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About this guide

Regardless of the exam board you are studying for your A level business course, to be successful you will need to show the examination skills of knowledge, application, analysis and evaluation. Knowledge is possibly the easiest skill to master. Any student that pays attention in class or watches YouTube videos recapping the topics on their syllabus is likely to pick up a thing or two about business.

Unfortunately, even if you master the theory behind every topic you have completed during your A level course, you are unlikely to achieve the grade you desire unless you can demonstrate the other exam skills. You need to be able to apply what you know about business, be able to analyse the different possible solutions to business problems and evaluate which idea is the most suitable.

This revision guide is designed to help students with arguably the two most complex skills in A level business – analysis and evaluation. This guide will help you build on the knowledge you have about fifteen of the most commonly examined A level Business topics and understand how you might analyse the issues surrounding these topics as well as evaluate answers to questions based on these areas of the syllabus.

Exam skills

Analysis is the skill of explaining the consequences of something. When students analyse, they explain causes and effects - the reasons why something might have happened and the consequences of that event.

In A level Business, analysing often involves examining the possible actions of a business and explaining the potential consequences of those actions. These consequences might be positive, such as improvements to the business, financial rewards or increased competitiveness, or they could be negative consequences, such as greater costs, a fall in productivity or a decline in market share. When you are analysing, the key questions to ask yourself are *'if the business were to do this, what could happen? What are the risks and what are the rewards'?*

Analysing a business dilemma leads naturally to the skill of evaluating. Evaluation is the skill of considering different possible options, reaching verdicts and making justified decisions.

In A level business exams, evaluation usually involves setting out two competing arguments or two contrasting courses of action that a business might take and making recommendations to the business over which option is preferable. One of the keys to demonstrating evaluation is to explain why you have chosen one course of action over an alternative, rather than just stating which option you believe is preferable. Students who are able to justify how they arrived at a conclusion are likely to achieve the highest marks.

One issue to consider when analysing and evaluating during exams is the importance of applying your ideas and verdicts to the business you are answering about. Too often, students miss out on marks for the analysis and evaluation they have shown in answers because their ideas are generic rather than applied to the specific circumstances of the business in the question. When analysing, try to consider *'what might the consequences be for **this** business'* and when evaluating, consider *'what is the best option for **this** business'?* Often, considering the circumstances of the business in the question can help students justify their evaluation.

1 Inventory Control

Edexcel 2.4.3 **AQA** 3.4.5 **Cambridge International** 4.3.2 **Eduqas** Component 1 **OCR** ✓

Knowledge recap

Inventory is more commonly referred to as **stock.** It includes all of the raw materials a business stores for use in its production processes, all of the partially completed products that are making their way through the production process as well as any completed products that the business is storing before dispatching them to customers.

An important decision for managers to make is how much stock to store. Some managers prefer to hold high levels of **buffer stocks** – this is a minimum amount of inventory that managers don't let supplies fall below. Other managers prefer to hold as little inventory as possible, believing this to be a more efficient approach.

An extreme approach to holding minimum stock levels is known as **Just In Time (JIT)** inventory management. JIT involves developing a relationship with suppliers that requires them to deliver raw materials to the business just moments before they are required in the production process, meaning that the business does not have to store the inventory before they use it. Finished products are then dispatched immediately to customers so that the business does not store any finished stock either. In order for JIT to work effectively, a close working relationship with suppliers is crucial.

Show the analysis

Inventory management is more important to some businesses than others. Businesses that provide some services, such as a law firm for example, may require very little inventory each month. For such organisations, customer service, promotional activities or labour costs may play a far more crucial role in the fortunes of the business than inventory management does. However, for some service sector businesses, inventory management is crucial. Fast food restaurants, for example, rely on supplies of ingredients being in stock in order for them to be competitive in the marketplace.

Effective inventory management is also particularly important to manufacturers. Without the raw materials to manufacture the goods they produce, their production systems may be shut down until supplies can be sourced.

So what are the consequences surrounding poor inventory management? To answer this, we need to investigate the implications of holding both too little and too much stock.

Businesses that base their inventory management system around holding very little stock benefit from lower costs. Firms that adopt Just In Time systems in particular don't require as much space to store stock. This means they can operate out of smaller, cheaper premises and don't need to rent such large warehouses or storage facilities. Storing little stock also means there is not the opportunity cost of time spent transporting inventory from warehouses to the production line and there is also less potential for breakages or damage to raw materials. If a business uses expensive components, as a car manufacturer might, storing very little stock may also mean insurance costs can be reduced. In addition, for firms that make use of perishable inventory, such as a supermarket, there is also less potential for stock to spoil or go beyond best before dates.

These potential cost reductions are an attractive proposition, especially for firms that compete on price. However, operating with low buffer stocks (or no buffer stocks in the case of JIT) carries risks. If there are any delays in receiving stock, such as shipping delays, transportation issues or the closure of a valued supplier, the business may be without the components it requires to produce its goods or service. Without any inventory of finished products, lead times to customers may increase, damaging customer relations and ultimately, the business may not be able to fulfil its contracts to customers, potentially damaging sales revenue and causing liquidity issues as well as possibly conceding market share to rival companies.

For businesses operating JIT, there is also the problem of sourcing suppliers that are prepared to deliver on a Just In Time basis, as more frequent deliveries will increase their own costs. To compensate for this, suppliers may charge higher prices for the raw materials they provide or offer shorter trade credit periods. Furthermore, as the business is going to be placing more frequent, smaller orders with their suppliers, they may not achieve the purchasing economies of scale which businesses that hold larger stock levels enjoy.

