal [illegible]ue	The additional revenue gained by a firm from selling one mo
Stakeholder	A person or group that has interest in, and/or is affected by,

1.2 Enterprise, Business and the Econo

Entrepreneurs play a crucial role in the economy. They look to combine resources innovate and start businesses, contributing to economic growth. In this section we the economy in detail.

1.2.1 Role of an Entrepreneur in the Economy

Creative Destruction

New ideas and processes are a fundamental part of how our economy works. A ke this is *creative destruction*. This is the notion that the old is replaced by the new. N can cause the demise of whatever existed before them (destruction).

Entrepreneurs can gain an advantage over the rest of the market by exploiting this idea. Those looking to set up or expand a business are always seeking new products, ideas and processes. The introduction of new products can be the most obvious example of how this, if successful, can destroy the market for older products. For example, the introduction of smartphones has all but killed off the production of regular mobile phones – and also affected sales of digital cameras and standalone music players.

It can also refer, though, to how *factors of production* (land, labour and capital) are organised (see section 1.2.3). Innovation can mean discovering the best or mo capital or resources. For example, a firm might cut costs through outsourcing labo market share as a result.

Jean-Baptiste Say, one of the first people to explain the theory behind the role of wrote in 1803 '*the entrepreneur shifts economic resources out of an area of lower [p area of higher productivity and greater yield*'. This is still true today – entrepreneur in order to make money.

There will be both winners and losers, though, as a result of creative destruction. T products that are replaced by newer ideas might lose if they can't adapt. Workers replaced by capital or their jobs are outsourced.

In general, though, creative destruction can be seen as good for an economy. It p the market power of bigger companies if entrepreneurs introduce new, successful

Making Decisions to Operate, Develop and Expand

Once the entrepreneur has set up a business, he or she will have full responsibility marketing to finance, operations and production. If the business is a sole trader, i. person, the entrepreneur will manage every area of the business. The bigger the f will require and so responsibilities will be broken down into various departments, purchasing departments.

The next step for the entrepreneur (who could be anyone from the sole owner to expand and develop their business.

This might involve:

- Purchasing new locations
- Investing in equipment
- Expanding current premises
- Hiring skilled staff
- Buying out rival companies
- Performing market research
- Investigating new product ideas
- Testing prototypes on the target market
- Researching the market
- Increasing brand awareness

Adding Value

Added Value is the difference between the price at which a business sells its produ producing that product/service. Businesses add value to their products/services in attractive and desirable to the customer. Firms achieve this by changing the produ changing the way that customers perceive the product (through advertising and b

You can calculate the added value of a product/service using the following formu

Added value	=	Selling price of product/service – Total cost of producing

Making a product/service more desirable helps to keep customers happy, attract n purchases – some customers might even refer their friends. Repeat purchases and reduce the business's advertising and marketing costs, and improve and consolida market share and market growth.

Value can be added functionally or *aesthetically*. Some ways to *functionally add va*

1. Offer customers several *alternative methods* of payment, e.g. credit card, d transfer, cheque or cash.
2. Offer customers the facility of purchasing a *gift voucher* for the product/se and friends on special occasions.
3. Issue customers with a *loyalty card* so that they can *get something back* ea or use a service.
4. Offer customers *cash discounts* on purchases or introduce *special promoti* buy one and get the second for half price).
5. Offer customers *warranties* and extended warranties on the product purch
6. Provide customers with a reliable *after-sales service* for the product.
7. Give customers the option of purchasing *'add-ons' or 'upgrades'* for the pr
8. Price the product or service appropriately. *Higher-priced* products create t and have a certain *'snob'* value.

Some ways to *aesthetically add value* to a product or service are:

1. Associate the product or service with *well-known* personalities or business
2. Package and present the product in a way that creates the *perception of v*
3. Present the product as a *uniquely designed 'must-have'* item.

1.2.1 Questions

1. **a)** What equation is used to calculate added value?
b) Identify two ways in which a firm can add value to products/se
- **i)** Functionally
- **ii)** Aesthetically

2. **a)** The introduction of tablet computers can be seen as an examp destruction. What goods or services might no longer be profita introduction of tablet computers?
b) Why might this be good for the economy?

1.2.2 Entrepreneurial Motives

Entrepreneurs are people that thrive on success, risk and reward. They come in all ideas!) and the reasons for becoming an entrepreneur can differ from person to p

Characteristics Required for an Entrepreneur

Their characteristics, however, are normally very similar and include:

- *Creative* – be able to look to the future
- *Hardworking* – have no problem putting in the necessary effort to run a business
- *Resilient* – be emotionally stable enough to bounce back from adversity
- *Self-confident* – have confidence in their own abilities and be able to communicate this
- *Risk-taking* – be willing to take chances that have potential for great reward
- *Initiative* – be able to take an idea/plan and act upon it with minimal guidance

Skills Required for a

There are skills that an e include:

- *Problem-solving* to understand h
- *Teamwork* – hav offer support wh
- *Communication* everyone can un
- *Organisation* – h and responsibilit
- *Numeracy* – have calculations, suc
- *Information tech* everyday life as t

Reasons Why People Set up Businesses

Entrepreneurship is stressful, risky and time-consuming. It is also self-gratifying ar contrasts and conflicts do not dissuade people from becoming entrepreneurs bec

1. Enjoy a good *challenge*
2. Are *creative* individuals by nature
3. Have always wanted to be their *own boss*
4. See that *profit* can be made from their enterprise
5. Want to *do things differently* from everyone else
6. Have been *insp* someone else
7. May have an *e* wanting to ent as social entrep techniques to t

Financial and Non-financial Reasons

There are *financial* and *non-financial* reasons for why people become entreprene *maximisation* and *profit satisficing* (financial) and flexibility of the *work-life balanc*

By focusing on *profit maximisation*, entrepreneurs can invest in the growth of thei many potential customers as possible. *Profit satisficing*, on the other hand, rather possible, involves generating enough profit to fulfil a business's requirements. The to make can depend on many factors, such as long-term investment plans and the

Society is shifting and the *work-life balance* (more on this in section 1.5.4.) is beco People no longer feel the need to work long hours as a way of earning more pay (of industries). Instead, people put value in their leisure and family time and so loo around their lives, rather than the other way round. This social change has encou businesses from their own homes. Home-based businesses are often small operat living without compromising on what is really important to them.

1.2.2 Questions

3. Explain one reason why a person would choose to set up their own

4. Read the names of five businesses below and identify why each ow their business. Reasons may include *ethical/moral stance*, *home w* *creativity*:

a) Social Justice Ltd
b) Imagine Inspire Innovate Ltd
c) Bargain Prices Plc
d) Green Warriors Ltd
e) Handmade Gifts

1.2.3 Factors of Production

Factors of production consist of the inputs needed to make a product or service: l
enterprise. These resources are often scarce and, therefore, valued highly by busin
economy plans to grow its service sector, for instance, it must have the land, labou
achieve this. If these factors are not present, the economy may need to encourage

Land

Land involves natural resources, the cost of which is the price of buying or renting
which production happens, such as the building that is rented for a factory, or a fa
bought for growing crops and looking after animals. Land is considered a limited
have more of it than others. Canada, for instance, has a great amount of oil reserv
area of the Amazon rainforest.

Labour

This is the work that people do in order to convert raw materials into other produ
Human capital is the measure of a worker in terms of their ability. The productivity
resource (human capital) can be increased by improving a worker's level of skill. T
variety of means, including investment in education or training and by the amoun
their roles. Workers that meet a high level of human capital will cost a business m
to demand higher wages. Human capital can consist of managers or subsidiary en
flexible as they can be reallocated to different parts of a business or economy dep
instance, an economy wishes to expand its industrial sector, it might offer grants t
up in that area. One of the main resources that a business would then need to rea

Capital

Capital is a twofold concept that can refer either to the physical or the financial:

Physical capital refers to tangible equipment that is used in the production proces
vehicles, while *financial* capital refers to money. It is the monetary capital that is u

Capital and labour, from a business point of view, are substitutes for each other. A
machine or a worker to make something; which one a business chooses will depe
labour and the productivity of each.

Enterprise

Entrepreneurs are the risk-taking and creative resources (people) who come up w
ideas are often what can make or break a business – the better the idea, the more
therefore, more sales and profit. If the business idea does not meet the expectatio
very opposite can occur.

Enterprise is the factor that refers to the head of production who manages the all
i.e. land, labour and capital. In economics, profits to business owners are included

1.2.3 Question.

5. **a)** Explain the difference between physical and financial capital.
b) Explain why labour is considered a flexible factor of productio

6. James Bolivar is a successful chef who wishes to start up his own r
factors of production he will need and explain examples for each o

1.2.4 Specialisation

What is Specialisation?

Adam Smith was an eighteenth-century economist who came up with the idea of specialisation. This is the idea that someone should be concentrating on only one aspect, or in the context of an economy, concentrating on producing one good. He suggested countries should only produce that which they are good at producing, i.e. the good they have an absolute advantage in, and trade with other countries to obtain all the other goods.

***For example**, France should specialise in producing wine and Belgium should specialise in producing beer. Then, in order to obtain both goods, France and Belgium should trade their excess wines and beers.*

Advantages and Disadvantages of Specialisation

If a country specialises in a good that it is good at producing, it usually is more efficient at producing that good. Therefore, efficiency increases with specialisation. This means production costs are reduced from specialisation, which will lower the price. Consumers would benefit from lower prices and inflation levels should be reduced.

Equally, specialisation would mean production would increase as countries will na
countries follow the suggestions of Adam Smith then they can find they have an i
producing the goods in which they have an absolute advantage and trading for th
benefit from lower prices and increased consumer choice from international good
increase in growth rates as production increases.

However, it is advised not 'to put all your eggs in one basket'. By specialising cour
diversity and shocks in certain sectors can have dramatic effects on economies sp
Specialising and trading increases interdependence among countries. As has been
financial crash, economic shocks spread across integrated economies; as one econ
were dependent on their trade will find they are also hit by the downturn.

Division of Labour

This idea of specialisation can also be applied to the production process of a good
theorised that the production process could be split into stages and if a person sp
the firm could benefit in a similar way to a specialising country.

***For example**, a firm produces dolls. The stages are; moulding the body parts, attac
face, making/attaching the clothes and making/attaching the hair. A person could m
stage, or, they could concentrate on only stage, such as painting the faces on all the*

Advantages and Disadvantages of Division of Labour

Division of labour provides efficiency benefits as the time spent switching betwe
practice makes perfect: people focus on one task and so will become experts as th

Workers may become experts at a task, but they may also find that they are unabl
have left the firm since they are unskilled in many other areas. On the whole, an ec
structural unemployment from division of labour. Division of labour can also lead
decreased levels of staff motivation. Workers may even find that their roles becon
productivity and increasing mistakes committed.

1.2.4 Questions

7. The 2008 financial crisis had a massive effect on economies aroun
many to decrease their levels of production. Explain why this decre
consequences for other countries, too.

8. Clay Creations Ltd is a small manufacturer of pottery goods, such a
mugs. The business is run by its owner, who employs five pottery
business is organised so that each worker has a hand in every stag
process, i.e. design, creation, firing in the kiln and glazing. Howeve
single worker are the business's most popular and so the owner is
focus that worker purely on design and then assign each other wo
tasks, such as only creating or only glazing.

Advise the owner on whether to reorganise the business so that ea
one element. Consider both the advantages and disadvantages of

1.2.5 The Wider Economy

Many of the economic measures and policy tools below are explained and revisite course. However, the point of them here is to explore their implications to busine the economic environment in which businesses operate.

Interest Rates

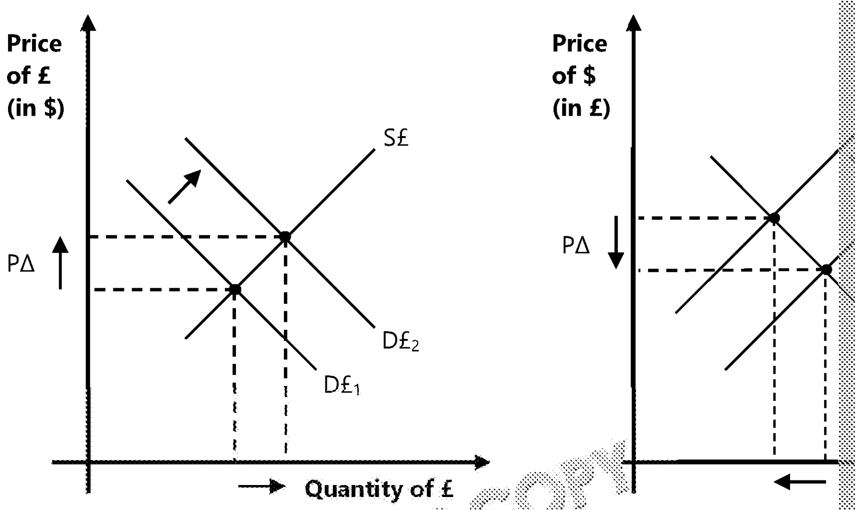
Firms may need to borrow money in order to invest. Interest rates determine how back when they borrow money. If interest rates go up, the cost of borrowing incre invest. Equally, investing money has an opportunity cost. The return a firm gets fr the interest the firm would receive from saving the money. Because interest rates firm gains from saving, the effects of interest rates on investment are twofold. If in becomes more expensive and its opportunity cost also increases; therefore, firms

Falling interest rates will increase demand for firms' goods. This is because consur saving will fall and they are more likely to go out and spend their money rather th borrowing has fallen and so consumers are more likely to borrow money in order businesses. An increase in interest rates will cause an increase in demand for t revenues increasing.

Exchange Rates

When a good is bought, an amount of money is given over 'in exchange' for the go shown by the amount of money swopped for it. The exchange rate shows how muc (exchanged) for another currency, or, the value of one currency (e.g. £) in terms of a

If an American consumer decides to buy a British good then they will need to cha into British currency (£s) because the good is valued in £s.



Let's look at the exchange rate of £s and $s and how this transaction would chang foreign exchange market. The top graph shows the demand and supply of £, the economy is shown on the x-axis; 'quantity of £'. The price of £s is shown on the y- shown in $s as we want to know how many £s we can get for $s. The bottom grap of $, the quantity of $s in the global economy is shown on the x-axis; 'quantity of y-axis and the price/value of $s is shown in £s as we want to know how many $s w

As the American wishes to buy £s, the demand for £s increases from D£$_1$ to D£$_2$. T increase by PΔ. The value of the £ has appreciated, this means the purchasing pov buy) has increased; the £ can buy more $s than before. As they sell their $s for £s, to S$$_2$ and the price of $s decreases by PΔ. The $ has depreciated in the value, thi decreased so its purchasing power has fallen and it can buy less £.

So how does this affect business...?
If the £ **appreciates**, then UK goods will appear more expensive in comparison to currency stays the same; ceteris paribus). UK businesses will lose 'international co demand for UK goods will fall and demand for foreign goods will rise; demand fo imports will rise. If the £ **depreciates**, UK goods appear cheaper in relation to fore exports will rise, and domestic consumers will shift away from buying imports so t

For exporting companies, the exchange rate affects the relative price of their good for their goods. An appreciation can mean a fall in demand (and, therefore, revenu mean a rise in demand (and, therefore, revenue).

For importing companies, the exchange rate affects their costs. If firms import fore import input materials for production, then an **appreciation** of *foreign* currency w products they are purchasing and thus will eat into their profit margins. A **deprec** lower the costs and thus increase profit margins.

Ceteris Paribus
This is one of the most important simplifications in economics. It means 'with all e

Let's use an example:

The prediction that 'you will be colder on a snowy day than you would be on a su many variables that come with this. The case may be, for instance, that you stay in heating on full and remain warm. Or, if you do go outside, you might wear a therm you may even be warmer than you would be on a sunny day, especially if the wind *Ceteris paribus* means that you assume all these other varying conditions do not c at how the outcome may differ if this one condition changes. You will be colder o wind speeds, surroundings and clothes worn remain the same on both days).

Taxation

Indirect taxes are taxes that are imposed on an economic agent but are not paid imposed on a producer but are passed on to a consumer. The tax is indirectly paid does not have to pay the tax, as in, they can choose not to buy the product that is on fuel or other goods and services are indirect taxes; VAT is an indirect tax, altho there are very few goods/services the tax doesn't apply to.

Direct taxes are paid directly by the economic agent that they are imposed upon tax is imposed on an agent and is paid directly by that agent to the government. T through consumption choice.

Taxes affect firms because they are a cost to firms. If the government increases ta more money away and will then have less profit. Equally, as taxes increase, firms w goods in order to cover this. Increased prices will mean a loss of customers.

If the government increases income tax, although this affects households, it still h taxes mean consumers have less disposable income. If consumers have less dispo less money to spend on goods and so firms will see a fall in demand for their goo

Unemployment

Unemployed workers are not receiving an income and will find they are less able t
means consumers will reduce their spending. Falling incomes and falling spending
goods will fall and they will lose revenue.

If employment is high, firms would have to offer higher than existing wages in ord
their current jobs and work for them instead. High levels of unemployment mean
workers and firms can offer lower wages because a low wage is better than no wa
unemployment means fewer customers are consuming firm's products, it is relativ
production because there is a pool of unused labour to employ.

Inflation

Inflation impacts consumers, business and the economy in many ways. Changing
their labels, print new menus, etc. Changing prices on machines, tills, vending mac
disconcerting for firms and can create uncertainty for future planning.

If prices increase then people's costs of living increase. Increased living costs r
therefore, consumption. Firms will find their sales and revenues fall. Increasing pri
increases their costs.

It additionally impacts those firms that interact on the global market. As UK prices
expensive on the global market in comparison to foreign goods. Therefore, inflati
competitiveness as it makes goods and services appear relatively expensive.

However, if inflation is anticipated, firms and governments can include it in planni
from inflation and mitigating its effects. Unanticipated inflation can throw off plan
lead to problems.

1.2.5 Questions

9. Complete the following table to show either benefits or drawbacks
an inflated economy.

Effects to businesses from an inflated econom

- Businesses can increase their prices without raising suspicion
- Consumers may become price-sensitive
- Business cash flow becomes much tighter
- It raises the value of property and stock
- Suppliers are able to increase their prices
- Company workers make demands for higher pay

Benefits	Drawb

10. Outward Bound Ltd is an exporter of toys based in the UK. The co
group of buyers in China and the USA and is making a reasonable

Explain how Outward Bound Ltd might be affected if:

a) China's currency appreciates
b) The USA's currency depreciates
c) The UK's currency appreciates

1.2 Keywords

Factors of Production	Inputs used to produce goods and services: land, labour, ra
Add Value	When a business turns the sum of raw materials into a produ Value added is calculated as: Selling price of product/servic product/service.
Specialisation	When a factor of production (such as labour) is devoted to effect being an increase in efficiency.
Division of Labour	When the productive process is split so each individual stage workers. This can improve the speed and efficiency of overa discussed by Adam Smith.
Interest Rate	The amount paid by borrowers of money to the lenders. An amount that commercial banks pay the central bank to bo
Exchange Rate	The price of one country's currency in terms of another.
Direct Tax	A tax that is paid directly by the individual or organisation to avoided or shifted to another person or organisation.
Indirect Tax	A tax that is collected by an intermediary between the consu These sorts of taxes can be avoided through consumption c
Inflation	An increase in the price level of goods and services over a
Unemployment	The percentage of people in an economy who are econom employment.

1.3 Introducing the Market

Economics Background...

In economics, certain assumptions are made in order to simplify the complex p
economy. One common assumption is the belief that economic agents are 'rat

- In terms of consumers, economists assume that they will make the best option that makes them happiest without influence or bias. In other wor maximise their utility.
- In terms of firms, economists assume that they will make the best decisi makes the most money without influence or bias. In other words produc profits.

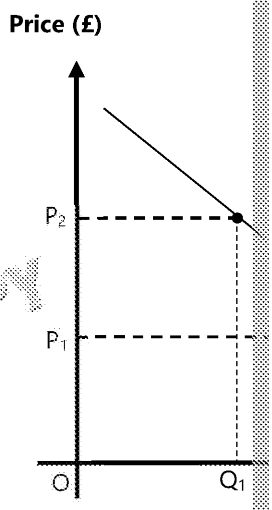
Unfortunately this is only an assumption and economic agents may not always undermine any model based on this assumption and their predictions cou Important decisions in running the economy or running private business are Inaccurate information and incorrect assumption could mean the wrong decisi always important to consider the assumptions and to contemplate how the ou them, for example, when consumers act irrationally.

There are many reasons why a consumer may decide on an irrational choice or the most efficient at creating happiness. Habitual behaviour is the idea that co because they are used to buying that product, making a habit out of certain be becomes a default one and they are unlikely to change.

The topic of consumer behaviour is one that is studied heavily by 'behavioural well-known behavioural economist and it may be interesting to look at his blo

1.3.1 Demand

If you demand something, you want it; consumers demand goods and goods are demanded. A demand curve shows the relationship between the amount of a good that is demanded (quantity demanded) and the price a person is willing to pay at each quantity. It is determined by consumers' decisions on how to use their resources to maximise their satisfaction. The diagram shows a demand curve.



A demand curve can show each individual consumer's demand for a good, or, if all the individual consumers' demand curves are collected then a demand curve can show the total demand for a good; the demand that it is in the entire market.

The law of demand is, as price rises the quantity demanded falls. This creates a negative-sloping demand curve. There are exceptions such as Veblen goods and Giffen goods, but for the exam. There are three main reasons listed below for the inverse relationshi help to further your understanding of demand.

1. **Income Effect**
   You are able to buy more of a good with a set amount of money if the price
   you can buy more with a fiver if the item price is 50p than you could if it was
   power': as price falls your purchasing power rises (your ability to buy goods i
   Whereas, if the price for a good rises, your money can't go as far. In other wo
   because the potential quantity of the good you can buy will decrease.

   In summary... price goes up, quantity falls: price goes down, quantity rises.

2. **Substitute Effect**
   As the price for something falls it will appear cheaper in comparison to other
   other goods remain at the same price). It is likely people will switch from buy
   this (cheaper) good. Therefore, the number of people demanding (wanting) t

   Equally, as the price rises the good will appear more expensive and people w
   Demand will fall as less people start demanding the good.

   In summary... price goes up, demand falls: price goes down, demand rises.

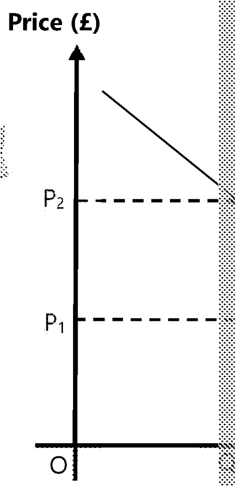
3. **Diminishing Marginal Utility**
   You buy goods to satisfy your want for a good. But, each consecutive good you buy will satisfy you a little less than the one previously. Say, for instance, you want a cookie. The first cookie satisfied your want for the cookie, the second one does again still but perhaps not as much as the first one. Again this happens with the third or fourth cookie, bringing you some happiness but not quite as much as the previous cookie. There may even be a point where you become sick of cookies and the next one is dissat

Diminishing = reducing
Marginal = next one along / consecutive
Utility = happiness

On the curve, this can be shown as for the first good (Q_1) you are happy to pay P_1
(Q_2) you are less happy with and are only willing to pay P_2 prices.

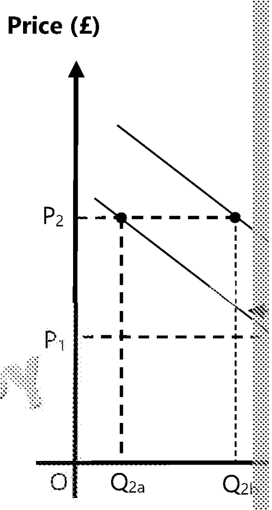
Movements and Shifts in the Demand Curve

Movements along the demand curve are when you move up and down the curve without the curve moving. For each quantity demanded there is a different price which reflects the consumer's willingness to pay and vice versa. A shift in the demand curve is when there is a change in quantity demanded at every price level. The whole curve will shift to either the left or right. As can be seen in the diagram, for a shift outwards of the demand curve from D_a to D_b, the quantity demanded at P_1 has increased from Q_{1a} to Q_{1b} and the quantity demanded at P_2 has increased from Q_{2a} to Q_{2b}. This means the consumer is willing to pay more for a greater number of goods. This happens when there is a change in the conditions of demand.



Shifts can be caused by:

- **Changes in Preferences, Fashions**
  (advertising, branding and publicity)
  The horsemeat scandal in 2013 caused a shift in the demand curve in the market for microwavable meals containing beef. As it was found out that a lot of the meals had contained horsemeat instead of beef, consumers shifted their preference away from these products. The demand for these products fell and the curve would have shifted inwards. Similarly, if it was found that a certain product was good for you, it would likely shift the demand curve out. Over the last [illegible] years or so, the preference for lamb has increased; meaning the demand curve for lamb has shifted out and this is why lamb prices have steadily risen over the years.

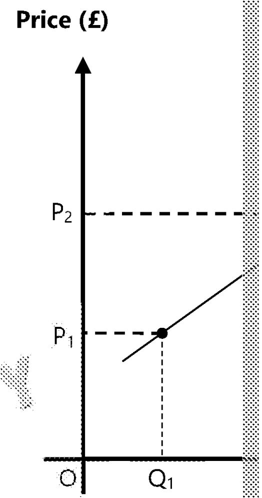


- **Seasonal**
  This is similar to the changes in preference. Some demand curves shift wit to become more demanded during Easter and Christmas time, much the s will increase during the Christmas season. The demand for airline tickets w holidays, which explains why ticket prices increase.
- **Changes in Demographics** (size and age of population)
  People of different ages demand different goods and services; therefore, i changes, it is likely the demand for certain goods will change. For exampl demand for baby products, whereas an ageing population is likely to incre
- **Change in Income**
  If peoples' incomes rise, they are able to buy more goods and it is assume demand will increase. It is unknown exactly which goods will be demande see some kind of change in their demand.
- **Changes in Prices for Other Goods** (price of substitutes and complemen
  If the price of cola was to increase, some people are likely to swop to lem lemonade will shift out as people are willing to pay more for each quantit increases above the new cola price and they instead swop back to buying goods is dependent on consumers' ability to compare the prices of goods falls, it is likely people will buy more lamb and also mint sauce. This fall in curve for mint sauce out.

1.3.1 Questions

1. Why is the demand curve downward-sloping?
2. What factors might cause the demand curve to *shift*?

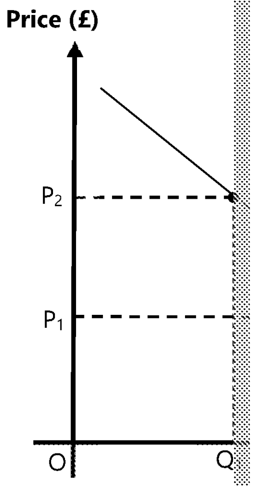
1.3.2 Supply



A firm will manufacture (produce) and supply (provide) a good to the market. A supply curve shows the relationship between the amount of a good that is supplied (quantity supplied) and the price of the good at each quantity. It is determined by producers' decisions on the quantity of goods to produce depending on their costs of production and price of their goods. The diagram shows a supply curve.

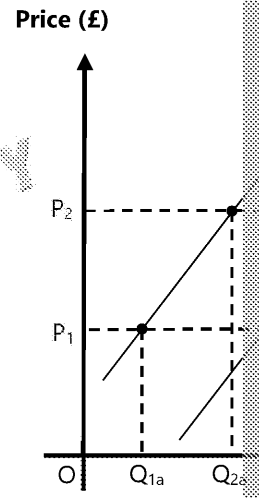
The supply curve is, usually, a positive slope. There are exceptions to this, there are goods with 'backwards-bending' supply curves, but you are not required to know this for the exam. The supply curve has a positive slope because the higher the price a good will sell at, the more willing a firm is to produce that good, ergo, quantity supplied increases with rising prices.

Movements and Shifts in the Supply Curve



Movements along the supply curve are when you move up and down the curve without the curve moving. For each quantity supplied there is a different price and vice versa.

A **shift** in the supply curve is when there is a change in quantity supplied at every price level. The whole curve will shift to either the left or right. As can be seen in the diagram, for a shift outwards of the supply curve from S_a to S_b, the quantity supplied at P_1 has decreased from Q_{1a} to Q_{1b}, and the quantity supplied at P_2 has decreased from Q_{2a} to Q_{2b}. This happens when the conditions of supply change.



Shifts in the supply curve can be caused by:

- **Changes in the Costs of Production**
  The supply of a good depends on the cost of making the good; this includes materials, labour, the machines used, electricity bills, etc. If these input costs increase then less can be produced and supplied at every price level and similarly, if input costs fall more can be produced at every price level.

  For example, the most influential input cost is oil price; oil is used to create energy and run machines. The effects of oil prices are felt by all businesses and are a large proportion of costs. Therefore, an increase in oil prices will shift the supply curve in.

- **New Technology**
  New technology can increase the efficiency of production by either improving capital or the techniques used to make th
  efficient a firm is able to produce more and thereby shift the supply curve
  produced at each price level.

- **Indirect Taxes**
  Indirect taxes are taxes that people pay indirectly; by this it is meant they goods rather than being taxed directly via income tax, for example. Indire if indirect taxes increase then the cost of the good will increase and thus t will be less willing to produce goods for the decreased profits.

- **Subsidies**
  Subsidies have an opposite effect to taxes on the cost of goods. Subsidies government to support employers by funding some of the costs of produ more able to supply goods and thus supply will increase.

- **Number of Firms**
  Greater numbers of producers mean there will be a greater supply of a go when firms leave a market, they will reduce the supply within the market. remember about the number of firms within a market is that other firms r compete via price, in order to encourage consumers to their product have to affect their price. A greater number of firms in a market means t the supply and this will have a downward pressure on prices and encour increased efficiency.

- **External Shocks**
  External shocks are things that happen outside of an economy but can sti financial crisis started in the US sub-prime mortgage market but this had global market. External shocks can cause economy-wide recession, or incr materials, or cause taxes to rise and fall, or cause more or fewer firms to le can have an effect on supply.

1.3.2 Questions

3. Why is the supply curve upward-sloping?

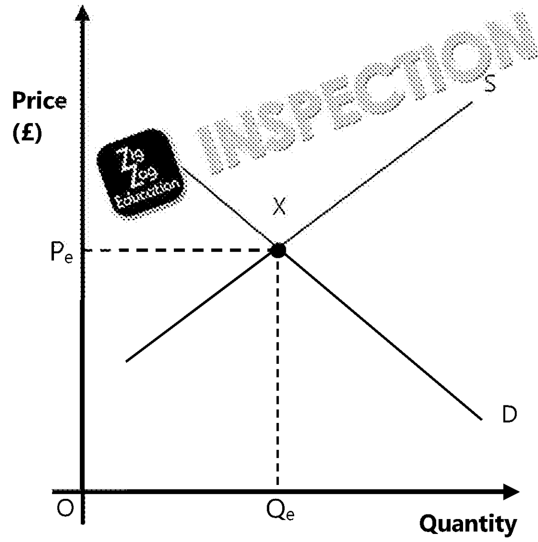
4. What factors might cause the supply curve to *shift*?

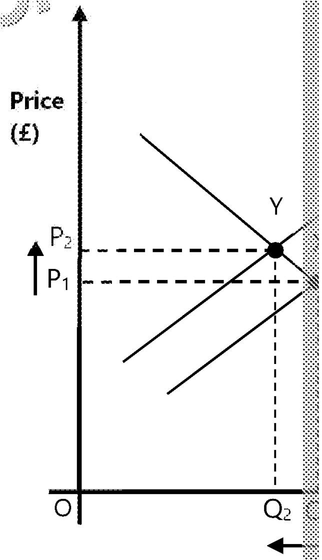
1.3.3 Price Determination

Price of a good is determined by the market and interaction of supply and deman where supply meets demand; the point where the price of the good means the vo willing to buy is the same volume producers are willing to sell. Point X is the mark the supply curve intersects the demand curve. The market equilibrium price is P_e a quantity is Q_e.

A drought would mean the supply of corn is reduced and supply curve will shift in equilibrium point with a new equilibrium price and quantity.

A shift of either curve in any direction would affect the market equilibrium point, p



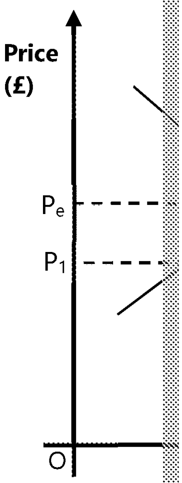


Economics has theories and makes predictions. In order to make these theories and predictions observations are undertaken, findings are analysed and models are found. This is done by identifying a problem, capturing the fundamentals of a situation and simplifying the rest in order to make the model as close to reality as possible without any complexities. These simplified details can change the outcome in reality and, therefore, it is important to consider which assumptions are used and to reflect on these assumptions when making a prediction.

Activity
Draw your o
demand gra
the market e
either the su
notice how t
to increases
quantity.

Excess Demand

A situation that results in an excess of demand is different to shifting the demand curve. An example would be a price cap on energy prices. The market equilibrium price for energy would be P_e; however, there is a capped price at P_1. This is the maximum price that can be charged for energy. At this price the quantity supplied is [illegible] and the quantity demanded is at Q_d. Q_d is greater than [illegible] therefore, there is an excess of supply.

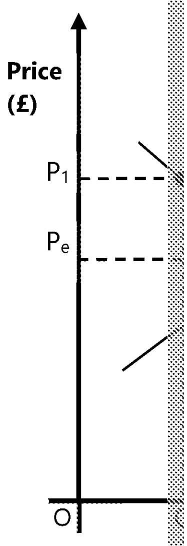


In a situation without a rule or regulation to keep the price at this level, the market forces would increase the price back to equilibrium. If a price for a good was lower than the price customers were willing to pay then there would be a shortage of Q_s to Q_d as more customers would be willing to buy the product at this price than producers would be willing to supply it.

Some customers would be willing to pay for the good and offer a higher price to
realise that customers are willing to pay more and will increase prices to gain mor

Any deviation will gravitate back towards equilibrium.

Excess Supply



A situation that results in an excess of demand is different to shifting the demand curve. An example would be the national minimum wage. In this situation, P_e is the market equilibrium price for labour (wage) and P1 is the minimum price for labour (minimum wage). At this price the quantity supplied is Q_s and the quantity demanded is Q_d; because Q_s is bigger than Q_d there is an excess of supply. In reality, this excess of supply is excess labour, or, unemployed labour. Th[illegible] the minimum wage is set to the equilibrium the less excess supply is created.

In a situation without [illegible] or regulation to keep the price at this level, the market forces would force the price back to equilibrium. If the price for a good was higher than the market equilibrium, this means not enough customers are *willing* to purchase the good for this price. Businesses would have to lower their prices again in order to entice customers back. As a response to the lowering price, more customers would want to buy the good and the excess supply would decrease.

Any deviation from the equilibrium will gravitate back towards equilibrium.

Limitations of the supply and demand model

Of course, this is a simplified model. Recall the idea of 'ceteris paribus' that was di
simple model of supply and demand makes several assumptions. For example, it
the *market power* to charge prices above the equilibrium rate. In reality, many firm
as brand loyalty, advertising and differing product quality. Therefore, the predictio
lead to a decrease in demand might not always be strictly true.

You will learn more about differing levels of competition within industries, and its
models, in the *Theme 2* component of your course.

Another issue is human behaviour. The model of supply and demand assumes tha
they weigh up all the pros and cons of a choice before making a decision, and car
personal benefit the purchase of a good will bring. Of course, this is not true. Hum
prone to all sorts of biases and mental shortcuts when making decisions about wh
case of consumers). This can mean that supply and demand models are unrealisti

1.3.3 Questions

5. Explain with reference to supply and demand curves, how a good
oversupplied will decrease in price.

6. What is meant by the term 'ceteris paribus' and why is this importa

1.3.4 Price Mechanism

In the first part of this course companion we looked at the idea of the '**basic econ** that because resources are limited we cannot satisfy all our wants and needs. In a problem is resolved through the price mechanism. Resources are (with exceptions possible to those who value them the most.

Firms need to determine what they should produce and the most efficient way to determine who to buy their good from and whether they are willing and able to p refers to the effect that price has on demand and supply. The market, the interact good, and the price mechanism can help determine this allocation of resources. F consumers who will switch their consumption from expensive goods to cheap goo demand and so firms are likely to stop producing in that market. The resources tha freed up and will then be allocated to more efficient firms within the market, or be more demanded.

There are three functions of the price mechanism:

1. **Rationing**
   Higher prices can ration (limit) demand to meet supply. If, for example, a reso of the good that uses that resource will increase. Fewer people are willing to rations the good so that it is allocated to only those who are willing to pay th those that value it the most.

2. **Incentive**
   The price mechanism encourages producers and consumers to behave in a c price rises, this encourages producers to raise the output of their goods and demand. There is the *incentive* to produce more because revenue will be hig

3. **Signalling**
   The price mechanism sends a signal to customers and producers that there h and/or supply. If demand decreases, prices will fall and this indicates that pro of goods they produce.

On occasion these functions of the price mechanism will not lead to the most effic and sellers and the government may have to intervene. This is known as *market fa*

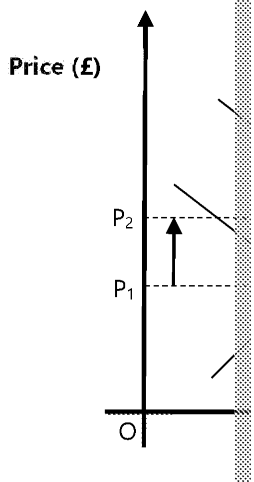
How Firms Respond to a Change in Demand

Many factors, such as technological breakthroughs, can create a change in deman in price.

Increase in Demand

When there is a spike in consumer demand, producers will often raise their prices accordingly. Following a rise in price, producers are willing to supply more goods as profitability is high.

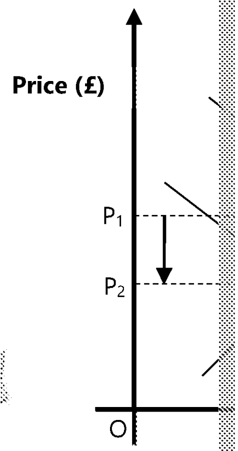
Increase in demand may come from a sudden change in fashion trends or, for example, where consumers want the latest watch or to catch a certain television show. Increases in demand shift the demand curve to the right, which moves the market equilibrium from X_1 to X_2.



Decrease in Demand

When demand falls, suppliers will normally lower their prices (from P_1 to P_2), but they will increase the quantity of goods they are prepared to produce. Any producers that still offer goods at P_1 will find they have a surplus (more goods than demand).

A decrease in demand might occur due to seasonality, such as the rise of ice cream sales in summer, or from an external shock such as a sudden outbreak of disease. Decreases in demand shift the demand curve to the left, which moves the market equilibrium from X_1 to X_2.