In contrast, firms that hold larger buffer stocks of raw materials and finished products will benefit from greater economies of scale and will also enjoy greater flexibility in their production. By holding larger stocks, businesses may be better placed to respond to sudden increases in demand or accept unexpected last minute orders from customers. Although their costs may be higher due to having to store large quantities of inventory, this may be counteracted by the increased revenue they can achieve by accepting these special orders.

Finally, businesses that store larger quantities of inventory may experience a greater choice when it comes to selecting suppliers, as they are not restricted to finding suppliers that will agree to deliver on a Just In Time basis. This may make it easier for the business to switch suppliers and source the lowest cost inventory.

The verdict

How important is inventory management?

This depends entirely on the nature of the business in question. For many smaller businesses, particularly those operating in the tertiary sector, the comparatively small amount of raw materials required in their operations means that effective inventory management, whilst desirable, is not necessarily as critical to the success of the business as other factors, such as customer service or product quality. However, in larger organisations, particularly manufacturers in the secondary sector that use significant quantities of stock in their production processes, effective inventory management is hugely important. This is because inventory management has a direct bearing on the costs of the organisation as well as on issues such as lead times to customers. Effective inventory management helps to control the costs of the organisation, which is particularly important to firms operating with slender profit margins or those utilising a low cost producer strategy to compete.

Effective inventory management is most critical for firms utilising Just In Time inventory systems. If such systems are not managed effectively then the consequences for the business can be severe, both in terms of its ability to satisfy and retain customers as well as its impact on revenue and profit.

Should businesses adopt Just In Time Inventory management?

This depends on two factors – what does the business produce and what is its relationship with suppliers like?

For businesses that don't require the use of large amounts of inventory, such as many service providers, there is less incentive to use JIT given the risks involved. In addition, organisations with fluctuating demand patterns may find efficiently operating JIT a difficult task. However, for businesses that use greater quantities of components and raw materials, JIT can be an excellent method of creating a 'leaner', more efficient organisation, reducing wastage and lowering costs. These lower costs can make the business more competitive. For these firms, the decision on whether to implement JIT may come down to suppliers – can suppliers be sourced that are reliable, flexible, cost effective and willing to deliver on a Just In Time basis?

2 Productivity

Edexcel 2.4.1 **AQA** 3.4.3 **Cambridge International** 4.1.2 **Eduqas** Component 1 **OCR** ✓

Knowledge recap

Productivity is a measurement. It measures the amount of output produced by a business in a given period of time. Organisations that are labour intensive may measure **labour productivity.** This examines the average output produced per worker in a given period of time. As many firms become more mechanised, the business may examine the **capital productivity** of the organisation. This shows the average output produced per unit of capital (such as a piece of machinery). Both measures of productivity can be tracked over time

Labour productivity is calculated by dividing the total output produced during a period of time by the number of workers employed over that period. Capital productivity is calculated by dividing the total output produced during a period of time by the amount of capital used in that period (such as the number of machines).

Increasing productivity is advantageous for businesses. Firstly, being more productive means more output can be produced in a given time period. This is beneficial to businesses trying to keep up with high demand, giving them more output to sell, which will increase sales revenue. Being more productive may also lower the costs of the business, particularly increases in labour productivity. This is because, if each worker is now capable of producing more units on average in a given time period, fewer employees are required to produce the firm's output target. This means labour costs can be reduced, driving down the unit cost of producing each product. This reduction in unit cost can be passed on to customers in order to make the business more price competitive or the business can maintain its current price level and enjoy a greater profit margin.

The UK suffers from a **productivity gap.** This means that the output per worker in the UK is lower than many other leading economies, such as the US, France and Germany. Consequently, managers in UK businesses are eager to find initiatives to improve productivity.

Show the analysis

There are many different options available to managers seeking to improve productivity that you can write about in exams and each has its own strengths and limitations. In terms of labour productivity, businesses could provide employees with more (or better) training. Theoretically, more training or education should improve the skills of the workforce, allowing them to perform their job role more productively. This investment in staff may have the added benefit of motivating workers and reducing issues such as absenteeism. However, there is often a financial cost attached to training as well as the opportunity cost of lost production whilst staff are receiving training. Furthermore, there is the risk that more highly trained and qualified staff may demand increased pay or take their newly acquired skills to a rival organisation. As an alternative to training, the business could improve productivity by relocating to a country where employees may already possess greater skills.

As well as training, there may be other ways to improve employee motivation that may boost productivity. Financial incentives such as output bonuses or piece rates may motivate the workforce to be more productive. However, financial incentives will incur a financial cost for the organisation and it may lead to problems with quality, as workers focus more on the volume of work they produce in order to achieve greater financial rewards than the quality and precision of their work.

An initiative advocated by Frederick Taylor as part of his Scientific Management studies at the beginning of the 20th Century was the use of production lines that embraced specialisation and the division of labour. By allowing employees to focus on a specialised task in the production process rather than a more varied range of activities, employees would develop greater competence in that task, leading them to be more productive. The adoption of Scientific Management principles led to significant productivity gains in businesses at the start of the last century and the division of labour is still commonly used in manufacturing. However, it is less straight forward to apply Scientific Management to service sector organisations and there are critics who claim that the monotony created by the division of labour can actually hinder productivity and lead to employee unrest and higher rates of labour turnover.