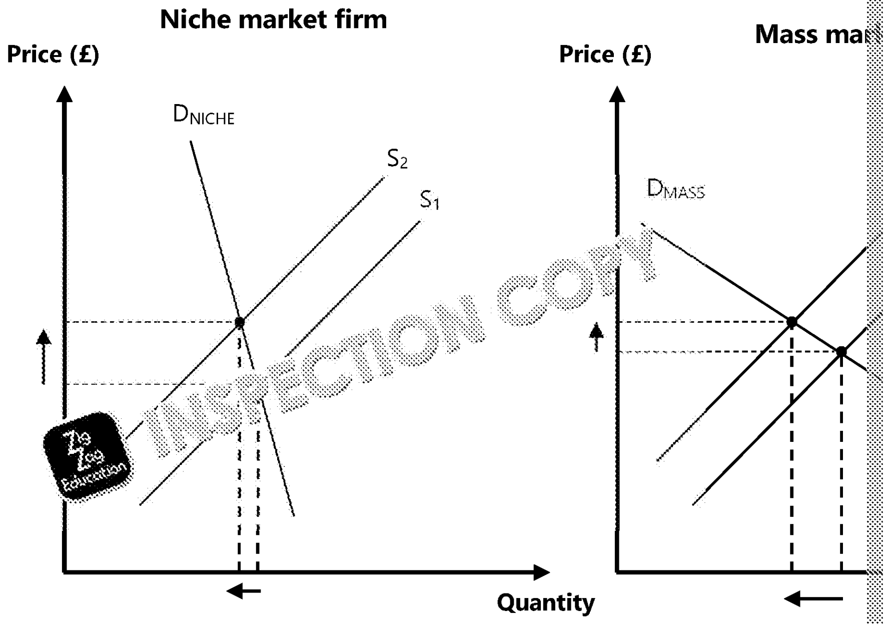


The Price Mechanism in the Context of Different Market Types

The price mechanism can work differently depending on the type of market. Firms can market their products on a *niche* scale or on a *mass* targeting small consumer groups and selling small quantities. By contrast, if a fi are many similar products on offer – but also more customers.

Niche Markets	M
Few customers	Many custom
Strong brand loyalty	Customers wi
Highly specialised firms	High sales vol
High-quality goods	Lower-quality
Lower competition	Lower risk (fir
Higher Prices	Lower prices

This means that the price mechanism works differently. In a niche market, consum means that their demand for goods and services is not so responsive to changes i following demand curves for niche and mass markets:



The price mechanism dictates that an upward shift in supply will cause prices to b demand curve is steep (more vertical). Customers are more loyal and are willing to and certain brands. This means that although the price increases by a large amou only decreases a slight amount (see diagram on left).

By contrast, the demand curve for a firm operating in a mass market will be much
will increase prices – but reduce the quantity sold by a *proportionately higher* amo

These diagrams show how the price mechanism means that firms operating in nic
prices (but achieve lower sales).

Potential Market Growth

No market is static for very long as there are always changes arising from:

1. *Seasonal* factors
2. Consumer *tastes*
3. Consumer *attitudes*
4. Government *regulations*
5. The availability of *new technologies*
6. *New competitors* entering the market
7. Changes in business *structure and outsourcing*

For these reasons businesses must be able to *recognise market trends*. A trend is the *general direction* in which things *tend to move*. For example, one current trend in marketing is for businesses to utilise social media. Firms around the world recognise how important a role the Internet plays in people's lives and so now invest heavily in their social media presences and online advertising.

It is important for a business to *review and analyse* such trends so that it can:

1. Make *better* decisions
2. Modify forecasts and set *realistic* targets in response to a trend
3. Anticipate and deliver the *right* resources to the *right* places at the *right* ti
4. Recognise opportunities for *innovation and improvement* on its product o
5. Develop a *strategic vision* and formulate *alternative futures* for its product

1.3.4 Questions

7. What are the three functions of the price mechanism?

8. Are prices likely to be higher or lower in a niche market when com

1.3.5 Understanding the Consumer

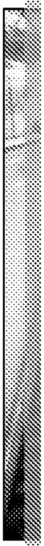
Primary and Secondary Market Research Data

Have you ever been stopped in the street to answer a few questions or received a
survey? If you answered 'yes', then you have taken part in market research.

Firms conduct market research by *collecting and analysing data* gathered from the
collect this data themselves (through email surveys or competitions, for example)
of *specialist market-research agencies*.

Primary Research

Primary research is *original research*, which involves gathering information *directly*
potential consumers. This can be carried out using face-to-face interviews, telephone interviews, postal surveys, web forms, email, observations, focus groups, consumer panels and test marketing.



Businesses often create *questionnaires* for use in primary research. They must take care, though – the following points should be considered when producing questionnaires:

1. *How* will the survey be *conducted*? (E.g. by face-to-face interview, by post, by telephone or over the Internet?) This will determine the *structure* of the questionnaire.
2. What is the *objective* of this survey?
3. *How many questions* will be asked?
4. Does the survey have any 'loaded' questions?
5. Are any of the questions *ambiguous*?

Advantages of using primary research:

- ✓ It finds *new* information about the target market.
- ✓ It reveals *relevant* and *up-to-date* information on the target market.
- ✓ It allows the business to *concentrate time and money* on its target market.

Disadvantages of using primary research:

- × It is *time-consuming* and *expensive*.
- × The *accuracy* and *reliability* of the data collected can depend on the *professi*
the *structure* of the questions asked.
- × The validity of the answers obtained depends on the *mood of the interviewe*
the opinion of the population as a whole.

Secondary Research

Secondary research is the collection of data from information that *already exists*. T
business archives, market reports, government [illegible], the Internet, newspa
journals. *Remember: all secondary research was once primary research!*

Advantages of using secondary research:

- ✓ It is *cheaper* and *quicker* to carry out than field research.
- ✓ Data [illegible] information about the *whole mass market*, rather than just the *targ*
- ✓ It allows the business to examine *trends* in its market.

Disadvantages of using secondary research:

- × The *reliability* of historic data must be treated with caution.
- × Secondary data is time-dependent: it may have been collected *with a specifi*
companies in the data may no longer exist), which does not *relate* to the bus
- × This historical data may also be *available to competitors*.

Quantitative or Qualitative?
Unlike primary and secondary research data, which differ in the way they are gath
research differ in the way they are documented.

Quantitative research asks *closed questions*, such as 'how many hours do you spe
or 'what is your favourite food?' The questions have very little scope for developm
sentence answer and are generally presented in numerical form, such as line grap

Qualitative research, on the other hand, asks *open questions*, such as 'why do yo
'what food do you associate with your childhood and why?' These questions are o
interviewee can give as long or short an answer as they like. The end result is gen
than statistics, allowing the researcher to investigate any themes that stretch acro

Primary and secondary research can be both qualitative (e.g. primary high-street i
published journal articles) and quantitative (e.g. primary face-to-face questionnair
surveys).

Effective Market Research takes both quantitative and qualitative research into co
make *more informed* marketing decisions, *reduce risk* and gain potential *competiti*
saw, market research is costly and time-consuming, but it can help businesses gat

- The *size* of the market
- The *state* of the market (i.e. whether there is demand and if it is growing or sh
- Central *elements* of the market (social, legal, economic, political and technolo
- *Competitors* and their business processes
- What the *public think* about all aspects of their product/service
- The *target markets* (i.e. the market *segment* to which they intend to sell)
- The *structure* of the market (i.e. the type, size and number of competitors)
- Consumer behaviour, their *needs*, *wants* and *price* they are willing to pay

Most market research processes go through the following steps:

1. *Identify* the problem
2. *Decide* on an appropriate method of research
3. *Determine* data type (primary or secondary) and sources
4. *Design* the data capture form
5. *Decide* on where to get the sample and on its size
6. *Collect* the data
7. *Analyse and interpret* the data
8. *Produce* a market research report

Limitations of Market Research, Sample Size and Bias

While market research has great value, there are some inherent problems with the da
businesses collect:

- ***Structure***: Data collected may not be specific enough to make good marketi
decisions; often the questions asked are too closed to be really useful.

- ***Size***: Just because your research says that 65% of the population will buy Kitt
doesn't mean they will – this data has come from a sample and may not refle
happens on a UK-wide scale. How can you be sure that your representative s
accurate enough to extrapolate the data to a UK level of potential sales?

  In other words, how do you know by asking 50 men aged 25–35 from Bo
  buy Lynx deodorant?

- ***Representation***: Data collected may not take into account regional differenc buy Welsh cakes in Sussex, but market researchers get a very positive respon potentially expensively misleading. Regional differences can be subtle, but if they can lead to disaster.

  Some companies, such as Coca-Cola, take a global approach to their mar while others, such as Domino's Pizza, allow each country to handle their o marketing for franchisees.

- ***Bias***: When companies collect data, they need to be as fair as possible. If a q is too closed, for instance, it would likely generate a one-sided response fro

  The interviewer needs to be fair, too. If the [illegible] is looking for a specif people that drink milk in each area) [illegible] miss other correlations (e.g than milk).

  Time affects [illegible]. A sample that is questioned one year may feel very cou[illegible] due to any number of factors, including average income, techno generation, and branding. Companies, therefore, need to sample over d get a fair picture of their target markets.

Questions to ask when deciding on a method of sampling:

1. What will the *cost* be?
2. Will it prevent sample *bias*?
3. How long will the *process* take?
4. How much *finance* is available?
5. Is it the *best method* for the task?
6. Who and where is the *target market*?
7. Can the population be *divided into groups*?
8. What *type* of product or service is being tested?
9. How *closely will it represent* the total population group?

Limitations of the sampling process can be found by asking the following questions:

1. Have the people sampled *told the truth*?
2. Has the 'right' *sample size* been chosen?
3. Has the data been collected *without bias*?
4. Have the appropriate questions been asked?
5. Has the appropriate target audience be[illegible]?
6. Has appropriate sampling technique been used?
7. Have the results of the sample been *correctly analysed*?
8. Has the sampler actually taken the sample, or were the *results fictitious*?

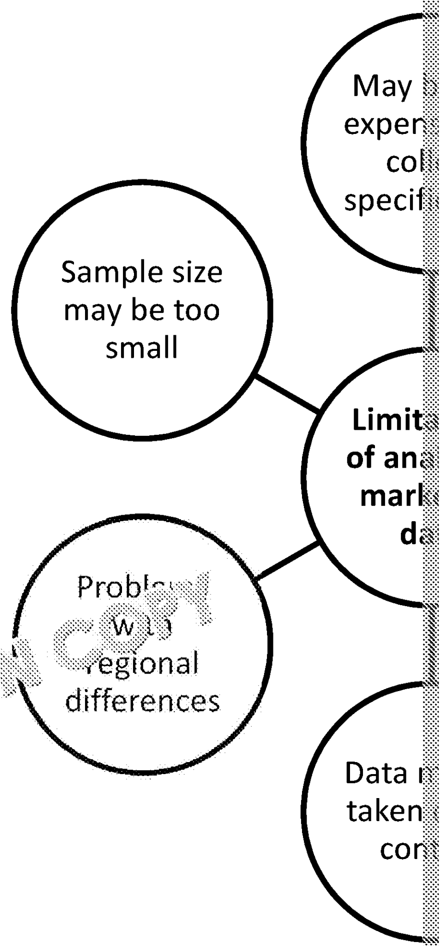


Diagram: The possible problem

Market Segmentation

If you peel an orange, you can break it into segments. No two segments are alike
for markets.

Businesses split their markets into *segments* in order to understand who the avera
and what they are willing to pay. Businesses pick out the segment of people that a
product/service and target them. Each segment that a business wishes to target re
This process (called *market segmentation*) is conducted to ensure that any market
produce a high return.

Market segmentation allows firms to conduct *differentiated* marketing, which focu
customers. *Undifferentiated* (or mass) marketing treats customers as a *homogeneo*

There are four common methods of market segmentation:

1. *Demographic segmentation* is by age, family size, occupation, ethnicity, educa
   game, for example, may be aimed at male children between the ages of 12 a
   textbooks for [illegible] would be primarily aimed at Business teachers.
2. *Geographic segmentation* is by town, county, country, climate and population
   tour business, for instance, may segment the market by town, county or even
   type of child pram, meanwhile, may use population birth growth rate to segm
3. *Behavioural segmentation* is based on how customers react to, and behave to
   analysing customers' brand loyalty, usage, attitudes, responses and price sen
   on offer.
4. *Psychographic segmentation* involves analysing customers according to their
   and attitudes.

Advantages of market segmentation include:

- ✓ It helps the business get to know its customers.
- ✓ It focuses business strategy on a specific target audience.
- ✓ It encourages the business to specialise to meet the needs of a particular seg
- ✓ It helps provide focus for the allocation of business resources.

Disadvantages of market segmentation include:

- × It is a costly and time-consuming process.
- × It could lead to the manufacture of too many different products.
- × It could over-narrow the focus of the business.

It is very important that a business targets the right group of customers – those w
vital to identify these segments correctly. Market segmentation helps businesses t
customers, recognise competitors, measure performance and anticipate future ma
impossible for a business to develop an effective marketing strategy (or 'fine tune
correctly identified the market segments.

1.3.5 Questions

9. Is [illegible] through market reports considered primary or secondar

10. a) Identify two advantages of primary research.
b) Identify three limitations of market research.

1.3.6 The Competition

Market Positioning

Once a business has collected enough data to give a fair picture of its target mark
needs to be able to make sense of it (drawing conclusions). One effective way of d
this is to collate the information into a *market map*. A market map takes two featu
price and size, speed and quantity) and compares them on two axes. This method
particularly useful for start-up companies or firms looking to introduce a new pro
way to identify any gaps in the market.

Take a look at the example market map below, which shows newspapers in the UK
content.

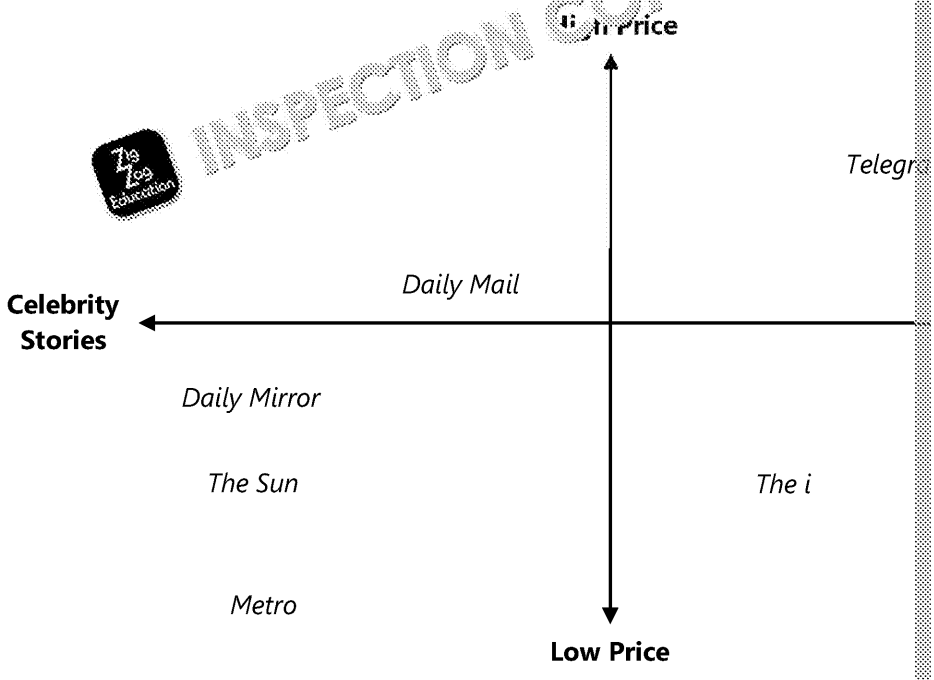


Diagram: M

The market map above shows how British newspapers differ by price and content. T
focus more on celebrity stories (left of the map) than *The Guardian*, *Telegraph*, *Indep*
Daily Mirror and *Metro* are similar in content but differ by price – *Daily Mirror* is the

Competitive Advantage of a Product or Service

When a company spots a gap in the market, it can use this information to better d
wants. This helps the company gain *competitive advantage* (or 'an edge') over its r
themselves in many ways, such as:

- Reliability of products/services
- Quality
- Price
- Key product features
- Customer service
- Convenience
- Infrastructures able to cope with demand
- Branding and promotion
- Innovation
- Marketing and advertising

Good examples of companies that manage to gain competitive advantage in thei
their strong branding to enter new markets), IKEA (providing quality products at l
innovate as trends change).

The Purpose of Product Differentiation

Companies use *product differentiation* as a way to gain advantage over their comp product with distinguishing features (*unique selling points or USPs*) and then mark the product stands out from the competition. Sir James Dyson saw a gap in the va with his invention of the 'bagless' vacuum. Dyson spent years researching and dev the perfect product. Since then, the name Dyson has become synonymous around high quality.

One main benefit of product differentiation for firms is that the producer does not ha to compete. If your product is the best quality option on the market and customers kn Once consumers are choosing your product over others, they may start to pick your b

How Firms Decide on Price and Level of Output

Companies use pricing strategies to evaluate business decisions based on the ma consequences that may arise. A company looking to sell a product or service can how much it is worth and what people would be willing to pay.

Competitive Pricing

In competitive pricing, there are price leaders (businesses that set the industry sta that follow suit). A business using competitive pricing will set its prices depending

Advantages of Competitive Pricing

- ✓ Price is not a competitive advantage for any firm.
- ✓ If a business is the price leader of its market, it gets to make the decisions on how much to charge.

Disadvantages of Comp

- × Since price is not a c must find another w rivals.
- × If a business is a pric mercy of whatever m the price.

Cost-plus Pricing

A business considers all possible costs that go into producing a good/service and

Advantages of Cost-plus Pricing

- ✓ Any price increases that a firm makes are easily justifiable when considering costs.
- ✓ Pricing is easy to calculate and so pricing decisions do not always have to be made by the most senior members of staff.

Disadvantages of Cost-

- × Price sensitivity (i.e. considered.
- × A vicious cycle can overestimates its bu overestimates its pr

Penetration Pricing

This is when a business sets an artificially low price for a product/service in order t

Advantages of Penetration Pricing

- ✓ A business using this form of pricing can catch its rivals off guard.
- ✓ Barriers to entry are high for other businesses.

Disadvantages of Pene

- × A business may wish consumers may dev
- × The reputation of th with low prices and,

Premium Pricing

This is when a business keeps the price of its products/services artificially high.

Advantages of Premium Pricing

- ✓ Premium pricing can create the illusion of premium quality.
- ✓ A business's brand then stands out since it is the expensive one.

Disadvantages of Prem

- × If enough rival com a firm will generate
- × Purchases from hig eventually dry up b will not be able to r

Price Skimming

A business may set an artificially high price for a product before any rivals have en

Advantages of Price Skimming

- ✓ The business can reap the rewards of high revenue before anyone else has had a chance to sell.
- ✓ High prices can create a brand image of high quality.

Disadvantages of Price

- × There is negative br once consumers lea purchased more che
- × If the price is too hig purchase at all.

Predatory Pricing

The dominant firm of a market sets a price so artificially low that no rival can poss

Advantages of Predatory Pricing

- ✓ It is a quick and efficient method of gaining control of the market.
- ✓ At such low prices, a firm can restrict competition from entering the market and even convince its rivals to leave.