A Japanese concept that may boost productivity is the formation of Kaizen groups. Kaizen is the philosophy that the business should constantly be making small, incremental changes to improve the productivity of the organisation rather than making large, one off changes. Worker groups may be formed that meet daily to suggest ideas and initiatives that may change how work is organised and completed. By regularly adapting the operations of the business, more productive ways of working can be quickly introduced whereas in Western businesses, initiatives to improve productivity may be reviewed and implemented far less frequently. However, it should be noted that labour productivity is lower in Japan than in the UK, although this is not necessarily attributable to Kaizen.

Productivity may also be increased through mechanisation and investment in new technology, possibly even replacing human labour with greater reliance on machinery. Mechanisation boosts productivity as machines can operate 24/7, may produce fewer defects and don't require breaks or absences unlike human labour. However, the set up costs involved can be significant and there may be resistance to mechanisation from the workforce, especially if job losses are involved.

The verdict

What is the best method of improving productivity?

To answer this, you need to consider the circumstances of the business you are writing about in the exam.

For businesses that are already highly mechanised and focused more on capital productivity than labour productivity, the greatest productivity gains are usually to be found by investing in updated technology and machinery, although firms that require a large workforce to operate the machinery may also consider greater investment in training so that the benefits of mechanisation can be maximised. In this scenario, the key question is can the business you are writing about afford the high set up costs of investing in new machinery?

For labour intensive firms, if their production process can be mechanised then this is often a method of creating significant increases in productivity. However, the appropriateness of this method may be dependent on the history and culture of the organisation. For example, although mechanisation may create productivity gains, if the history and brand name of the organisation is rooted in craftsmanship or if the ethics of the organisation may conflict with the job losses that mechanisation might generate, this method may not be advisable. Similarly, relocating to a country where a more productive workforce could be recruited may only be suitable if such a measure can be reconciled with the ethics of the organisation.

In organisations that already benefit from highly motivated employees or in firms that have a highly skilled and qualified workforce, there are fewer advantages to be gained from initiatives such as the division of labour or financial incentives such as piece rates. Such firms may experience greater improvements to productivity through use of initiatives such as Kaizen groups, investment in training or non-financial methods of motivation such as job rotation or job enrichment.

Remember – the key is to recommend a method that is sympathetic to the circumstances of the business you are writing about.

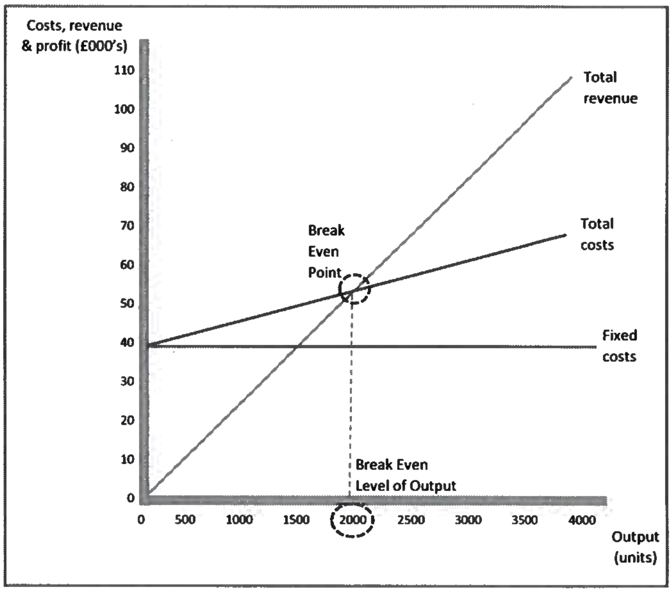
3 Break Even Analysis

Edexcel 2.2.3 AQA 3.5.2 Cambridge International 5.3.3 Eduqas Component 1 OCR ✓

Knowledge recap

Breaking even means a business has generated enough revenue to cover its total costs, but not so much that it has made a profit. The concept of breaking even is particularly important to new businesses, as it gives entrepreneurs an idea of how much they need to produce and sell in order to cover the costs of running their business.

The number of products that a business needs to sell in order to break even is known as the **break even level of output.** To calculate the break even level of output, the fixed costs of the business are divided by the selling price minus the variable costs per unit. Businesses may compile a break even chart that plots their fixed costs, total costs and sales revenue to calculate their **break even point** – the point at which the total costs of the business is equal to the total sales revenue.



Break even charts are useful to entrepreneurs because not only do they provide a visual representation of how many units must be produced and sold to break even, but they also display how much profit or loss will be achieved at different levels of output.

In addition, break even charts can be used to calculate the **margin of safety** if different levels of output are reached. If a business has a margin of safety, it means that their current level of output is greater than the break even level of output. For example, if a business has a break even level of output of 2000 units a month, but is actually producing and selling 2300 units, then it has a margin of safety of 300 units each month.

Show the analysis

Break even analysis is useful as a decision making tool. At its most basic level, it helps prospective entrepreneurs decide if a business venture is even viable. For example, by estimating the fixed and variable costs of a business idea and deciding how much they will charge for each product, entrepreneurs can calculate how many sales they would need to make each month in order to cover their total costs and if they feel that target is not achievable, they can quickly see that they don't have a viable, profitable business concept.

Accordingly, break even analysis can help reduce some of the risk attached to starting a new business venture. By conducting break even analysis, entrepreneurs can plan how long it might take for a new venture to achieve sufficient demand to break even and assess whether the business could survive long enough to achieve that level of output. In addition, break even analysis may form a part of the entrepreneur's business plan, with some financial institutions insisting on seeing evidence of break even analysis before they are willing to lend funding to the entrepreneur.