Disadvantages of Pred

- × Predatory pricing is doing this will be pu

1.3.6 Questions

11. Choose a product type (such as sweets or magazines) and draw a two axes. Examples of axes include price, age group and location. What could the reasons be for this?

12. Give one advantage and one disadvantage of the following:

- **a)** Price skimming
- **b)** Cost-plus pricing
- **c)** Premium pricing

1.3 Keywords

Rationing	A function of price, as a resource becomes scarce then its p demand for it.
Incentive	A function of price, as a resource increases in price, supplier more goods as this will earn them higher revenue.
Signalling	A function of price, the idea that price sends messages to c whether or not to enter a market. Falling prices will prompt c rising prices will prompt producers to enter a market.
Niche Market	A market in which firms target smaller consumer groups and higher price. In order to achieve this, businesses focus on fac high-quality goods.
Mass Market	A market in which many firms sell many goods. Prices are lik m[illegible] quality may also be lower. Customers will hap

1.4 The Role of Credit in the Economy

Businesses might require loans for several reasons. Entrepreneurs might take on a
of setting up a business. This includes the large costs of acquiring premises and e
costs of wages and materials required for production that may not be immediatel
might also want to borrow money to expand their operations. In this section we c
important role in the economy.

1.4.1 Role of Banks in the Economy

Banks and financial services play a large role in our economy, contributing about
of banks in the economy with a focus on the services that are provided to busines

Channelling Savings towards Investment, and Providing Credit

Banks and other financial institutions are known as 'financial intermediaries'. This
indirect link (they 'intermediate') between those that want to save and individuals
Finance might take different forms. It's important to distinguish between secu
secured loan is taken out against property or another type of asset. If the debtor
then the creditor (the bank) can claim the property or asset as payment instead. A
not backed up with any asset.

As well as long-term loans, banks will provide specific types of accounts to busine
day-to-day actions such as paying staff and bills. Just like accounts for individuals,
provide overdrafts, which give the option of short-term borrowing to help with th
is irregular. Direct debits can be used to pay utility bills. Businesses also have acce
cards, as well as statements and online banking.

Firms can also take out mortgages – just like individuals buying houses – for prop
advice about this, and other services, particularly to new enterprises. More establi
shares which can also be arranged by banks or other financial institutions.

Would you be willing to lend money to someone for 25 years – even if you
back?
People want to save or borrow money for different lengths of time. Banks allow
by pooling all of the money together. One of the most common forms of borro
these are over a period of 25 years. A bank will have many small depositors hol
and savings accounts. These depositors will require access to the money over re
because it's highly unlikely they will want access to that money at the same time
money out over longer periods – for example, to those buying a house.

Why might a company need access to finance?
Here are a few possible reasons:

- To cover the start-up costs of launching a new business
- In order to expand and grow – perhaps buying new factories or taking on
- To cover day-to-day expenses if revenue is less frequent

Interest Rates and Collateral

An interest rate is the cost of borrowing money. If a company borrows £1,000 at a
it will have to repay £1,100. If a loan is unsecured then the interest rate will be hig
risk to the lender is higher because there is no *collateral*. This is reflected in the hi
agreed over a certain time frame with regular repayments. For example, a firm mi
years. The firm will most likely be required to repay instalments of this per month
interest due.

Business overdrafts, if planned, are interest free. If not planned then the interest c
amount overdrawn each day. If a company is £1,000 overdrawn beyond the plann
will pay $\frac{1}{365}$ of the annual interest rate on the £1,000.

1.4.1 Questions

1. Which is more expensive for a borrower – a secured or an unsecur
2. Explain why companies might need access to finance.

1.4.2 Risk and Liability

Entrepreneurs run into *risk* and *uncertainty* whenever they make decisions. These
can involve anything from expanding a production line or hiring more staff to mo
locations, buying equipment or making capital investment. The decision could eve
be whether to give up a comfortable job in order to pursue a business venture.

Every decision carries with it a degree of *risk* or *uncertainty* and potential for *rewa*
expects to get out of the business decision if it is successful). The words 'risk' and
mean the same thing; however, a subtle distinction can be made between them.

Uncertainty: this is a negative effect that comes from the general course of busin
costs and rewards for businesses in ways they cannot possibly predict. As such, bu
uncertainty – however, they can be prepared! Many firms build themselves portfo
way, should one product start to fail due to unforeseen circumstances, the busine
sales in order to survive (thanks to its other products).

Risk: like gamblers, firms take risks with every decision they make in the hopes th
reward. A new investment, for example, can either succeed or fail. Firms use risk m
assess the potential impact of their business decisions, weighing the potential rew
main objective here is to achieve the greatest reward with the least amount of risk
uncertainty, therefore, is the amount of control a firm has over it.

Let's use capital investment as an example:

Businesses undertake *capital investment* for many reasons, such as to *replace* broke
modern equipment or to help expand their operations. Whatever the reason, capita
finance for a considerable number of years and so it is important that the *right* inve

If a new piece of machinery costs £25,000, but could potentially double current sa
weigh up the risk against the reward. Is doubling sales enough to pay for the new
it take to pay off the £25,000? How long will the machinery last before the firm ne
Will the company need to hire more staff as well?

There is uncertainty, too: the investment could fail, or the business's products cou
consumer market. Does the business have enough other products in its portfolio t
uncertainty?

Implications of Limited and Unlimited Liability

The liability of a business (i.e. its financial responsibility) falls into two categories: owner that has *unlimited liability* has complete responsibility for the finances of th *limited liability*, on the other hand, has a set financial point that they are responsib

Unlimited Liability

Sole trader is the most common form of a business with unlimited liability. It only and so it is quick, easy and cheap to set up. The owner controls all assets of the bu responsible for all liabilities too.

Unlimited liability can also apply to partnerships: if, for instance, four people each that eventually fell into debt by £400,000, each owner would be liable for £100,00 investment.

Advantages of unlimited liability include:

- ✓ Simple to set up since it only requires one person: the owner.
- ✓ All profits go to the owner of the business.
- ✓ If the business fails, the owner is the only person affected and so it is easy to

Disadvantages of unlimited liability include:

- × All assets belong to the owner, but then so do all liabilities (debts).
- × Raising finance can be difficult, as the owner is limited to finding a loan or us
- × The owner can employ other people, but he/she is the only member of the b business stops working).

If a business with unlimited liability gets into financial trouble, i.e. the debts outwe business will go *bankrupt*. Unlimited liability means it is the responsibility of the o business – the owner's liability, therefore, is unlimited.

Limited Liability

Many sole traders eventually change to limited companies (normally private limite ownership is shared. Assets belong to the business, rather than a single owner, wh a group of shareholders. Leadership of the business is managed by a board of dir shareholders.

Shareholders have responsibility for a slice of the business; however, this slice is li liable for any debts of the business above their original investment. If, for instance shares in a private limited company, that person will only be responsible for £10,5 money the firm might lose in future).

Advantages of limited liability:

- ✓ Shareholders are protected as they are only responsible for what they invest.
- ✓ Limited liability makes raising finance much easier for the business, as the firm
- ✓ A limited company keeps running whether or not the shareholders change.

Disadvantages of limited liability:

- × Limited companies, by their nature, can grow large and, therefore, become m need to employ more management to keep processes organised.
- × Companies with limited liability must make their accounts publicly available.
- × Since shareholders own the company, they have sway over who is appointed create a conflict of interest.

Example:
Mad Hatters plc started life as a retailer of hats and scarves. Once it became succe company was floated on the stock market with 250 shares going for £10.00 apiec investors bought up 50 shares each, but only managed to pay off 20 of them. Eac therefore, owned 50 shares but still owed the money for 30.

After the stock market floatation, Mad Hatters plc's shareholders encouraged the to sell novelty sun hats in cold climates. This did not go well and eventually led to closure of the business. Mad Hatters plc went into *liquidation*, which means they h off all their assets in order to pay the debts.

However, the assets were not enough to pay off the debts. That's why the business close. So who was responsible for the company's finances?

The responsibility for Mad Hatters' debts fell with the company's shareholders, who a limited liability. This meant that each shareholder only owed back on the shares t not yet paid. In this case, each shareholder owed 30 shares at £10.00 each, i.e.

The Mad Hatters plc example demonstrates how it is relatively easy for businesse issue. Investors have limited liability, i.e. limited to the value of the shares they ow to put money down since they know this is also the maximum they can stand to l

Note the difference: When businesses with unlimited liability are forced to close, same thing happens to companies with limited liability, however, they go into *liqu*

1.4.2 Questions

3. Identify and explain one reason why it is generally easier to raise c with limited liability than as a company with unlimited liability.

4. Copy out and complete the following sentences using the words *li*

Companies that have ____________________ liability will normally companies with ____________________ liability. This, of course, ca difficult to manage as firms that have ____________________ liabi complicated organisational structures. Shareholders have certain p with ____________________ liability, such as being able to vote on appointed to a company's board of directors. The owner of a comp ____________________ liability has responsibility for all its assets a debts. A company with ____________________ liability may stop fu principal owner while a company with ____________________ liabi regardless of who ends up leading it. Companies with ___________ fewer options available for raising finance than companies with ___ liability.

1.4.3 Credit and Its Impact within the Economy

Entrepreneurs raise finance for many reasons, including funding the setup of a bu
developing production areas and expanding their current business.

Types of Credit

Overdrafts
Banks offer overdrafts to most of their customers, including businesses. Businesse
the short term as a way to cover themselves during difficult months or while waiti

Advantages of overdrafts as a method of finance include:

- ✓ They are flexible; businesses can use them when they need to and pay back a
- ✓ Businesses do not need to propose anything with their bank before using the
  extend their overdraft)

Disadvantages of overdrafts as a method of finance include:

- × Interest rates are very high with overdrafts
- × The amount of money covered by overdrafts is often very limited

Loans
Provided by banks and other financial establishments, loans differ from overdrafts
business can use an overdraft as and when they need it (provided they haven't alr
be planned for. A business make a case to the loan provider (i.e. bank) in order to
loan; the business and loan provider will then negotiate a loan amount and paym
Businesses generally apply for loans as a way to pay for large expenses, such as n

Advantages of loans as a method of finance:

- ✓ The payback is negotiable between the business and loan provider
- ✓ Interest rates are generally lower than that of overdrafts

Disadvantages of loans as a method of finance:

- × Businesses must normally provide a security deposit for loans, such as deeds
- × Since each loan is specific to the business, the loan provider will generally onl
  business has in assets

Trade Credit
When businesses make purchases from suppliers, they often negotiate a payback
business to pay back in eight weeks, for example, the business is not going to pay
cash can be used to finance other business areas instead while they generate mor

Advantages of trade credit as a method of finance include:

- ✓ Every supplier works in their own way and so the business can negotiate diffe
  to make certain they always have enough cash available to pay their debts
- ✓ Paying in eight weeks instead of one ensures the business has cash available
  development

Disadvantages of trade credit as a method of finance include:

- × The business must be sure they are going to have the cash available by the p
  issue a significant charge to the business as a penalty
- × In addition to the previous point, the business may suffer the consequences
  them, which could lead to fewer suppliers wanting to negotiate with them in

Sources of Credit

While types of credit describes the method of finance (i.e. how it is provided to the entrepreneur), sources of credit concern who (person or organisation) is providing the finance.

Other Businesses

It is common for big businesses to buy shares in smaller businesses, especially if they operate in the same market. Smaller firms are valuable, as they often control particular pockets of the market that bigger businesses find difficulty in penetrating (such as the environmentally-conscious consumer). Smaller businesses also benefit from the finance that larger corporations can provide.

Advantages of other businesses as a financial source include:

- ✓ Bigger businesses have more funding available to support development of sm
- ✓ If a business buys significant shares in a smaller firm, they can grant access to contacts, which would help the firm grow further

Disadvantages of other businesses as a financial source include:

- × If investors own a large share of the business, they will have significant power could cause conflict within the organisation
- × Many small firms make their mark by targeting consumers who are interested often ethical) business. The small firms must be careful, therefore, if they char influence: small firms that start behaving too much like their investors (i.e. oth customer base that they originally catered for

Banks

All businesses have to answer to the bank manager in some way or another, whether asking for a loan, dipping into their overdraft or simply finding out the best way to save money. Most businesses can utilise the bank as a source of finance, though it can be difficult for less profitable (or still developing) firms to find support in this manner.

Advantages of banks as a financial source include:

- ✓ Since banks are institutions, rather than individuals, there is potential for a business to access a lot of money
- ✓ The bank will not be shareholder in the business and so the owner is free to u

Disadvantages of banks as a financial source include:

- × Banks often require strict payback plans for borrowers
- × Interest rates can increase, generating more costs for the business

Other Types of Finance

Venture Capital

This method of finance starts with a proposal; a business puts forward a plan to an investor, such as a business angel, to explain what the business wish to do and how much money they need. If the investor likes the plan, they will decide to invest by either granting the money or giving a loan.

A great example of venture capital success is Levi Roots' *Reggae Reggae Sauce*, which began as a single-kitchen operation in Brixton, London. Watch Levi's pitch on the BBC television show Dragon's Den: *zzed.uk/5867-dragonsden*

Advantages of venture capital as a method of finance include:

- ✓ Many venture capitalists are also successful business leaders and so can act a
- ✓ Some businesses look to venture capitalists when all other sources are unava taking a risk in order to fund these businesses

Disadvantages of venture capital as a method of finance include:

- × By investing in the company, the venture capitalist is taking a risk and so expe return. This can lead to a high demand of dividend payments, which could ot the company
- × Advice is very useful to businesses, but investors can become too involved wi interests

Share Capital

If two entrepreneurs start a business together, each person will own a 50 per cent share (unless they negotiate otherwise). A share, therefore, represents a stake in the business.

The status of businesses can change over time. If a business becomes successful, they may become a private or public limited company. This would then allow other investors to stake a claim by purchasing shares. Businesses generally consider issuing share capital as a long-term form of finance: a firm would not consider this as a way to generate cash for a new piece of machinery.

Advantages of share capital as a method of finance include:

- ✓ Companies only pay shareholders if they have been profitable
- ✓ Investors have limited liability on their shares: this means that they do not ha than their share, even if the business make a loss

Disadvantages of share capital as a method of finance include:

- × Since investors are buying shares in a business, they gain an element of contr of interest
- × Shareholders expect dividends if a company is profitable, which means less m development of the firm

Leasing

Many businesses choose leasing over purchasing items, such as property or equip more cash at the end. This option is also appealing when a business has a short-te not have the right equipment or the money to purchase them.

Advantages of leasing as a method of finance include:

- ✓ Businesses that lease do not have large amounts of money wrapped up in ex over for other things, such as business development
- ✓ The owner of the property is responsible for its maintenance rather than the

Disadvantages of leasing as a method of finance include:

- × Paying a lease on a property is a continual cost to business, which would never pro however (e.g. through taking out a mortgage), the business would h which may be worth more than the money they could have saved
- × If the owner of the leased item decides to sell it, the business has no control o

Other Sources of Finance

Personal Savings

This source of finance, also known as the *owner's capital*, is the amount of cash th the firm. Personal savings are generally used by sole traders, partnerships and fres way of assets.

Advantages of using personal savings include:

- ✓ The cash is quick to access since it is the business owner who is making the investment, rather than an external source, such as a loan provider
- ✓ If an owner is personally invested, he/she may take greater care in the succes the business

Disadvantages of using personal savings include:

- × Any loss of profits for the business is a [illegible] loss for the owner, who has inv
- × Owners can be over-controlling of the business if they are also the investors

Retained Profit

This is the profit that a business keeps after all expenses, taxes and shareholder di source of finance is available to most organisation types except fresh start-ups; th made enough (or any) profit.

Advantages of retained profit include:

- ✓ If a business were to apply for a bank loan, they would need to provide repor the business already earned the retained profits, no one will need to ask then
- ✓ Investment of retained profits can lead to development of a business to the p than before. This would help increase the value of the business' shares, makir potentially attracting further investment

Disadvantages of retained profit include:

- × If a business make a considerable amount in retained profits, shareholders m receiving higher dividends. This can lead to de-investment from unhappy sha negative image for the business.
- × There is an opportunity cost to be considered: a business might be deciding or saving them in order to generate a healthy amount of interest. If the owne profits, they must be sure that they are going to make more money from dev interest they could have made by saving the profits

Sale of Assets

This involves a business selling off their possessions, such as property or vehicles, source is available to most business types, except new startups since they general they can afford to sell.

Advantages of sales of assets include:

- ✓ It allows businesses to focus [illegible] on developing themselves, rather tha money locked up in assets
- ✓ Unlike shares, for example, the finance is freely available to the business need to do is sell the asset

Disadvantages of sales of assets include:

- × An asset is no longer an asset once it is sold; if a business still need access to for example, but have already sold their asset, they will need to pay rent on a Essentially, this turns a business' asset into a cost
- × The business need to be sure that the asset is worth less to them than the po with the now-available cash. This is a risk for any business.

Individual Investors

For most businesses, costs are generally low at the beginning (especially compare starts making profit), that is unless significant infrastructure is required, such as te The costs may be relatively low, but they are still high for businesses that are just development phase. As such, many new firms look to individuals, such as friends a

Advantages of individual investors as a financial source include:

- ✓ Business owner and investor can negotiate a payback period that suits all pa
- ✓ Securing the finance is a relatively quick process since both the business own know each other.

Disadvantages of individual investors as a financial source include:

- × Investors have a share in the business's profits. In the beginning, a firm may h £10,000 in order to start trading. If a friend then puts up the cash, their contri business. In five years' time, the business could be making profit in the millio up £10,000 would own half of that.
- × Investors have a say in business activities. By providing financial support, the a s[illegible]ial [illegible] in the business and, therefore, be able to influence how th

Peer-to-peer funding

This source of finance can involve any number of people, from two investors to a milli peer funding by making formal applications; each application will explain how much they intend to do with it. Each proposal is published online so that all potential invest welcome to put down as much, or as little, money as they like (there is normally a mi the proposal gets enough funding, it is accepted and the business receives 100 per ce

Peer-to-peer funding is generally a source of finance chosen by startups and deve firms may also use it as a way to generate finance for business development.

Advantages of peer-to-peer funding as a financial source include:

- ✓ There are few financial costs involved for the business, because peer-to-peer
- ✓ Peer-to-peer funding acts as a forum for business proposals: if the funding is problem with the proposal.

Disadvantages of peer-to-peer funding as a financial source include:

- × Peer-to-peer funding is a time-dependent process. This means that if the bus investment to cover 100 per cent of the proposal by the time limit, all fundin
- × While it does not cost the business financially, it takes a lot of time and effort funding proposal.

Online Collaborative Funding

This source, also known as *crowdfunding*, works in a similar way to peer-to-peer fu being that while peer-to-peer funding is a loan, crowd funding offers a grant. Cro generally financed by individuals who are already interested in the business. If the instance, many of the financiers will be fa[illegible] peer-to-peer, if a business reque confirm 100 per cent of the finance within a specified time limit or they receive no businesses will also offer something in exchange for a bid, such as a copy of the n been financ[illegible] a c[illegible]ate with an author who needs funding for her next bo

Advantages of online collaborative funding as a financial source include:

- ✓ There are few financial costs involved for the business, because crowdfundin
- ✓ Crowdfunding acts as a forum for business proposals: if the funding is not gi the proposal.

Disadvantages of online collaborative funding as a financial source include:

- × Crowdfunding is a time-dependent process. This means that if the business d to cover 100 per cent of the proposal by the time limit, all funding is revoked
- × While it does not cost the business financially, it takes a lot of time and effort crowdfunding proposal.

Challenges in Obtaining Credit

Small- to medium-sized businesses face many challenges of which the most prom
Businesses need to be paid on time by their customers; if a firm does not receive
for its services, it will have trouble meeting any day-to-day bills and, as a result, lo
Having a good credit rating is, therefore, essential to most businesses as it allows
easily and to larger values) and negotiate more lenient trade credit agreements w

In order to better control their credit ratings, businesses often employ cash-flow f
businesses to predict what cash will be coming in and what cash will be going out
in section 1.6.4.). Once a firm can predict its cash flow, it will be in a better positio
can afford to make and which it should absolutely avoid.

1.4.3 Questions

5. Put the following phrases into two categories: either *method of finance*
The first one has been done for you.

Overdraft	*Loan*	*Personal savings*	*Trade cr*
Bank	*Share capital*	*Retained profit*	*Other fi*

Source of Finance	Method o
	Overdraft

6. Mariah Cherry is the owner of a small greengrocer business. Cherr
and is looking to purchase another in order to grow her business. S
how to fund the purchase of the new location: personal savings, re
assets.

Identify and explain which of the three methods of finances would
Cherry's business expansion.

1.4 Keywords

Dividend	The money that shareholders receive after all the expenses
Shareholder	A partial owner of a company. Shareholders invest money in stake in its success
Grant	Cash that is given to a business. Unlike with loans, companie back
Share	Partial ownership of a company. If, for example, a compan person owns 10 shares, they own 10 per cent of the compa
Stock market	A place where company shares are bought and sold. Exam London stock exchanges.
Float	When a company decides to trade its shares on the stock m
Liquidation	A company's assets are no longer enough to pay the debts company will then sell off its assets in order to pay what deb
Secured loan	A loan issued by a bank with some sort of asset (property, fo This asset can be claimed by the issuer of the loan if the deb will have lower borrowing costs (interest rate) than an unsec
Collateral	An asset that is promised to be handed over to a lender if th repay a loan.

1.5 Market Failure and Government Int

1.5.1 Market Failure and Externalities

Competitive markets can drive innovation, incentivise efficiency and bring about r because, in order for a firm to remain within a market, it must keep customers. Co the price of a good and relative prices of other goods. This means that firms need cheaper than other firms in order to keep consumers buying their products. Conse competition from other firms, they will need to look for new ways to lower their c prices. Another way firms can entice consumers to buy their goods is to look at no a good. This means firms will be looking for innovative new and improved produc

However, the price mechanism, introduced in section [illegible], is not perfect and ther market may not allocate resources efficiently and is unable to find the optimal ma occur when there is a misallocation of resources leading to goods that are unders market and in some cases, [illegible] provided at all.

The only example of market failure you will need to learn for your exam is the underconsumption of goods with external benefits and overconsumption of goods with external costs.

Extra Activity!
Although not nee
the website belo
market failures: z

Costs occur during the production of a good and during the consumption of a good (when it is purchased). Benefits also occur during both th revenue producers receive) and during the consumption of a good.

Producers weigh up the costs they incur against the benefits they'll receive before and will do so if benefits ≥ costs. Equally, consumers weigh up the costs they incu before deciding to purchase a good and will do so if benefits ≥ costs. If there are experienced by the producer or consumer then these will not be accounted for ar 'externalities'.

- × Private Costs are costs that impact the economic agents directly involved good
- × External Costs are costs that impact a third party who is not involved in th externality)
- × Social Costs are the total costs involved in the market transaction includir

- ✓ Private Benefits are benefits that impact the economic agents directly inv the good
- ✓ External Benefits are benefits that impact a third party who is not involved positive externality)
- ✓ Social Benefits are the total benefits involved in the market transaction including both private and external benefits

The externality diagrams [illegible] from the supply and demand diagram to 'internalise' the externality. This means it attempts to include the external effects within the internal workings of the market.

An
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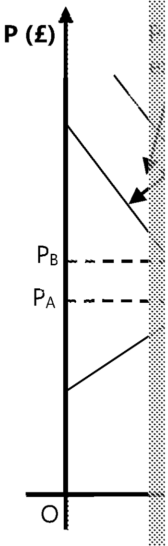
Positive Externality



A positive externality results from the consumption or production of a good or service and impacts a third party in a positive way. Consumers are assumed to purchase goods that maximise their utility which doesn't include accounting for any external benefits, and this is shown by the marginal private benefit (MPB) curve. It is downwards-sloping, just like the demand curve; each marginal good brings a diminished marginal benefit to the consumer. But, there is an additional benefit to society from the consumption or production of this good, including that this benefit in the market mechanism would push the demand curve outwards. This is because increased benefits would mean consumers would be willing to pay more for the good. Adding the external benefits to the private benefit at each quantity level creates the marginal social benefit (MPB) curve. The external benefit from consuming this good can be seen by the distance between the MPB and M

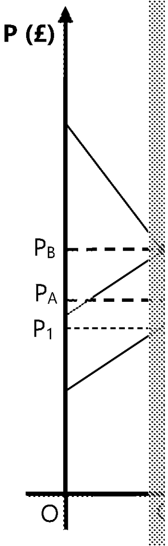
'A' shows the equilibrium point the free market would find, here the price is at P_A
market failure because at this point there is a misallocation of resources in the ec
undersupplied. The shaded triangle is the 'welfare gain area' and it shows the wel
moving to the optimal equilibrium point.

'B' shows the socially optimal equilibrium point. Price is higher at P_B, because the
has more 'worth', and quantity has increased to Q_B which is more beneficial to the
greater 'spillover' of the external benefit.

For a positive externality diagram a subsidy can be implemented to increase quan
without increasing the price. The amount of subsidy can be seen as the distance b

For example: *Vaccinations have an external benefit. Let's say Q_A is a quarter of you*
These people will become immune to the diseases, but, there is a reduced chance y
your class are the third party that benefit from the consumption of this good despite
market transaction. However, if more people were to buy the vaccine there would b
your class would fall ill. Let's say Q_B is three quarters of your class, at this point (B)
the resources (the sum total of all the resources you and your class peers have) and
spillover effect. The government may subsidise vaccinations for certain groups of pe
risk groups, or fully subsidise them, such as the measles, mumps and rubella vaccin

Negative Externality



A negative externality results from the production or consumption of a good or service and impacts a third party in a negative way. Producers are assumed to produce goods that maximise their profits (see [illegible]), this doesn't include accounting for any external costs and this is shown by the marginal private cost (MPC) curve. It is upwards-sloping, just like the supply curve. But, there is an additional cost to society from the production or consumption of this good, including that this cost in the market mechanism would push the supply curve inwards. This is because increased costs would mean producers would be willing to supply less of the good. Adding the external costs to the private costs at each quantity level creates the marginal social cost (MPC) curve. The external cost from producing the good can be seen by the distance between the MPC and MSC.

'A' shows the equilibrium point the free market would find, here the price is at P_A
market failure because at this point there is a misallocation of resources in the ec
oversupplied. The shaded triangle is the 'welfare loss area' and it shows the welfa
equilibrium.

'B' shows the socially optimal equilibrium point. Price is higher at P_B, because the
price, and quantity has decreased to Q_B which is more beneficial to the economy
the external cost.

Negative externality diagrams are similar to tax diagrams. A tax can be imposed t
optimum level by increasing the price. The amount of tax can be seen as the dista
curves.

For example: *the delivery of goods to supermarkets and shops has an external cost*
lorries delivering goods to the shops in the area. This would pollute the air and co
damaging to society by increasing traffic and reducing the air quality with potentia
level for society would be at point B where quantity was reduced to Q_B *and there we*
and congestion on the roads.

1.5.1 Questions

1. What is:
   a) Private cost?
   b) Social cost?
   c) External cost?

2. What is:
   a) Private benefit?
   b) Social benefit?
   c) External benefit?

3. How might a market fail if a good has an external benefit?

4. How might a market fail if a good has an external cost?

1.5.2 Government Intervention and Failure

Why Intervene and Government Failure Causes

In the last section we discussed market failure; this section discusses how govern
in order to *correct* this failure.

Where the market may fail the government can step in (intervene) in order to corr
reallocate resources to the more socially optimal market equilibrium. The govern
to protect the well-being of the environment, society and the economy.

However, the government may instead create further market failures that result in
meant that the final outcome results in more welfare loss than the free market ou
present itself in a variety of ways:

- Price signal distortion
- Unintended consequences
- Excessive admin costs
    - There are costs involved with implementing policies and with moni
      [illegible] the way to explaining where lost resources have been allocated.
- Information gaps
    - Government can cause information gaps, but equally the informatic
      can mean governments are misinformed. They may cause failures b
      suggestions built from inaccurate models and predictions.

Here are some examples of how the government may intervene to correct externa
methods may result in various government failure types.

Examples of Government Intervention into Markets:

- Minimum wage
- Minimum age to purchase alcohol and tobacco
- Free education
- Free healthcare
- CO$_2$ emissions standards for all new vehicles
- Guaranteeing a minimum price to farmers for their produce

Overconsumption of Goods with Negative Externalities

The unaccounted for social cost means the market will produce at a socially subop
may intervene in order to manipulate the market in a way to 'internalise the exter
thereby forcing the market to produce at the social optimum equilibrium.

Adding a tax to a good with a negative external cost will push up the cost of prod
willing to supply the good and, therefore, the extent of the externality decreases a
quantity supplied. This will in turn push the price of the good up and fewer consu
the good at this price and, again, the extent of the externality will decrease along
demanded. The aim of the tax is to reduce the consumption and production of the go

However, as discussed previously, the incidence of the tax may mean the consume
tax. In the case of the tobacco and cigarette market this may be a good thing and
consumers [illegible]. In the case of the energy market, however, there could be som
generation of electricity uses fossil fuels which release harmful pollution into the a
extraction and consumption of petrol and gas. A tax may be implemented to restr
modern-day necessity and with the burden falling on to consumers, this may leav
their costs of living, which presents a social and economic struggle.

Tradable Pollution Permits

Pollution is a negative externality and is a critical modern-day problem. A 'polluta however, there is no guarantee firms will reduce the pollution they produce. Firms relatively inelastically to increasing pollution costs because energy is essential to p government will increase but it is unlikely to affect pollution levels. Furthermore, r the cost of the tax more and will carry on polluting and producing and just pay m find it harder to cover their increasing costs.

Taxes attempt to manipulate the market and thereby distort the price mechanism pollution permit is used to try to limit the pollution using a more market-based ap permits allow firms to produce a set amount of carbon. If they produce under the to sell their excess permits. This provides an incentive to firms to pollute less beca they receive, thereby reducing the total amount of pollution emitted. Additionally become more competitive and the demand for the good will increase, thereby c of consumers towards lower-polluting goods. If firms produce over their set amou permits from lower-polluting companies. This provides an incentive not to pollute cost and the consequent increase in price will shift consumers away from high-p market function for pollution, intervention attempts to work with the market rathe

The tradable permits allow pollution to be distributed to various firms depending reduce the total pollution omitted. However, high-polluting firms are usually riche firms will find they are unable to produce their goods while rich firms carry on pol

Underconsumption of Goods with Positive Externalities

Adding a subsidy to goods and services with positive external benefits can help to socially optimum level because some of the costs of production are funded; produ goods. This in turn means the price will fall and consumers will be more willing to effect of the external benefit increases with the increase in supply and demand.

However, the subsidy removes the need of the firm to become more efficient and essentially means they are already reduced. This means a subsidy discourages the within the market.

Methods of Government Intervention

Regulation

Governments might intervene to regulate markets. This is common if the regulato are becoming too big and powerful and are able to use this market power to over

Legislation

Governments might introduce legislation to limit the consumption of goods that p example, the minimum age to purchase tobacco and alcohol and the prohibition o

Indirect taxation

As well as introducing legislation, governments might impose indirect taxes on th services that produce negative externalities. Indirect taxes are paid by the seller – consumer as they are passed on through higher prices. Indirect taxes can be avoid Both tobacco and alcohol products are subject to these types of taxation.

Grants and subsidies

The government might offer grants or subsidies to boost the production of goods externalities. For example, education and healthcare are provided free of charge. A This is to guarantee a certain level of food supply and ensure that farmers receive externalities to agriculture – people value the countryside for its views but this is n

Voluntary agreements

The government may also encourage businesses and other parties to adhere to ce example, it may pressure firms in certain industries to adhere to limit emissions at

Causes of government failure

Distortion of Price Signals

Government intervention into markets can cause the price mechanism to function
subsidises the agricultural production of a certain good, for example, then farmer
than is demanded on the free market.

Unintended Consequences

There are often unintended – and unforeseen – consequences to government inte
government were to introduce a maximum rent for properties to deal with the hig
might work well in the short term, but over the longer term it would mean that th
would exceed the supply. It might also cause immigration to increase if living cost
the problem.

Excessive Administration Costs

Intervention into markets by governments can be costly to run due to administ
greater than the benefit of the intervention program then it can be classed as gov

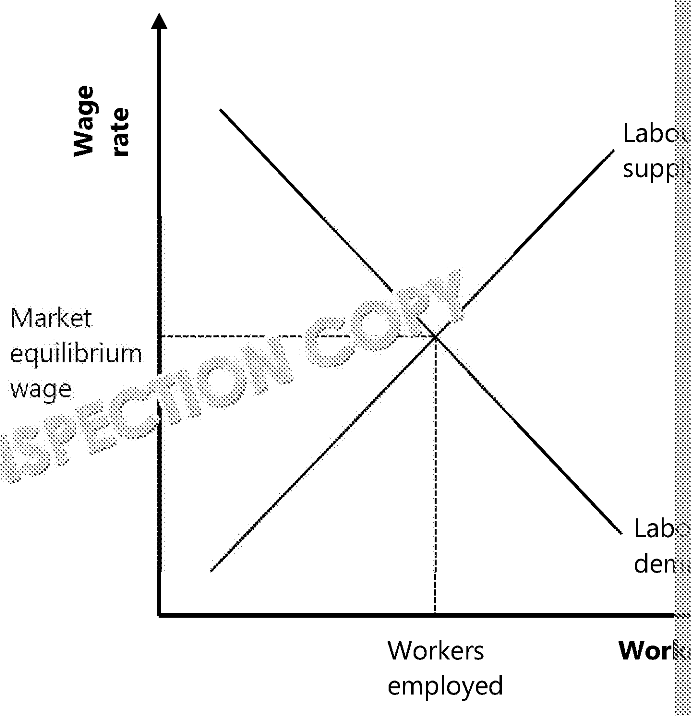
Informatio[illegible]s

It may be impossible, or very hard, for governments to truly estimate the cost of t
solve. There are positive externalities to people attending university, for example.
useful skills and higher productivity. There is, therefore, an argument that the gov
costs of running universities – but by how much? The benefits of university educa
quantify exactly and, therefore, the government may well over- or under-subsidise

Case Study: the labour market

We can use supply and demand analysis introduced in section 1.3 when looking a
difference is that instead of price on the y-axis we have the **wage rate**, and the qu
number of **workers**.

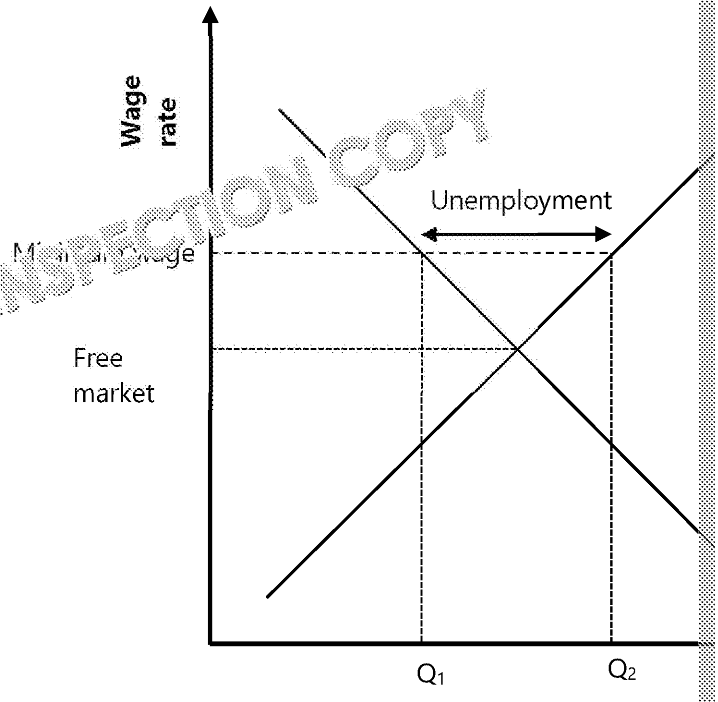
The idea of supply and demand is exactly the same in labour markets. In this case,
employment. The demand is by firms looking to fill positions and use labour as a
intersection of supply and demand determines the **market wage rate**. This is sho



The labour market presents a good example of when there might be a difference
the price in practice.

Government Intervention

In the UK we have a minimum wage system which is an example of **government** Employers can't pay less than £6.50 per hour to those aged over 21. What happen rate as determined by supply and demand? Consider the diagram below. The min floor' below which wages can't legally fall. The result is a discrepancy: the amount to supply at this higher rate is *above* the amount of labour that employers are will The difference between the amount of labour supplied and demanded (Q_2 – Q_1 o *unemployment*.



Costs and Benefits of the Minimum Wage

On the face of it, the minimum wage seems bad – it causes unemployment. Of co more complicated and involves subjective judgments. The main idea is to alleviate living standards – but this only helps the *employed*.

There is evidence that higher wages lead to higher productivity – people tend to Also, if all firms have to pay the same minimum wage, for example, then the playi everyone knows that firms can't undercut them on wages and sell products more products is passed on to consumers.

The minimum wage was introduced in 1999 in the UK and since then there hasn't that unemployment has increased as a result. Remember the idea of ceteris parib 2008 the economy was booming which may have meant reduced unemployment

1.5.2 Questions

5. Give an example of a situation in which goods with positive extern **underconsumed** if only provided by the free market.

6. Explain how the introduction of a minimum wage can cause unem *increase*.

1.5 Keywords

Externality	A cost or a benefit that is not captured by the market – they involved in the transaction.
Market Failure	When a good or service is underconsumed because the mo example, there is no market for street lighting because it wo monetise the service.
Subsidy	Money paid by the government to boost the production of correct the underprovision of a good by the market.
Government Failure	This occurs when resources are allocated inefficiently follow
Market Failure	This occurs when the market does not allocate resources eff social costs exceed social benefits and there is a net cost to
Externality	A cost or a benefit that is not captured by the market – they involved in the transaction.
Information Gap	A difference between the public perception of the costs or ben reality. If there is a large difference then there may be a cas in the market.
External Benefit	The gains to economic agents outside the transaction follov good or service by others.
External Cost	The cost to economic agents outside the transaction followi or service by others.
Private Benefit	The gains to a household or firm following the consumption
Private Cost	The cost to society (those that are affected whether involve arise following the production of a good or service.
Social Optimum Position	The ideal balance between supply and demand for society the actual market equilibrium.
Social Benefit	The gains to society (those that are affected whether involv that arise following the production of a good or service.
Social Cost	The cost to a household or firm following the consumption o
Non-excludability	A good has this characteristic if it can be consumed withou customers cannot be barred from consumption.
Private Good	A good (or service) that once consumed by someone cann person. Hence they are excludable and rivalrous.
Public Good	A good (or service) that can be consumed by anybody with the availability of the goods to others.

1.6 Revenue, Costs, Profits and Cash

1.6.1 Revenue and Costs

Calculation of Sales Volume and Sales Revenue

The calculations for sales volume and revenue show a business how many sales th
how much cash flow this represents.