Break even analysis is also useful as a price setting tool. Entrepreneurs can use break even analysis to see how changes to their selling price will affect their break even level of output, their profits or the losses they may make. Similarly, entrepreneurs can use break even analysis as a 'what if' scenario planning tool, investigating how any changes to their fixed or variable costs would affect their break even point and the viability of their business venture. This may even encourage entrepreneurs to investigate means of lowering their costs, sourcing cheaper locations, insurance or suppliers in order to reduce the costs of running their business and bring down the break even level of output. Accordingly, break even analysis may help reduce the start-up costs of a new business venture.

However, there are factors that limit the usefulness of break even analysis. Firstly, there is the problem of the accuracy of the forecasts that inform break even analysis. First time entrepreneurs may find it difficult to accurately cost their business or determine what price customers are willing to pay. If any of the data used in break even analysis is inaccurate, it means that the entrepreneur is making decisions based on a break even level of output that has been miscalculated.

A further problem is that break even analysis only informs an entrepreneur how many units need to be produced to break even – encouraging entrepreneurs to produce to such a level without any guarantees that there will be sufficient demand to sell that many units. In some respects, trying to achieve a break even level of output too early may mean that a business invests too much money in inventory or raw materials that there simply is not enough demand to justify, leading to rising costs and unsold products.

Even accurately conducted break even analysis is dependent on conditions remaining constant. Any future changes to wage costs, changes in rental costs or increases in raw material costs will lead to changes in the break even point, but such changes can be difficult to forecast in advance, particularly for inexperienced entrepreneurs.

Finally, although the simplicity of break even analysis makes it popular, it becomes more difficult to apply to firms that produce multiple products, all with different selling prices and variable costs. For such firms, it becomes more difficult to determine how many of each product or service need to be sold to cover the fixed costs of the business.

The verdict

How useful is break even analysis?

Break even analysis is undoubtedly an invaluable planning tool for businesses. The problem with it is that the businesses for whom break even analysis is most useful – new business start ups – are also the businesses that will find it the most difficult to accurately calculate. Without previous records of how much different costs might be or what sales prices customers may be prepared to pay, break even analysis involves a large degree of guess work for first time entrepreneurs. When break even analysis is inaccurate, its usefulness is diminished.

Therefore, it is fair to conclude that the usefulness of break even analysis depends primarily on how accurately it is completed. If the entrepreneur can forecast with confidence what their fixed costs, variable costs and selling price will be and can be similarly confident that these costs and prices will remain constant in the medium term, then break even analysis is incredibly useful. The less confidence the entrepreneur has in the data that has informed their break even analysis, the less dependable it becomes as a planning tool.

Accordingly, the usefulness of break even analysis depends to some extent on the quality of the market research conducted by the entrepreneur. The more time the entrepreneur invests into researching costs of items such as raw materials, wage rates, fixed costs such as rent and insurance as well as potential selling prices, the more accurate and useful break even analysis is likely to be. In addition, the fewer products or services the business sells, the easier break even is to conduct accurately and the more useful it should be.

4 Branding

Edexcel 1.3.2 **AQA** 3.3.4 **Cambridge International** 3.3.7 **Eduqas** Component 1 **OCR** ✓

Knowledge recap

Branding is the process of differentiating a business from rivals through developing a name, design or logo that consumers instantly recognise and associate with a particular product. For example, as soon as consumers hear the name 'Cadbury', they typically associate it with confectionary. If consumers see the Nike 'Swoosh', it instantly conjures up images of sportswear. If consumers were asked to name a well-designed car, they might instinctively think of one of the German manufacturers, such as Audi.

When a business develops a brand name, it means that they become *synonymous* in the minds of consumers with a certain type of product. What is the first business that comes to mind when you think of smart phones, designer fashion or vacuum cleaners? By having a brand name, you closely associate the name of that business with that type of product.

Branding influences the way consumers perceive a business. Accordingly, businesses might try and brand themselves in different ways. Some organisations try to develop a **performance brand.** This means they want to be synonymous with aspects of the product such as dependability and superior function. Other firms may try to develop an image as an **innovative brand.** This means the business is associated with technological advancements. A **service brand** means the business wishes to be known for its high levels of customer care and consumer experience. Many industries will have a business attempting to be perceived as a **luxury brand,** offering consumers superior quality at a higher price than rivals. A contrasting approach is to develop a **value brand,** with customers recognising you for more basic product offerings at an affordable price point. Businesses with a strong Corporate Social Responsibility stance may try to develop a **conscious brand,** meaning the business is perceived as fostering positive relations with all stakeholder groups.

Over time, a business may decide that it wishes to attempt to change the way that consumers perceive the business. For example, a business traditionally seen as a value brand may wish to change its perception to be seen as more luxurious. This process of changing consumer perceptions is known as **rebranding.**

Show the analysis

How do businesses build brands?

It might be assumed that brand names always develop organically – if a business is innovative then consumers will recognise this and, over time, the business will develop a reputation as an innovator in its industry. Whilst this *may* happen, there are many examples of organisations that have a **unique selling point** or point of differentiation without being recognised for it by consumers. Similarly, there are examples of businesses that are widely perceived as possessing a strength that may be undeserved. Developing a USP is a powerful tool in brand building as it helps the business to stand out in the marketplace, but managers may need to utilise other ways of ensuring that consumers' perception of the business is the one the organisation is aiming for.

Perhaps one of the most powerful tools in brand building is **advertising.** Adverts help cultivate a strong brand name through the message they communicate and the type of media the adverts appear in. For example, if a business is trying to develop an image as a luxury brand, then it can communicate through its adverts all of the aspects of superior quality that the product possesses. It can also ensure that the adverts appear in media viewed by consumers prepared to pay a higher price for a more luxurious product. Advertising can be effective in building a brand name due to the large number of potential consumers it can reach. However, many forms of mass media are expensive, increasing the costs of the business.

Sponsorships may also reach a large number of people and may be a cheaper alternative to advertising. In addition, sponsorships have the benefit of aligning your brand with the image of the event or organisation you are sponsoring. For example, a business attempting to develop a conscious brand may sponsor charitable fundraisers or events linked to environmental sustainability. However, this also means that your brand can be tarnished by any negative activities of the organisation or event being sponsored.

Many firms now utilise **social media** platforms to help create the desired brand identity. The advantage of this method is that organisations can target different market segments through different forms of social media and it may be a lower cost option to advertising. It also helps develop closer links to consumers, who can communicate directly with the business through social media. However, businesses need to maintain an active schedule of relevant social media output in order for it to be effective and it can be challenging to stand out from the social media profile of rival organisations.

How important is branding?

Branding is important due to the benefits it can create, particularly in highly competitive markets. For some organisations, their brand name allows them to **add value** to their product. For example, two rival clothing retailers may outsource the manufacturing of their garments to the same overseas factory. However, consumers may desire Business A's clothes far more than Business B's because of the brand Business A has developed for elegance, quality and style. This increased added value may mean businesses can command a **premium price** for their products because of the strength of their brand. Branding can even **reduce the price elasticity of demand** of a product. Firms with a strong brand name may find they are able to increase prices without suffering a significant fall in demand because consumers have become **brand loyal** to their products.

Branding may also **reduce competition** by acting as a barrier to entry, with new firms being discouraged from entering the market for fear of not being able to compete with existing brand names. Furthermore, a strong brand name may help the business when **recruiting** new employees, with the most skilled and qualified employees desiring positions in businesses that have a portfolio of prestigious products with a distinctive brand.

The verdict

How important is branding?

There are lucrative benefits to developing a reputable brand. Financially, if a strong brand can attract increased demand, command a higher price and reduce the price elasticity of a product, then it is a clear line of argument to link this to improved revenue, profits, profitability and shareholder returns. However, does this mean that a business cannot be successful without strong branding? The answer to this may depend on the nature of the product being sold.

There are many examples of products where branding has less of an impact on consumer's purchasing decisions. For example, if you were to consider purchasing a lightbulb, a lettuce or a shuttlecock, you may value convenience and price more highly than branding, even though the manufacturers of these products all run lucrative businesses. In addition, it is important to recognise that building a brand can be expensive, incurs an opportunity cost and may not necessarily be successful. Not every business trying to develop an identity as a luxury brand will be perceived that way.

Also, it could be argued that the importance of branding is relative. In markets dominated by branded goods and services, a strong brand may be more important than in an industry where rival firms may not have an identifiable brand either.

5 Pricing Strategies

Edexcel 1.3.3 **AQA** 3.3.4 **Cambridge International** 3.3.5 **Eduqas** Component 1 **OCR** ✓

Knowledge recap

Before setting a price for their product, managers must first decide the **pricing strategy** they wish to use. One simple strategy is **cost-plus pricing.** This involves adding a percentage on top of the unit cost of producing a product to determine the price charged.

Two contrasting pricing strategies are price skimming and penetration pricing. **Price skimming** is often used with technological products or other products whose launch is being anticipated by the market. It involves releasing the product at a high price in order to maximise the revenue earned from customers that are eager to purchase it, but then gradually reducing the price of the product as it progresses through its product life cycle. **Penetration pricing** is the opposite approach and is often used by new brands that are trying to penetrate a competitive marketplace. Products are launched at a low price in order to offer customers an incentive to switch from their usual brand, but the price is then increased over time as the product develops a stronger brand name.

Products that lack differentiation from rival brands in the marketplace may use **competitive pricing.** This involves setting a price that is comparable to those charged by rival firms. Often, businesses with a lower market share (known as 'price takers') adjust their prices to keep them in line with any changes the market leader (known as the 'price maker') makes.

An aggressive pricing strategy is **predatory pricing.** This is when a business sets prices at such a low level that other firms can no longer compete and exit the marketplace.

Alongside the pricing strategies, businesses may also employ **pricing tactics.** A popular tactic is **psychological pricing.** This is when a price is set marginally below a round number, such as £19.99, to give the illusion that the product is better value. Some firms may also employ **price discrimination** tactics. This is when price reductions are offered to certain market segments, such as children or over-65's, to encourage their custom.

Show the analysis

Managers will need to consider many different factors when setting the price of their products. For many businesses, the degree of competition they face will be an important determinant of price. Firms that operate in markets with many rivals often have to use price as a means of competing. Unless the business has a dominant market share and is the price leader, managers may be forced to use a competitive pricing strategy in order to attract customers. Businesses in markets with fewer competitors may be in the more enviable position of having more control over price and may be able to charge a premium for their products, increasing their profit margins.

Unless the business is adopting a loss leading pricing strategy to win market share, the production costs a business incurs will also be a key determinant of price. In order to generate profits, managers must set a price that is greater than the unit cost of producing the product. If managers set a price that is low in relation to production costs then this creates greater pressure to sell a larger volume of products, as the profit margin on each sale is slender.