Sales Volume

This is the number of sales that a company has made. In order to calculate sales v

- *price per unit*, i.e. how the price of one single product/service
- *total sales revenue*

The calculation is then:

$$Sales\ Volume\ =\frac{\text{Total Sales Revenue}}{\text{Selling Price Per Unit}}$$

Example:

Alarms 4 U Ltd sell £50,000 of car alarms in one year. The selling price of each car

The calculation for this is:

$$Sales\ Volume\ of\ Alarms\ 4\ U\ Ltd=\frac{\text{Total Sales Reve}}{\text{Selling Price Per A}}$$

$$Sales\ Volume\ of\ Alarms\ 4\ U\ Ltd=\frac{49{,}000}{17.50}$$

$$\boldsymbol{Sales\ Volume\ of\ Alarms\ 4\ U\ Ltd}=2800\ units\ s$$

Sales Revenue

This is the amount of money a company makes from the sales of a product/servic
needs *the number of units sold* (i.e. how many products/services did they sell?) and
were sold.

The calculation for this figure is:

$$Sales\ Revenue\ =Price\ per\ unit\ \times Number\ of\ units$$

Example:

Fresh Look Ltd want to calculate the amount of money they made on sunglasses i
of sunglasses at a price of £8.00 each.

$$Sales\ Revenue\ =Price\ per\ pair\ of\ sunglasses\ \times Number\ o$$

$$Sales\ Revenue\ =8.00\times 30000$$

$$\boldsymbol{Sales\ Revenue}=\boldsymbol{£240{,}000}$$

Calculation of Fixed Costs and Variable Costs

Once a business has calculated their sales revenue, they are one step closer to bei work out their gross and net profits. First, however, they need to calculate their *fix variable costs.*

Fixed Costs

These are the costs of a business that never change, regardless of how many good produced, advertised or sold. The business could produce 100 units or 1,000 units costs would not change.

Fixed costs include council tax, insurance, annual interest (on loans), property rent rental, electricity.

Focus: Annual Interest

If a company has taken out a loan of £25,000 at an interest rate of 5 per cent, the the business pays in one year will be:

$$Annual\ interest\ paid = Total\ loan\ amount \times Interes$$

$$Annual\ interest\ paid = 25000 \times 0.05$$

$$\boldsymbol{Annual\ interest\ paid = £1,250}$$

Variable Costs

These are the costs that change with every good/service sold by a business. The m the higher the variable costs.

Variable costs include raw materials, production supplies, by-the-hour contract wo

What are Total Costs?

$$Total\ Costs = Fixed\ Costs + Total\ Variable\ Cost$$

Total Costs is the sum of Variable Costs and Fixed Costs together.

Fixed Costs always stay the same while Variable Costs are dependent on how man Variable Cost of a product is £2.50, and you make one product, that is £2.50. How your Variable Costs will be £25.00.

Difference between Fixed and Variable Costs

A firm's fixed costs are an expense whether they make any money or not and so it between those fixed and variable costs.

Chatty People Ltd are a manufacturer of mobile phones. The company rent two fa Chatty People's fixed and variable costs are the following:

Costs for Chatty People Ltd	
Rent of two factories	Electricity for factories
Costs of transporting phones	Raw materials
Salary for 50 regular staff	Supplies for production
Rental of equipment	Annual interest on loan

The costs of the business split into Fixed Costs and Variable Costs:

Costs for Chatty People Ltd	
Fixed Costs	**Variable Cost**
Rent of two factories	Raw materials
Electricity for factories	Costs of transporting p
Salary for 50 regular staff	Supplies for productio
Annual interest on loan	
Rental of equipment	

Each time Chatty People Ltd produce a new mobile phone, their variable costs wil raw materials to produce the phone, plus production supplies and some way of tr wholesalers. The fixed costs, however, will stay the same no matter how many pho they make no sales, the firm will still have fixed costs.

Tip: Fixed or Variable?
When looking at the costs of a business, think about which would likely change de goods/services a company produces. Any cost that increases with higher output a a *variable cost*. Any cost that stays the same no matter how many goods/services a *fixed cost*.

Average Costs
Businesses calculate average costs when they wish to find out the individual cost o

Let's use an example:
A self-help publisher produces 10,000 books every month, which costs the comp calculate the average cost of one book, the company uses the following equatio

$$\text{Average Cost per item} = \frac{\text{Total Costs}}{\text{Total Items Produced}}$$

$$\text{Average Cost per item} = \frac{£12{,}000}{10{,}000}$$

$$\textbf{Average Cost per item} = \textbf{£1.20}$$

Using these figures, the self-help firm would need to charge a selling price of at le profit from each book. A profit of £0.01 per book is minimal, however, and not rea it is more likely to price the book at £2.40 or more. Then again, if the firm only sel need to charge more like £10.00 per book just to make a reasonable profit.

Percentage Change

Converting data into percentages can help managers better understand what is g
especially when trying to make sense of one set of costs to the next.

Let's use the previous company as an example.

The firm's current average cost per item is £1.20. However, five years ago, that ave
difference between these two figures is £0.29, but what would that be as a percen

$$\text{Percentage Change} = \frac{\text{Difference}}{\text{Original figure}} \times 100$$

$$\text{Percentage Change for total cost per item} = \frac{0.29}{0.91} \times 1$$

$$\text{Percentage Change for total cost per item} = 0.32\ (to\ 2\ d$$

$$\textbf{Percentage Change for total cost per item} = \mathbf{31.87}\ \boldsymbol{per}$$

This shows that the company has experienced a near-32 per cent change in the to
over the last five years. Armed with this information, the company would likely de
accordingly, i.e. by around 32 per cent.

1.6.1 Questions

1. Many Faces Ltd manufactures novelty masks. They are popular du
   for fancy dress parties. The selling price of one mask is £12.50.
   a) In 2014–15, Many Faces Ltd sold £6,950 worth of masks. Calc
   masks sold by Many Faces Ltd during 2014–15.
   b) In 2013–14, Many Faces Ltd sold 13,000 masks. Calculate the
   that year.

2. Rearrange the following into fixed costs and variable costs.

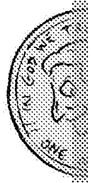
Costs for Many Faces Ltd	
Mortgage on factory	Electricity and othe
Salary for 15 regular staff	Raw materials for
Annual interest on loan	Extra staff during
Production line costs	rental of regular e

Fixed C	**Variable C**

1.6.2 The Relationship between Revenue and Cost

Break-even analysis is commonly used by firms to calculate the number of goods
profitable. When the *total costs* of a business's actions meet the *total revenue* mad
products/services, a business has *broken even*. Anything after the break-even poin

Contribution



The first thing you need when calculating break-even is the contribution. This is the difference between what variable costs a company has for making a single product and how much revenue they earn from selling it.

The calculation for this is:

$$\text{Contribution} = \text{Selling Price of one good} - \text{Variable Costs of}$$

Example:
Light On Ltd sells bedside lamps to wholesalers around the UK. The company only
which sells [illegible]00 per unit. The variable costs of making one Shine-On lamp in
£3.50 for the supplies to produce it.

The calculation for contribution is:

$$\text{Contribution for Shine On lamp} = \text{Selling Price of one lamp} - \text{Variable}$$

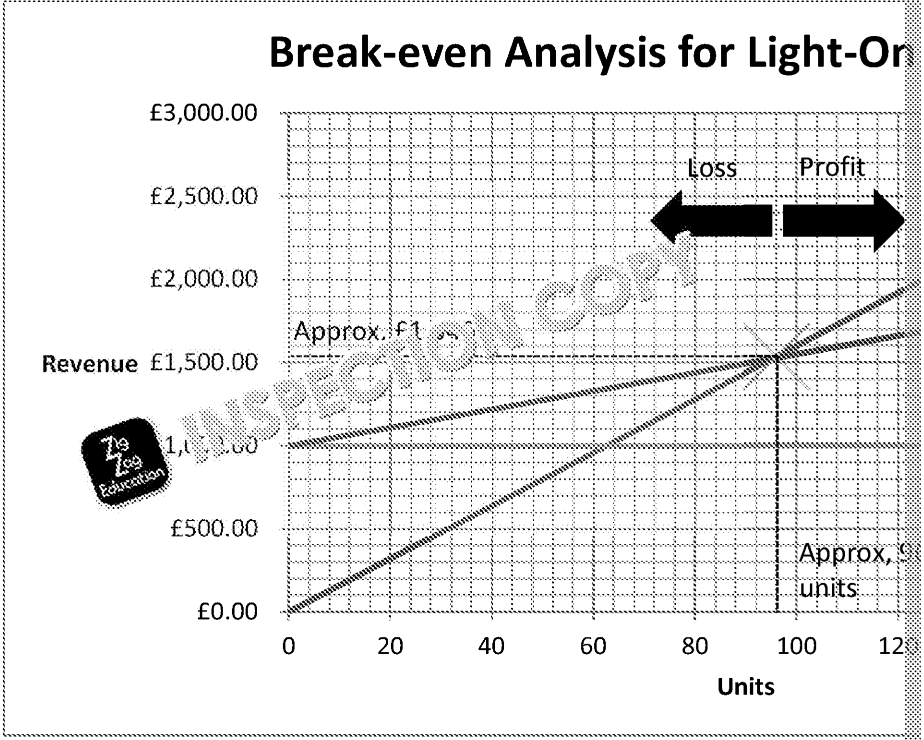
$$\text{Contribution for Shine On lamp} = 16.00 - (2.00 + 3.$$

$$\textbf{Contribution for Shine On lamp} = \textbf{£10.50}$$

Break-even

The break-even point shows where a company is neither making a profit nor a los
and total revenue cross, i.e. where both figures are exactly the same.

The following diagram is an example break-even graph for Light-On Ltd.



Graph: Break-

Anything before the break-even point (i.e. to the left of the cross) shows loss whil (i.e. to the right of the cross) shows profit. The previous graph tells us that Light-O lamps before they can start making a profit. Anything less than 96 units will be a l units, they will make neither a profit nor loss.

Calculating Break-even

Take another look at the graph for Light-On Ltd's break-even point. Do you notic for the break-even point?

Looking at a graph is not always the most accurate way to define break-even. If b they can calculate break-even using the following formula:

$$\textit{Break even point} = \frac{\textit{Total Fixed Costs}}{\textit{Contribution Per Unit}}$$

Remember that Light-On Ltd sell their lamps for £16.00 each. We calculated in a p contribution per unit was £10.50. The graph shows Light-On Ltd's Fixed Costs as £

Now that we have this information, we can calculate break-even:

$$\text{Break-even point for Light On Ltd} = \frac{\textit{Total Fixed Co}}{\textit{Contribution Per}}$$

$$\text{Break-even point for Light On Ltd} = \frac{1000}{10.50}$$

$$\boldsymbol{\textit{Break-even point for Light On Ltd}} = \mathbf{95.24}\ \boldsymbol{\textit{units}}\ (\boldsymbol{t}$$

Break-even Always Rounds Up

There is a problem with this figure: a company cannot produce 95.24 units. They c units. Since 95 units is less than break-even (i.e. making a loss), we always *round u* would become 96 units, 15.3 would become 16 units, 180.45 would become 181 u

Using the break-even figure for the number of units, you can also calculate how m using the equation for Total Revenue.

$$\textit{Revenue at break even} = \textit{Sales Volume}\ [\textit{at break even point}]$$

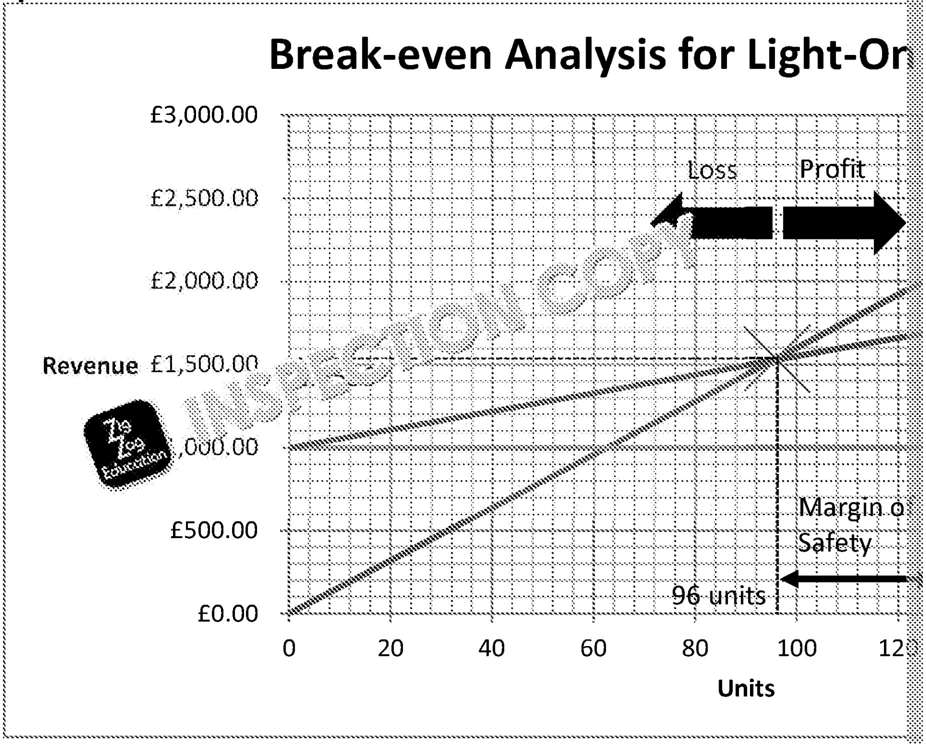
$$\textit{Revenue at break even} = 96 \times 16.00$$

$$\boldsymbol{\textit{Revenue at break even}} = \mathbf{£1,536}$$

Margin of Safety

This shows the difference between the break-even point that a company needs to
and the actual output the company is making.

Example:



Graph: Break-even Analysis with Ma

If the break-even point for Light-On Ltd is 96 units, but the company have actuall
calculate the margin of safety using the following equation:

$$Margin\ of\ Safety = Actual\ Sales\ Volume - Break$$

$$Margin\ of\ Safety = 128 - 96$$

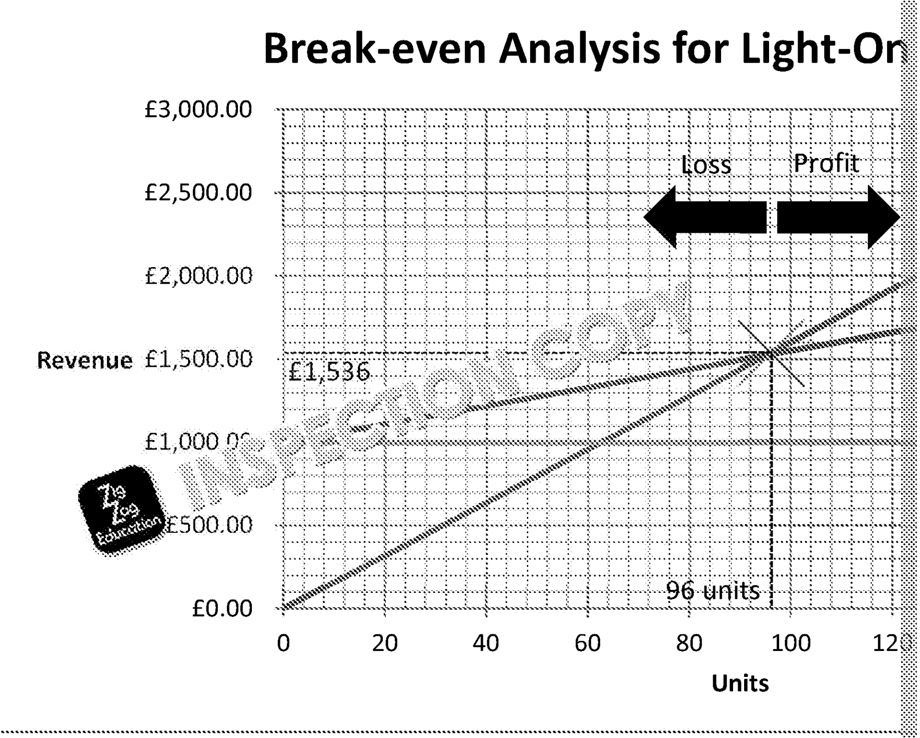
$$\boldsymbol{Margin\ of\ Safety = 32}$$

Below shows a table of different margins of safety for Light-On Ltd.

Break-even point	Actual number of sales	Margin
96	160	
96	[illegible]	
96	128	
96	101	
[illegible]	96	

Interpreting Break-even Charts

Take another look at the break-even chart for Light-On Ltd.



You now understand how to calculate Total Costs, Total Revenue, Contribution, M
Finally, you can calculate Total Variable Costs using the following equation:

$$Total\ Variable\ Costs = Variable\ Cost\ per\ unit \times Sales$$

However, if you do not know the original Variable Cost per unit, you can use the f

$$Total\ Variable\ Costs = Total\ Costs - Fixed\ Cost$$

In the case of Light-On Ltd, Fixed Costs stay at £1,000 no matter how many units t
because of the Total Variable Costs, and so, if you subtract the Fixed Costs from th
the Total Variable Costs!

You can use the break-even graph to find all of these figures.

Example:

There is another line drawn on the graph at 140 units. Follow this to the Fixed Cos
lines and you have the following:

- Units: 140
- Total Costs: £1,770.00
- Total Revenue: £[illegible]40.00
- Total Variable Costs: £770.00 (i.e. Total Costs – Fixed Costs)

Limitations of Break-even Analysis

Analysing break-even point is an integral part in running a business. It makes the easy to view and understand, which helps a business make decisions and understa consequences of those decisions (such as introducing a product to the market). Th are, however, limitations to the usefulness of break-even:

- The method only takes into account elements that the firm can control, such price per unit and the number of goods produced. It does not consider any e factors
- It is difficult to look at more than one product at a time. Most companies hav which would, therefore, not appear on a break-even graph
- All costs include only those that a business can plan for. They do not involve
- Businesses often buy in bulk. If a firm negotiate a deal with their supplier that would then change the graph and would not rise by the same amount w
- Break-even graphs only really work if a company's products/service all sell at
- Just because a business produces goods/services, it does not mean they a
- Break-even graphs assume revenue increases as price increases. However r once price is too high.

1.6.2 Questions

3. The variable costs of one mask add up to £4.00. Total fixed costs a

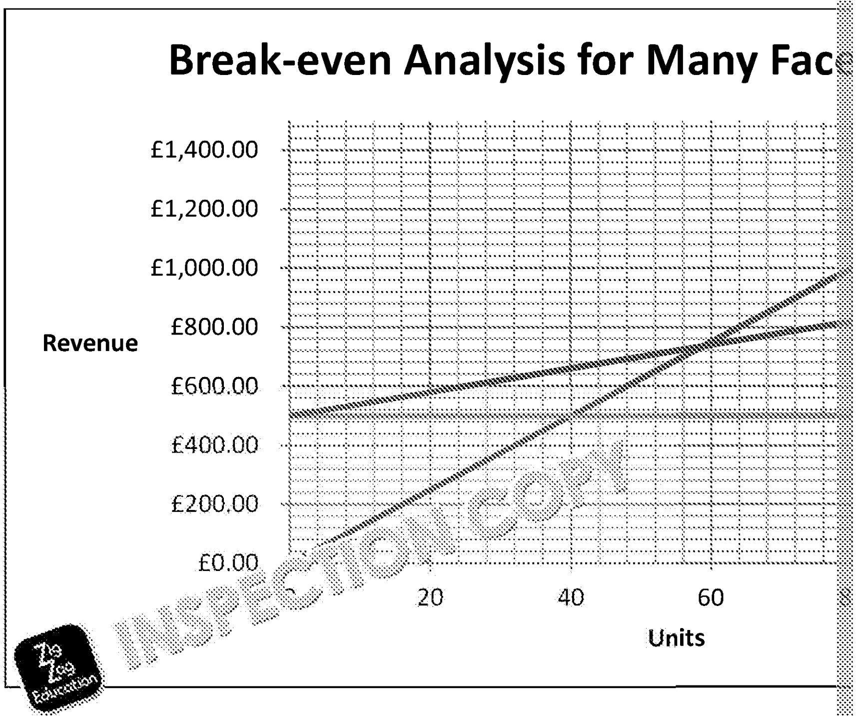
a) Calculate the contribution per mask.

b) Calculate the break-even point.

c) The variable costs have now changed. Study the graph below

i) Label each line on the graph.

ii) Identify the break-even point.