The product's positioning in the market will also help determine its price. Undifferentiated and non-branded products often compete by offering consumers greater value than branded alternatives and usually adopt low price strategies. Such strategies can be highly successful as long as the business can continue to minimise their operating costs. If a rival firm is able to offer consumers a cheaper price, the business's market share can quickly erode. Businesses that possess a point of differentiation or a unique selling point will take this into consideration when setting their price. If the business's products are differentiated in a way that consumers value and have a stronger brand name, the firm may be able to command a higher price than rivals, creating greater added value and higher profit margins. However, points of differentiation can be imitated by rivals, so firms need to continue to innovate or invest in promotion to maintain a strong brand name and command a higher price.

The product life cycle is a determinant of price. A product may be priced differently in the growth stage of its life cycle compared to when it enters the decline phase for example. The managers of product portfolios will use concepts such as the product life cycle to carefully adjust the prices of the products they manage in order to balance the desire to increase or maintain market share with the desire to maximise sales revenue.

Finally, the price elasticity of a product is always an important consideration when setting prices and will determine whether the business benefits from price rises or price reductions. Price inelastic products generate greater revenue when prices are increased, because the percentage that sales fall by is lower than the percentage prices increase by. Managers that calculate that they have price elastic products in their portfolio will favour price reductions. This is because the percentage that managers reduce prices by will be less than the percentage that sales rise by when prices are cut. This means that the business will benefit from greater sales revenue at the lower price and, potentially, more profit.

The verdict

What is the most significant determinant of price?

For smaller firms operating in competitive markets, it's hard to look beyond the prices of competitors as the greatest determinant of price. Businesses with smaller market shares in markets with many rivals constantly use the price set by the market leader as a reference point and are likely to reduce and increase their own prices in line with the actions of the price maker in the industry. Even products in such markets that are considered to have a point of differentiation are likely to keep a keen eye on any alteration in price that that the market leader makes. The exception to this might be for new entrants to the market place that need to ensure that the price they charge is higher than the production costs of each unit. However, once that firm establishes a market share and begins to benefit from greater economies of scale, they too may become more heavily influenced by the price leader in the industry.

Firms that enjoy a more dominant market position or businesses that operate in markets with fewer competitors may find that there are different influences on the price they set. For such organisations, it is possible that the strength of their brand name is the key determinant of price, regardless of the prices rival goods sell for.

Should a business cut its prices?

This depends primarily on the price elasticity of the product. If the product is price inelastic (for example, if its PED is -0.7), then price reductions would not be advisable. However, for a price elastic product (for example, a product with a PED of -1.5), price reductions would increase the total revenue generated, even though the revenue per sale is less.

Alongside the price elasticity of a product, the other issue to consider when deciding to cut prices is the state of the economy. During periods of recession, even some branded goods may consider price reductions in order to prevent a loss of market share to more price competitive rivals.

6 Market Segmentation

Edexcel 1.1.2 **AQA** 3.3.3 **Cambridge International** 3.1.6 **Eduqas** Component 1 **OCR** ✓

Knowledge recap

Markets are made up of customers who all have different needs. Take the market for cars in the UK for example. This market is made up of millions of consumers that all desire a car, but their specific needs might be different. Some require a car to fit a modest budget, others require a car big enough for a large family, some demand fuel efficiency due to the large amount of miles they cover whilst others require a car that presents an image of luxury. The dilemma for managers is that if they design a product without understanding the needs of different groups, they risk appealing to none of them. This is why businesses conduct market segmentation – the process of using market research to identify groups or **segments** of customers that share similar needs so that the business can decide which segments to target with products.

There are different ways that customers can be grouped into market segments. The most common method is **demographic segmentation,** where customers are divided into groups based on a personal characteristic such as their age or gender. For example, a clothes retailer may conclude that males and females have different needs when it comes to fashion or a radio station may determine that teenagers have different tastes to over 65's when it comes to music genres.

Some businesses may determine that customers might not have different needs based on their demographic characteristics. For example, a fast food chain might find that males and females and teenagers and over 65's share similar needs from a burger. However, these businesses might conclude that customers have different needs depending on their location. Segmenting consumers based on where they live is known as **geographic segmentation.** Using this method, the fast food chain might realise that consumers in the Middle East have different needs to those in Japan based on the tastes and customs in those nations.

Another common method of segmenting a market is **income segmentation.** This divides consumers into segments according to the income they earn. In some markets, such as tobacco, a person's income may not affect their needs from the product. However, in markets such as cosmetics, hotels or holidays, consumers on lower incomes may have different needs to those on higher incomes. Businesses often split consumers into income brackets using **socio-economic groupings**, which divides people into groups based on their profession.

Behavioural segmentation divides consumers according to purchasing behaviours, such as how frequently they buy a product, when they buy a product or the quantity they buy it in. Chocolate manufacturers may segment consumers according to their behaviour, developing different sized bars of the same chocolate to suit consumers with different needs or selling bars in multipacks to satisfy consumers that use the product more frequently.

Psychographic segmentation divides the market according to people's opinions or lifestyles. For example, media companies may identify different needs for consumers of magazines and newspapers based on their values or opinions or holiday companies may notice different requirements for holiday packages for consumers based on their lifestyle, such as active people preferring adventure holidays whilst families with young children favour relaxing, all-inclusive vacations.

Once managers have determined how they believe a market should be segmented, they must then decide which segments to target. Businesses that decide to concentrate their efforts on meeting the specific needs of just one market segment are known as **niche marketing** organisations. Businesses that decide to ignore the more individual needs of different segments and design products intended to meet the broader needs of most market segments are known as **mass marketers.**

Show the analysis

One of the main uses of market segmentation is in helping managers to understand the market. So many products may seem generic, but when analysed in greater detail it becomes apparent that consumers do not all have the same needs from that product. For example, it would be easy to assume that the needs consumers have from a toothpaste is generic, but this may not be the case. Some may require a product designed for sensitive teeth, others desire a whitening toothpaste, some demand added fluoride whilst others prefer a gentler flavour for children. Market segmentation forces managers to discover and consider these needs before deciding to target each of these segments, specialise in the needs of just one segment or try to design a mass market product that appeals to a cross section of consumers. This improves communication with consumers and may help inform new product development and innovations.

Market segmentation can also be cost effective. By dividing consumers into groups that share characteristics or behaviours, businesses can focus their product development on the specific needs of these segments rather than spending money creating products that fail to match the needs of any segment closely enough to be profitable. As well as helping managers design products, market segmentation can also help with the advertising of them. For example, if a fashion company identifies a segment of consumers that all enjoy a similar lifestyle, such as surfers, then they may be able to pinpoint ways of targeting advertising and promotions directly at this segment rather than using mass media advertising and hoping that surfers happen upon it.

Market segmentation may also facilitate better customer retention. By identifying the needs of different segments in the market, the business can develop products that satisfy some of those needs. This should lead to enhanced customer satisfaction, more repeat customers and consumers that may be loyal to the brand and be prepared to purchase future products that the business develops. If customers are more satisfied, there is also the potential to charge higher prices for products that consumers feel are differentiated to their needs, which may increase profits.

However, there are limitations to segmentation. Firstly, the business may misinterpret the results of market research and inaccurately diagnose the needs of consumers. This may lead to the development of products that there is no market for, generating additional costs for a business. Furthermore, the business might accurately segment the market but find that many of the segments are quite small. Money may be invested into research and development or additional market research before it becomes apparent that a segment cannot be profitably targeted with bespoke products. Also, if businesses do decide to create customised products to meet the needs of different market segments, this may mean that opportunities for economies of scale are lost and may mean more stock has to be stored as the business has to carry more product lines.

The verdict

To what extent is market segmentation useful to businesses?

Market segmentation is useful, but businesses need to be cautious when making decisions based on their findings. Firstly, the business must be confident enough in the reliability and interpretation of their market research to be satisfied that they have accurately identified the needs of different segments. Any misinterpretation when segmenting the market limits its usefulness. Then, they must be intelligent in the segments they choose to target to ensure they do not end up developing bespoke product lines for a segment that turns out to be too small to be profitable. In exams, it is important to remember that market segmentation is not just valuable to businesses that decide to adopt a niche marketing strategy. Segmentation is equally important to mass marketing firms as it allows them to identify the needs of different groups of consumers and determine whether different segments might have enough overlapping or compromised needs that would allow the company to target multiple segments with a more generic, mass produced product.

7 Motivating Employees

Edexcel 1.4.4 **AQA** 3.6.4 **Cambridge International** 2.2 **Eduqas** Component 1 **OCR** ✓

Knowledge recap

Motivation is the desire to do something. In the case of the employees, it is the desire to complete work. Each exam board varies slightly in the motivation theories students are required to know about, but the work of Frederick Taylor, Elton Mayo, Abraham Maslow and Frederick Herzberg feature on most.

Taylor's ideology centred on incentivising productivity through **monetary rewards.** In order to discourage **soldiering** (the idea that employees would work as slowly as they could get away with), Taylor favoured a piece rate system of pay, with workers being rewarded for each unit of output. In order to aid workers in their productivity, Taylor deployed the division of labour to simplify the tasks employees performed and used time and motion studies to identify 'the one best way' of performing a task before training each employee in that way.

Mayo set up a series of experiments known as the **Hawthorne Studies** to reprove the Taylorist principle that financial rewards were motivational. The studies also investigated whether other physical variables, such as lighting, temperature, shift patterns and the length and frequency of rest breaks influenced motivation. Mayo discovered that each adaptation he made to physical variables always resulted in greater productivity, even when he reverted conditions back to their original status. He concluded that pay and the physical environment had little impact on motivation and that productivity was continuously rising because the employees involved in the studies enjoyed the team element of the experiments and the social interaction they experienced with their colleagues, but also with the supervisors of the experiments, who even began to involve the workers in the design of the studies. This notion of **consultation** was judged to be highly motivational.

Maslow developed a hierarchy of motivational factors he believed workers progressed through during their career. Initially, motivation stemmed from the desire to purchase food and shelter and could be satisfied by monetary rewards. But once people had the income to satisfy these basic needs, they would look to the next level of **Maslow's Hierarchy** to motivate them – the need to feel secure. As people progress up the hierarchy, Maslow claimed employees were motivated by the need for belonging, then self-esteem and, finally, self-actualisation and reaching their full potential.

Like Maslow, Herzberg identified **non-monetary** factors that he believed were the key to motivating employees. He developed two categories he termed **hygiene factors** and **motivators.** He proposed that hygiene factors, such as pay, wouldn't motivate people but could demotivate them if they felt they weren't satisfied. Herzberg believed only the factors on his list of motivators, such as responsibility and opportunities for promotion, could increase productivity.

Show the analysis

There are many possible benefits to a highly motivated labour force. One is obviously the increase in productivity that should occur, with motivated employees able to produce a greater volume of work over a given period. This additional productivity provides the business with additional output, which might allow the firm to keep up with demand and generate greater revenue. However, it can also lead to lower labour costs, as the business will not require as large a workforce if each employee is capable of producing more work. These lower costs might allow the business to be more price competitive.