4. Identify and explain two limitations of the break-even graph.

1.6.3 Profit and Loss

Market Entry and Exit

We have seen in previous sections that one of the main reasons for businesses to potential to make profit. This is the opposite for any market that seems unprofitab look for ways in which they can escape. If the business is a sole trader, it can be re business is represented by a sole owner and operator and so shutdown costs are limited company, however, market exit can be extremely tricky – there may be leg environmental impact, plus potentially thousands of workers that will need to bec

Once a market becomes profitable, other businesses may wish to get a slice, i.e. e businesses in one market, however, the smaller each slice and so many larger firm benefit from the high *barriers to entry*. These are the requirements for a business t Telecommunications, for instance, has very high barriers to entry since companies to start providing their services. If a firm does not have this infrastructure, it can al though this is going to cost a lot and will limit the amount of savings a firm can o its rivals.

Calculating Profits

When analysing the success of a business, we often talk about three types of prof *profit for the year*, (i.e. *net profit*).

Gross Profit

Businesses find gross profit by subtracting the *cost of sales (COS)* of producing go *revenue* they make for the company. Gross profit allows a company to calculate th the raw materials needed to produce a good/service.

$$Gross\ Profit = Revenue - COS$$

Let's use an example:

Sparkling Crystal Ltd are a company that produce glasses for fine-dining restaura materials for manufacturing the glasses, supplies needed for the production line a working on each glass.

All together, the raw materials, supplies and labour amounted to £6,000 for the ye Sparkling Crystal Ltd was £14,000.

$$Gross\ Profit = Revenue - COS$$

$$Gross\ Profit = 14000 - 6000$$

$$\boldsymbol{Gross\ Profit = £8,000}$$

This gross profit for 2014–15 shows that Sparkling Crystal Ltd were able to add va

Cost of Sales for All

If a company is a retailer (such as a corner shop), instead of a manufacturer or ser
calculated by using the amount of stock they started with (e.g. at the beginning o
the amount they have at the end (e.g. at the end of the year).

$$\begin{array}{r} \mathit{Opening\ stock} \\ +\ \mathit{Stock\ bought} \\ -\ \mathit{Closing\ stock} \\ =\ \boldsymbol{Cost\ of\ Sales} \end{array}$$

Cost of sales only includes the stock which was actually used during the financial p
hopefully be sold next financial period.

Operating Profit

More than a statement of how much value a business adds to their raw materials,
left over after other operating costs (also known as fixed costs) have also been de
costs to the business of non-key activities, such as day-to-day administration.

$$Operating\ Profit = Gross\ Profit - Other\ Operating\ E$$

Many business analysts prefer to look at operating profit rather than gross profit b
idea of how much profit the business has really made. A firm might make £20,000
operating costs are £21,000, then that figure is not really worth much.

Net Profit

This third profit is also known as the 'bottom line' because it is generally found on
statement of comprehensive income. Net profit is calculated using a company's *ope*

$$Net\ Profit = Operating\ Profit - Interest$$

This is the final number before any tax or dividends are paid. Investors prefer to lo
any other figure because it gives the best indication of how much profit a compan
operating and gross profits are both positive, a negative net profit would make a
to investors.

Statement of Comprehensive Income

This statement, also known as the 'Profit and Loss Account', gives a breakdown of
profits. Let's take a look at these figures in action.

Profit and Loss Account for Sparkling Crystal Ltd in

	Expenses	**In**
Sales Revenue (a.k.a. Turnover)		£1
Raw materials	£2000	
Production supplies	£1000	
Labour costs	£3000	
Cost of Sales	**£6000**	
GROSS PROFIT		**£**
Business expenses	£1900	
Administrative expenses	£1100	
Other Operating Expenses	**£3000**	
OPERATING PROFIT		**£**
Interest Paid	£965	
NET PROFIT		**£**

The profit and loss account shows that Sparkling Crystal Ltd made £14,000 in sale

- Subtract Cost of Sales (sum of raw materials, production supplies and labour of £8,000
- Subtract other operating expenses (sum of business expenses and administra find the operating profit of £5,000
- Finally, subtract interest paid from the operating profit in order to find the bo which comes to £4,035

Profitability

You can use the profit and loss account as a way to calculate a firm's profitability, into profit. This is shown as a ratio: how much of the company's sales revenue rep

These ratios (*gross profit margin, operating profit margin and net profit margin*) he as they give a more informed idea of how much profit the firm can expect depend they make.

Gross Profit Margin

This shows how much of a company's sales revenue represents actual gross profit Crystal Ltd:

$$\text{Gross Profit Margin} = \frac{Gross\ Profit}{Revenue} \times 100$$

$$\text{Gross Profit Margin} = \frac{8000}{14000} \times 100$$

$$\textbf{Gross Profit Margin} = \mathbf{57.14}\ \boldsymbol{per\ cent}$$

This calculation shows us that for every £1.00 of sales revenue for Sparkling Crysta represents gross profit, i.e. every pound represents £0.57 of gross profit.

Operating Profit Margin

This shows how much of a company's sales revenue represents actual operating p Crystal Ltd:

$$Operating\ Profit\ Margin = \frac{Operating\ Profit}{Revenue} \times 1$$

$$Operating\ Profit\ Margin = \frac{5000}{14000} \times 100$$

$$\boldsymbol{Operating\ Profit\ Margin} = \mathbf{35.71}\ \boldsymbol{per\ cent}$$

This calculation shows us that for every £1.00 of sales revenue for Sparkling Crysta represents operating profit, i.e. every pound represents £0.36 (rounded up) of ope

Net Profit Margin

This shows how much of a company's sales revenue represents actual net profit. S Crystal Ltd:

$$Net\ Profit\ Margin = \frac{Net\ Profit}{Revenue} \times 100$$

$$Net\ Profit\ Margin = \frac{4035}{14000} \times 100$$

$$\boldsymbol{Net\ Profit\ Margin} = \mathbf{28.82}\ \boldsymbol{per\ cent}$$

This calculation shows us that for every £1.00 of sales revenue for Sparkling Crysta represents net profit, i.e. every pound represents £0.29 (rounded up) of net profit.

Comparing Profitability

Gross profit, operating profit, net profit. These figures are almost meaningless wit
going to learn anything from these numbers, they need to be compared someho

Profit and Loss Accounts for Sparkling Crystal L			
	2014–15		201
	Expenses	Income	Expenses
Sales Revenue (a.k.a. Turnover)		£14000	
Cost of Sales	£6000		£5000
GROSS PROFIT		£8000	
OPERATING PROFIT		£[illegible]000	
NET PROFIT		<u>**£4035**</u>	

The previous table shows the profit and loss accounts for Sparkling Crystal Ltd c
2014–15. The net profit (bottom line) is much lower in 2013–14 due to the numbe
to generate

The profit margins for 2013–14 are calculated as:

$$Gross\ Profit\ Margin = \frac{Gross\ Profit}{Revenue} \times 100$$

$$Gross\ Profit\ Margin = \frac{5000}{10000} \times 100$$

$$\boldsymbol{Gross\ Profit\ Margin = 50\ per\ cent}$$

$$Operating\ Profit\ Margin = \frac{Operating\ Profit}{Revenue} \times 1$$

$$Operating\ Profit\ Margin = \frac{3200}{10000} \times 100$$

$$\boldsymbol{Operating\ Profit\ Margin = 32\ per\ cent}$$

$$Net\ Profit\ Margin = \frac{Net\ Profit}{Revenue} \times 100$$

$$Net\ Profit\ Margin = \frac{2515}{10000} \times 100$$

$$\boldsymbol{Net\ Profit\ Margin = 25.15\ per\ cent}$$

Comparing these three figures with the ones before, not only did Sparkling Crysta
2014–15 but the company was also more profitable.

There's Always Another Way
Companies can get the even-bigger picture on their profitability by comparing th
competitors – that is if other companies publish their profit and loss accounts for
use statistics for their market as a benchmark for how profitable they should be c
competition.

Increasing Profitability and the Difference between Cash and Pr

The long-term aim for almost any company is to make a profit. This is true for the trader all the way up to the multinational corporation. Companies, therefore, need their profitability.

Examples ways to achieve this include:

- Decrease cost of sales by reducing the amount of raw materials needed for e
- Generate higher sales by increasing promotion of products/services
- Increase efficiency of workforce
- Provided there is still demand, the company could produce more goods/serv further sales
- Evaluate how much of the company's day-to-day expenses are essential

As explained in the previous sections, profit is the prime, long-term objective for a overall success of a firm while cash flow, on the other hand, tells us how efficient a com

Cash flow is integral to the day-to-day running of a business. Regardless of how m the long run, if they do not have enough cash to pay their suppliers from one mo term), they will come into serious problems. These issues could lead to the busine trust them, or, worse, going bankrupt from having so many more expenses than i

Let's use Sparkling Crystal Ltd as an example:

Profit and Loss Account for Sparkling Crystal Ltd during 2014–15		
	Expenses	**Income**
Sales Revenue (a.k.a. Turnover)		£14000
Cost of Sales	£6000	
GROSS PROFIT		£8000
OPERATING PROFIT		£5000
NET PROFIT		**£4035**

The company had a net profit of £4035. However, take a look at their incomings a

Incomings and Outgoings for Sparkling Crystal Ltd 2014–15	
	£
Cash received (Incoming)	14000
Cash paid (Outgoing)	12965
Net Cash Flow	**1035**

Sparkling Crystal Ltd's net cash flow is positive, but it is much lower than their net they, and most firms, do [illegible]

Certain customers, for example, will have longer payment plans than others (espe in bulk!). Some suppliers will also demand Sparkling Crystal Ltd to pay quickly (i.e. might give the company a couple of months. All of these inflows and outflows aff have available in order to pay their short-term debts.

Remember: profit is the goal in the long term, but a company must have cash free actions. When it comes to the actual running of a business, profit is important, bu

Remember Me:
The following three calculations will be important come exam time. Make sure yo
and have them memorised!

$$\text{Gross Profit Margin} = \frac{Gross\ Profit}{Revenue} \times 100$$

$$\text{Operating Profit Margin} = \frac{Operating\ Profit}{Revenue} \times 10$$

$$\text{Net Profit Margin} = \frac{Net\ Profit}{Revenue} \times 100$$

1.6.3 Questions

5. Sweet Things Ltd is a baker of cakes, tarts and biscuits. The compa
labour, ingredients and production supplies for the year 2014–15 v
came to £135,000.

a) Calculate the company's gross profit for 2014–15.

b) Complete the following profit and loss account for Sweet Thing

Profit and Loss Account for Sweet Things Ltd in 2		
	Expenses	**I**
Sales Revenue (a.k.a. Turnover)		£
Ingredients	£13000	
Production supplies	£6000	
Labour costs	£35000	
Cost of Sales		
GROSS PROFIT		
Business expenses	£8900	
Administrative expenses	£5000	
Other Operating Expenses	**£13000**	
OPERATING PROFIT		
Interest Paid	£2650	
NET PROFIT		

6. The table below shows the incomings and outgoings for Sweet Thi

a) Calculate the net cash flow of 2014–15.

b) Give two reasons why the net cash flow for Sweet Things Ltd
company's net profit.

Incomings and Outgoings for Sweet Things Ltd 2014–15	
	£
Cash received (Incoming)	135000
Cash paid (Outgoing)	83550
Net Cash Flow	

1.6.4 Business Survival and Cash Flow

Cash-flow Forecasts

Firms draw up plans in order to prepare for the future. Cash-flow forecasts show h
and out of a business over a specific period of time. Forecasts are predictions bas
have made.

Sunny Side Up Ltd is a company that manufactures deck chairs and garden furnitu
cash-flow forecast for the company during one year.

All figures in £000	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
OPENING BALANCE	50	(10)	(70)	(30)	0	20	70	110
INFLOW								
Sales	20	20	120	110	150	130	130	110
TOTAL INFLOW	70	10	50	80	150	150	200	220
OUTFLOW								
Equipment	0	0	0	0	0	0	10	0
Wages	70	70	70	70	70	70	70	70
Factory maintenance	0	0	0	0	50	0	0	0
Marketing and advertising	5	5	5	5	5	5	5	5
Other expenses	5	5	5	5	5	5	5	5
TOTAL OUTFLOW	80	80	80	80	130	80	90	80
CLOSING BALANCE	(10)	(70)	(30)	0	20	70	110	140

Note: the closing balance of each month is calculated by subtracting TOTAL OUTFLOW from TOTAL INFLOW. This figure, the closing balance, is carried forward as the opening balance for the next month

Note: negative figures on cash-flow forecasts are shown using brackets (parentheses)

The forecast shows Sunny Side Up Ltd will have a negative cash flow by Decembe
in the spring and summer months while autumn and winter months are more diff

Your turn:
Fill in the following cash-flow forecast for Sunny Side Up Ltd. The opening balanc

All figures in £000	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
OPENING BALANCE	150							
INFLOW								
Sales	20	20	120	110	150	130	130	110
TOTAL INFLOW								
OUTFLOW								
Equipment hire	0	0	0	0	0	0	10	0
Wages	70	70	70	70	70	70	70	70
Factory maintenance	0	0	0	0	50	0	0	0
Marketing and advertising	5	5	5	5	5	5	5	5
Other expenses	5	5	5	5	5	5	5	5
TOTAL OUTFLOW	80	80	80	80	130	80	90	80
CLOSING BALANCE								

The Use and Limitations of a Cash-flow Forecast

Cash-flow forecasts are useful for businesses because they show when there will b
They also show any increases in credit requirements, when cash will be tight and,
needs to be more careful. Cash-flow forecasts are good for use in negotiations ov
because the business can demonstrate exactly when they expect to have the cash
This data helps businesses with financial risk, too: if a firm predicts that it is going
instance, it will probably avoid making any large investments during that month.

There are limitations with cash-flow forecasts, however, which include:

- Forecasts are based on predictions that were accurate at the time, however t
  tastes in garden furniture)
- Forecasts are less accurate over long periods of time
- Unforeseen expenses may hit the business, [illegible] external factors
- Forecasts are only predictions and [illegible] businesses should not depend on them
- Technology can change, which [illegible] production cheaper / more expensive
- Competitors and [illegible] may change the market are not accounted for in t
- Seasonal fact[illegible] as buying garden furniture in summer, may change de

1.6.4 Questions

7. Complete the following cash-flow forecast.

All figures in £000	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
OPENING BALANCE	125							
INFLOW								
Sales	100	75	70	70	50	50	45	40
TOTAL INFLOW								
OUTFLOW								
Equipment hire	20	0	0	0	0	0	0	0
Wages	90	90	90	90	90	90	90	90
Factory maintenance	0	0	75	0	0	0	0	0
Marketing and advertising	10	0	0	0	0	0	0	0
Other expenses	15	15	15	15	15	15	15	25
TOTAL OUTFLOW								
CLOSING BALANCE								

8. Identify and explain one benefit and two limitations of using a cas

1.6 Keywords

Sales forecast	A prediction of the sales a company will make in the next p
Sales volume	The number of units sold
Sales revenue	The amount of cash generated by selling products
Fixed costs	These are costs that do not change with the number of goo
Variable costs	These are costs that change according to the number of g
Total Costs	The sum of fixed and variable costs
Disposable income	The amount of cash consumers have available to spend on absolutely necessary
Contribution	The difference between the variable costs of producing a g of revenue a company earns from selling it
Break-even	The point where total costs of producing a good/service an earned meet

Keyword Glossary

Add Value	When a business turns the sum of raw materials into a pro more. Value added is calculated as: Selling price of proc create product/service.
Break-even	The point where total costs of producing a good/service earned meet.
Collateral	An asset that is promised to be handed over to a lender to repay a loan.
Contribution	The difference between the variable costs of producing amount of revenue a company earns from selling it.
Direct Tax	A tax that is paid directly by the individual or organisatio be avoided or shifted to another person or organisation.
Disposable Income	The amount of money consumers have available to spend absolutely necessary.
Dividend	The money that shareholders receive after all the expens been paid.
Division of Labour	When the productive process is split so each individual st workers. This can improve the speed and efficiency of ov discussed by Adam Smith.
Exchange Rate	The price of one country's currency in terms of another.
External Benefit	The gains to economic agents outside the transaction fo good or service by others.
External Cost	The cost to economic agents outside the transaction foll good or service by others.
Externality	A cost or a benefit that is not captured by the market – t involved in the transaction.
Externality	A cost or a benefit that is not captured by the market – t involved in the transaction.
Factors of Production	Inputs used to produce goods and services: land, labour
Fixed Costs	These are costs that do not change with the number of g
Float	When a company decides to trade its shares on the stoc
Government Failure	This occurs when resources are allocated inefficiently foll intervention.
Grant	Cash that is given to a business. Unlike with loans, compa grants back.
Incentive	A function of price, as a resource increases in price, supp more goods as this will earn them higher revenue.
Indirect Tax	Tax that is collected by an intermediary between the co These sorts of taxes can be avoided through consumptio
Inflation	An increase in the price level of goods and services over
Information Gap	A difference between public perception of the costs or b and reality. If there is a large difference then there may b intervention in the market.
Interest Rate	The amount paid by borrowers of money to the lenders. the amount that commercial banks pay the central ban
Liquidation	A company's assets are no longer enough to pay the de The company will then sell off its assets in order to pay wh
Marginal Revenue	The additional revenue gained by a firm from selling one
Market Failure	When a good or service is underconsumed because the example, there is no market for street lighting because it monetise the service.
Market Failure	This occurs when the market does not allocate resource social costs exceed social benefits and there is a net cos

Mass Market	A market in which many firms sell many goods. Prices ar markets – but quality may also be lower. Customers will producers.
Niche Market	A market in which firms target smaller consumer groups a higher price. In order to achieve this, businesses focus and high-quality goods.
Non-excludability	A good has this characteristic if it can be consumed wit customers cannot be barred from consumption.
Opportunity Cost	The next best alternative that is forgone when making a
Private Benefit	The gains to a household or firm following the consumpt
Private Cost	The cost to society (those that are affected whether inv that arise following the production of a good or service.
Private Good	A good (or service) that once consumed by someone c another person. Hence they are excludable and rivalrou
Profit Maximisation	An objective for firms: to generate as much profit a quantity of output and price.
Public Good	A good (or service) that can be consumed by anybody reducing the availability of the good to others.
Rationing	A function of price, as a resource becomes scarce then demand for it.
Sales Forecast	A prediction of the sales a company will make in the ne
Sales Revenue	The amount of cash generated by selling products.
Sales Volume	The number of units sold.
Satisficing	The idea of achieving the minimally acceptable result r In terms of business objectives this refers to the idea that minimum level of profit that their shareholders accept – profits – instead of trying to maximise profits.
Secured Loan	A loan issued by a bank with some sort of asset (propert *collateral*. This asset can be claimed by the issuer of the secured loan will have lower borrowing costs (interest ra
Share	Partial ownership of a company. If, for example, a comp one person owns 10 shares, they own 10 per cent of the
Shareholder	A partial owner of a company. Shareholders invest mon a stake in its success.
Signalling	A function of price, the idea that price sends messages over whether or not to enter a market. Falling prices will market; rising prices will prompt producers to enter a ma
Social Benefit	The gains to society (those that are affected whether in that arise following the production of a good or service.
Social Cost	The cost to a household or firm following the consumptio
Social Optimum Position	The ideal balance between supply and demand for soc the actual market equilibrium.
Specialisation	When a factor of production (such as labour) is devoted effect being an increase in efficiency.
Stakeholder	A person or group that has interest in, and/or is affected a business.
Stock market	A place where company shares are bought and sold. E and London stock exchanges.
Subsidy	Money paid by the government to boost the productio to correct the underprovision of a good by the market.
Total Costs	The sum of fixed and variable costs.
Unemployment	The percentage of people in an economy who are eco in employment.
Variable Costs	These are costs that change according to the number o

Answers

1.1 Scarcity, Choice and Potential Conflict

1. The basic economic problem is that humans have unlimited wants and needs – but th
available to satisfy them. This is the idea of *scarcity*.

2. If you choose to spend it on the revision book then the private benefit is owning the
grade when it comes to exam time. The opportunity cost is the enjoyment of seeing a
with friends.

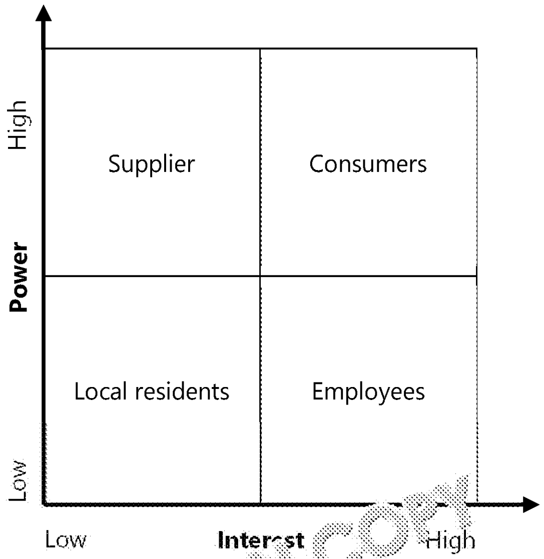
If you choose to go to the cinema then the private benefit and the opportunity cost f
seeing the film – but the opportunity cost is not owning the book and possibly having

3. Students should show understanding of the SMART acronym:

- **S**pecific
- **M**easurable
- **A**chievable
- **R**ealistic
- **T**ime-bound

4. a) At the point of sales maximisation, firms are producing as many goods as they c
b) The objective of profit maximisation aims to generate the most money possible
a business.
c) When a firm aims to generate revenue between a minimum and absolute maxim
on satisficing.

5. The following shows a completed stakeholder map for Tennis Elbow Ltd:



6. **Shareholders and Employees:** While shareholders might be looking for higher profit
employees may rather the higher profits were spent on increasing salaries or improv

Suppliers and Consumers: Tennis Elbow's consumers may demand more products th
materials can fulfil.

Business Owners and Local Community: If the business owners wish to expand Ten
in order to do so. This may bring about pollution and/or congestion and go against th

1.2 Enterprise, Business and the Economy

1. a) The calculation used to define value added is:
Selling price of product/service – Total cost of producing the product/service

b) Students should identify two ways for each form:

  i) Functional ways of adding value include: cash discounts; increasing price; a
  of payment.

  ii) Aesthetic ways of adding value include: celebrity endorsement; innovative

2. a) The obvious answer is that tablet computers might cause a decline in sales of re
But they may also contribute to declining sales in any number of things that can
players, physical maps, cameras, etc.

b) It is a whole new industry that creates jobs. But it also means that the market po
industry might be eroded by newer companies that use factors of productio
lower cost. Furthermore, it arguably improve the lives and well-being of users –
quest for economic growth.

3. Examples of reasons include: entrepreneurs are creative by nature; they are inspired b
be their own bosses.

4. a) Social Justice Ltd: ethical/moral stance

b) Imagine Inspire Innovate Ltd: creativity

c) Bargain Prices Plc: profit

d) Green Warriors Ltd: ethical/moral stance

e) Handmade Gifts: home working

It could be argued that some of these names fall into more than one category; Handm
allow the business owner to support local businesses while Imagine Inspire Innovate L
making a profit with creativity being a side effect. However, the only thing that we kn
so that is all learners have to make any judgments.

5. a) Learners should show understanding of the fact that physical capital refers to ta
equipment, while financial capital focuses on money. Entrepreneurs use their fin
physical capital.

b) For this answer, learners should show understanding that flexibility comes from
whether to a different part of a business or to a different part of the economy.

6. Students should show understanding of all four factors of production: enterprise, land

Examples of factors that James could employ include:

- **Enterprise:** James may be a good chef, but how good is his idea? Has he done
that his idea is going to hit the mark within his chosen target audience? Enterp
James needs to be sure that he is going to make a profit from his investment.
- **Land:** natural resources for James's business include contracts with farms and
with the raw materials it needs.
- **Capital:** physical capital that James needs includes equipment, facilities and pr
course, he will need financial capital, i.e. money to put down for either rent or
- **Labour:** this will include the employment of kitchen staff, front of house and m

7. Learners should show understanding of the fact that, while effective, specialisation ca
countries. This may [illegible] to a lack of diversity and an increase in susceptibility to
one country's economy fails, all other economies that relied on the goods it produced

8. Learners should show understanding of the advantages and disadvantages that come

Possible advantages may include:

- Workers become more expert at their specific task
- The business can focus on producing more of its most popular pottery, which leads
- Efficiency of the workforce increases through practice and the fact that there is little
- With increased efficiency come lower overall costs of production

Possible disadvantages may include:

- Workers can become unskilled in every other aspect of the business
- Repetition of a task can lead to demotivation of staff
- Once motivation levels reach a low, production costs will begin to increase as it take produce its goods
- Demotivation can also lead to boredom and, potentially, a higher number of errors
- Division of labour can create a divide between departments, making communicatio every worker did the same job

The learner can argue either side for this answer as long as it is backed up with logica arguments provided.

9. Benefits

- Businesses can increase their prices without raising suspicion
- It raises the value of property and stock

Drawbacks

- Consumers may become more price-sensitive
- Business cash flow becomes much tighter
- Suppliers are able to increase their prices
- Co[illegible] workers make demands for higher pay

10. Learners should be able to explain that:

a) If China's currency appreciates, demand may rise from that country since now b make more purchases.

b) If the USA's currency depreciates, demand may decrease in that country since th makes the £ appear strong and, therefore, expensive.

c) If the UK's currency appreciates, both Chinese customers and those in the USA m from the company since the price of the £ has increased.

1.3 Introducing the Market

1. The demand curve is downward-sloping because as the price increases consumers wi At low prices the quantity demanded is high, and at high prices the quantity demand

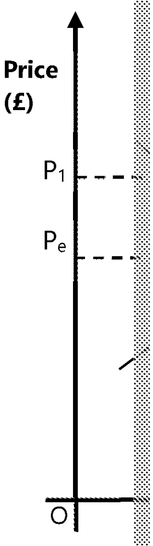
2. There are several factors listed in the text that explain why the demand curve might s

- Changes in prices for other goods
  - Demand for a good might be affected by the price of another good. If one g consuming another, similar good, then an increase in price of the first good the other.
- Changes in income
  - If people feel wealthier then they tend to consume more and demand increa increase then homeowners will feel wealthier and purchase more goods and outwards.
- Changing demographics
  - The average age of a population might change over time. An ageing popula retirement homes, cruise holidays, etc. A population with a high fertility rate people will see demand increase for childcare services, etc.
- Seasonal changes
  - The time of the year can affect demand for certain goods and services. Dece [illegible] things festive. The summer will see outward shifts in demand for ice lo [illegible] demand for coats and scarves.
- Changes in preferences
  - Consumers' preferences change over time. For example, over recent years th fuelled by British success on the international stage, and growing awareness led to a large outward shift in demand for recreational road bikes.

3. The supply curve is upward-sloping because as the price increases suppliers are willin the quantity supplied is low, at high prices the quantity supplied is high.

4. There are numerous factors that might cause the supply curve to shift. For example:
- Changes in the cost of production
  - An increase in the cost of raw materials can shift the supply curve inwards if
- New technology
  - If new technological processes are discovered that improve production effici outward.
- Subsidies
  - A subsidy on production will shift the supply curve outwards. Governments goods, for example, in order to guarantee food supplies.
- Taxes
  - Indirect taxes will shift the supply curve inwards as the cost of production is

5. If a good is oversupplied – that is, supply at a certain price is higher than the quantity that consumers are willing to purchase – then the price will necessarily fall. In the diagram to the right, supply Q_S, is higher than the quantity demanded, Q_D, and at this price consumers are not willing to purchase that amount of goods. The result is that producers will have to reduce their supply and the price at which they are willing to sell at, or they won't see the goods. Eventually, supply and demand interact and the new price is determined at P_e, and Q_e goods are sold.



6. The 'ceteris paribus' idea – which means 'all other things being equal' – is important because it allows us to focus on a single idea and ignore any other factors that may affect it. It can be used to ignore both known and unknown factors.

7. Rationing, incentive and signalling. See text for details of each.

8. Prices are likely to be higher. Firms operating in niche markets can charge more due to factors such as brand loyalty and higher-quality products.

9. Reading through market reports is considered secondary market research, as it is sec research is conducted by gathering first-hand information on a target market (such a

10. a) Advantages of primary research include: reveals new information; keeps the res market; and allows the business time to concentrate on its target market.

b) Limitations could include: size (i.e. too small a sample); bias (i.e. interviewer alre correlations); representation (e.g. regions can differ); expense and time consum (e.g. closed questions).

11. Students should create a market map with two opposing axes, such as price (low to h and add in any products to compare. Gaps in the map may signify a genuine market reason for not filling some gaps, such as a high-priced chocolate bar of extremely low

12. a) Price skimming
Advantages include: businesses make high revenue before rivals can enter the associated with high quality.
Disadvantages include: possible consumer backlash once people learn the prod a firm's prices are too high, no one will buy from them.

b) Cost-plus pricing
Advantages include: justifiable changes and ease of calculation.
Disadvantages include: price sensitivity and overestimation of price.

c) Premium pricing
Advantages include: the illusion of quality and making a brand stand out.
Disadvantages include: the threat of cheaper alternatives and isolation of lower- represent high sales.

1.4 The Role of Credit in the Economy

1. An unsecured loan is more expensive (it will have higher interest rates). This is becaus recipient of the loan cannot repay the money back the bank has no collateral it can cl reflect this higher risk of default.

2. Businesses might need access to finance for many reasons. It might be necessary in o expand an already established enterprise. It may simply be needed to cover outgoing which case an overdraft might be used).

3. Students must show understanding that limited liability means shareholders are only investment they put into the company, i.e. worst-case scenario: they only stand to los

4. Companies that have ***limited*** liability will normally grow larger than companies with u make them more difficult to manage as firms that have ***limited*** liability often have co Shareholders have certain powers over companies with ***limited*** liability, such as being appointed to a company's board of directors. The owner of a company with ***unlimite*** assets and, therefore, [illegible] company with ***unlimited*** liability may stop functi while a company with ***limited*** liability can continue on regardless of who ends up lea liability have fewer options available for raising finance than companies with ***limited***

5.

Source of Finance	Method of Finance
Personal savings	Overdraft
Individual investor	Loan
Bank	Trade credit
Retained profit	Share capital
Other firms	Venture capital

6. Students are expected to choose retained profits in this instance. Reasons for this dec
   - Retained profits can be accessed with very little effort on the business's part
   - investment can make the business look more attractive to other potential inve further growth
   - This is better than personal savings. If Mariah Cherry used her own personal sa she would be completely liable if the venture failed
   - This is also better than sale of assets. Mariah Cherry's business is still quite sma assets of worth to sell, besides the original location which is currently the only
   - **One note on retained profits, however:** the business must be careful of the sure that it will pay off

1.5 Market Failure and Government Intervention

1. a) Private costs directly affect the economic agents involved in a market transactio
b) Social costs are the total costs: both private and external costs combined.
c) External costs impact a third party that is otherwise not involved in a market tra

2. a) Private benefits affect the economic agents involved in a market transaction.
b) Social benefits are the combined private and external benefits.
c) External benefits affect a third party that is otherwise not involved in a market tr

3. A market might fail if the external benefit (which offers a positive externality) is not ca or service provides benefits that are not reflected in the market price and is *under*con healthcare, pensions.

4. A market might fail if the external cost (which offers a negative externality) is not capt service provides benefits that are not reflected in the market price and is *over*consum fatty food.

5. A good example is education. If children (or their families) had to pay for the educati school. However, there are benefits to society. An educated population is more produ economic growth. If children are in school there may be lower levels of delinquency a

6. A government might introduce a minimum wage to guarantee a certain standard of l However, if this wage is above the market wage then it can cause unemployment bec between the number of people willing to work for that wage and the number of jobs wage. Whether or not this is an example of government failure is a subjective questio those *with* a job a certain level of income. However, it might lead to an increase in the

1.6 Revenue, Costs, Profits and Cash

1. a)

$$Sales\ Volume = \frac{Total\ Sales\ Revenue}{Selling\ Price\ Per\ Unit}$$

$$Sales\ Volume = \frac{6950}{12.50}$$

$$Sales\ Volume = 556\ units$$

b)

$$Sales\ Revenue = Price\ per\ unit \times Number\ of\ units\ so$$

$$Sales\ Revenue = 12.50\ x\ 13000$$

$$Sales\ Revenue = £162{,}500$$

2. Fixed costs
- Mortgage on factory
- Salary for 15 regular staff
- Annual interest on [illegible]
- Electricity and other bills
- R[illegible] regular equipment

Variable costs
- Production line costs
- Raw materials for masks
- Extra staff during busy season

3. a)

$$Contribution = Selling\ Price\ of\ one\ good - Variable\ Costs\ of$$

$$Contribution = 12.50 - 4$$

$$Contribution = £8.50$$

b)

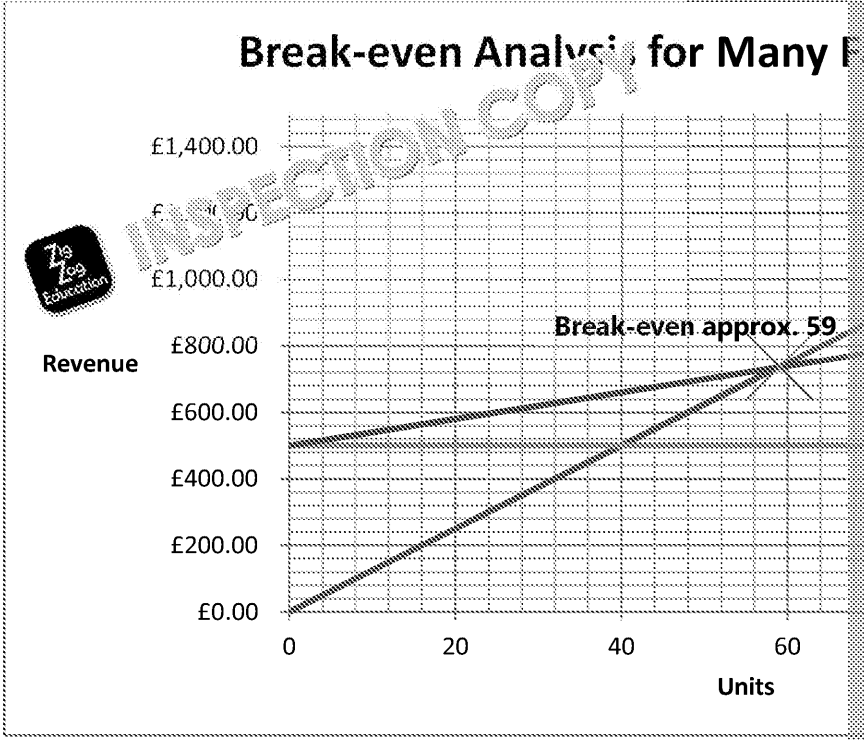
$$Break\ even\ point = \frac{Total\ Fixed\ Costs}{Contribution\ Per\ Unit}$$

$$Break\ even\ point = \frac{500}{8.50}$$

$$Break\ even\ point = 58.82$$

$$Break\ even\ point = 59\ units$$

c)



4. Limitations might include:
Break-even charts work best when analysing just one product/service. Any company t
then, would find break-even a difficult method to use effectively.

A company's break-even analysis assumes that all products manufactured will also be
so does not give an accurate impression of the business' finances.

Break-even charts do not include unforeseen costs that a company might incur. If unf
graphs, the break-even point would likely have to shift continually.

Likewise, break-even charts only take into account those factors that companies can c
external factors.

5. a)

$$Gross\ Profit = Revenue - COS$$

$$Gross\ Profit = 135000 - 54000$$

$$Gross\ Profit = £81{,}000$$

b)

Profit and Loss Account for Sweet Things Ltd in 2014		
	Expenses	**In**
Sales Revenue (a.k.a. Turnover)		*£1*
Ingredients	*£13000*	
Production supplies	*£6000*	
Labour costs	*£35000*	
Cost of Sales	***£54000***	
GROSS PROFIT		***£8***
Business expenses	*£8900*	
Administrative expenses	*£5000*	
Other Operating Expenses	***£13000***	
OPERATING PROFIT		***£2***
Interest Paid	*£2650*	
NET PROFIT		***£2***

6. a)

Incomings and Outgoings for Sweet Things Ltd 2014–15	
	£
Cash received (Incoming)	*135000*
Cash paid (Outgoing)	*83550*
Net Cash Flow	***51450***

b) Answers may include (but not limited to) debtors paying in the next tax year, sal and government grants.

7.

All figures in £000	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**A**
OPENING BALANCE	*125*	*90*	*60*	*(50)*	*(85)*	*(140)*	*(195)*	*(2*
INFLOW								
Sales	*100*	*75*	*70*	*70*	*50*	*50*	*45*	*4*
TOTAL INFLOW	*225*	*165*	*130*	*20*	*(35)*	*(90)*	*(150)*	*(2*
OUTFLOW								
Equipment hire	*20*	*0*	*0*	*0*	*0*	*0*	*0*	
Wages	*90*	*90*	*90*	*90*	*90*	*90*	*90*	*9*
Factory maintenance	*0*	*0*	*75*	*0*	*0*	*0*	*0*	
Marketing and advertising	*10*	*0*	*0*	*0*	*0*	*0*	*0*	
Other expenses	*15*	*15*	*15*	*15*	*15*	*15*	*15*	*2*
TOTAL OUTFLOW	*135*	*105*	*180*	*105*	*105*	*105*	*105*	*1*
CLOSING BALANCE	*90*	*60*	*(50)*	*(85)*	*(140)*	*(195)*	*(255)*	*(3*

8. Benefit:
Timings. Firms use [illegible] predict when cash comes in and goes out. This helps firms have a [illegible] cash flow and when a negative one, giving them a good idea of when bills.

Limitation one:
Cash flow forecasts do not work well as long-term prediction as firms do not always k come their way.

Limitation two:
Technology can change, making the production process cheaper / more expensive. Li affecting the demand for the company's products/services.