Organisations with a motivated workforce may also benefit from superior quality. For manufacturers, this might mean better quality goods and fewer defects, lowering the unit cost of production. In tertiary sector businesses this better quality might take the form of enhanced customer service, resulting in greater customer retention. In both manufacturers and service providers, better quality might provide the prospect of charging higher prices.

If a business has motivated employees it can also create human resource benefits. Firms with a motivated labour force may experience lower rates of absenteeism and reduced labour turnover, potentially driving down the labour costs of the organisation as well as reducing the likelihood of industrial disputes and creating better employer-employee relations. The business may also develop an employer brand, becoming renowned as a desirable company to work for due to the positive sentiments existing staff may express about the organisation. This may facilitate a more effective recruitment process, attracting better candidates to fill job vacancies.

In contrast, if an organisation suffers from a demotivated workforce, then in the short run it may hinder productivity and be the cause of absenteeism, driving up the costs of the organisation, making it potentially less efficient and less competitive. In the medium term, issues with quality and customer service may become apparent, making customer retention more challenging, particularly for businesses not adopting a low-cost producer strategy. In the long run, labour turnover is likely to be higher in an organisation where employees suffer from low levels of motivation and hiring quality recruits with a reputation for having an unhappy working environment will be challenging.

The verdict

What is the most effective method of motivating employees?

At the heart of this question is the issue of whether systems designed to motivate employees need to focus on financial rewards, such as piece work, bonuses, commission and profit sharing or non-financial techniques such as empowerment, job enlargement, job rotation, job enrichment and flexible working practices. In exam answers, you should remember that businesses can incorporate many different systems into their approach to motivation, utilising both financial and non-financial techniques.

However, it may be suitable to adopt different approaches to motivation depending on the circumstances of the firm. Although not universal, Taylorist techniques such as piece rates are likely to be more successful in manufacturing firms with unskilled or semi-skilled employees whilst initiatives inspired by Herzberg such as job enrichment may be more successful with professions, where staff have greater training and qualifications.

In exam case studies, it's also useful to try and pinpoint the business's existing approach to motivation and assess how successful it is when recommending the most effective method of motivation. For example, if a business deploying bonuses and commissions for its sales staff is experiencing falling revenue and rising labour turnover, this may imply that financial motivational techniques are not currently successful. Therefore, it may not be suitable to conclude that the business should use another financial technique, such as profit sharing, when the evidence leans towards adopting non-financial systems, such as consultation or teamworking.

Another important consideration in exams is balancing your opinion on the best method of motivation with what is feasible for the business the question is on. For example, ordinarily it might be suitable to suggest that the employees of a supermarket may be motivated by a profit sharing scheme. However, if the case study highlights that the profits of the company have been falling for a number of years, how feasible is it to withhold a proportion of these dwindling profits from shareholders in order to reward employees? Similarly, you may suggest in an answer that a business should adopt systems such as piece rate pay or productivity bonuses. However, if the case study mentions the prospect of a forthcoming recession, how feasible are motivational techniques that increase the costs of the business?

Issues such as the size of the business are important considerations when suggesting techniques such as flexible working. Also, consider the skills and experience of the employees when recommending how to motivate them.

Sources of Finance

Edexcel 2.1.1 & 2.1.2 **AQA** 3.5.3 **Cambridge International** 5.2.6 **Eduqas** Component 1 **OCR** ✓

Knowledge recap

Businesses that are looking to finance expansion have two options available. The first is to fund growth through **internal sources of finance.** This is money that is generated by the business or its owners. Alternatively, the business may seek an **external source of finance.** This is funding that comes from outside of the business.

Internal sources of finance are commonly used to fund new business ventures through the entrepreneur investing their **own capital** that they have saved prior to forming their business. However, once a business is operational and is looking to finance growth, other sources of internal finance become available. Over time, a business will purchase assets such as property, machinery and equipment. As the business grows and evolves, some of these assets may no longer be required by the business but will still have value. The business could **sell unwanted assets** to raise finance. Even assets that the business requires can be used to raise funds through **sale and lease back.**

The other form of internal finance available to established organisations is **retained profits.** Rather than distributing all of the annual profits to shareholders in the form of dividends, the directors of the organisation may decide to retain a proportion of the profits to help fund future business growth.

The sources of external finance available to businesses are more plentiful. Banks may be willing to provide **loans** or **mortgages,** which are loans that are secured against the value of an asset. They may also offer the business an **overdraft,** which is a facility that allows the company to spend more money than it has in its bank account up to an agreed limit.

Alternatively, the business could sell **share capital** to new investors to raise funds. A **business angel** is a wealthy individual, normally an entrepreneur themselves, who looks to invest in newer businesses they believe have the potential to grow. They will provide funding in return for a share of the company. **Venture capital** companies manage vast pools of money that many investors have contributed to. Venture capital firms seek investment in more established organisations that offer greater returns. Like business angels, they invest finance in return for a share of the ownership. Both business angels and venture capital firms usually look to sell their stake for a profit once they have assisted in the expansion of the business.

The government also act as an external source of finance through the provision of **grants.** These might be distributed at a local level through town and county councils or nationally through central government. Some charitable organisations also provide business funding through the awarding of grants.

Larger organisations can raise funds through **debentures.** A debenture is a bond that the organisation sells on financial markets. The business agrees to repay the purchaser of the bond its full value plus an agreed amount of interest on a fixed date in the future.

A recent development to external finance is known as **crowdfunding.** This method commonly uses internet sites to publicise the business and its expansion plans in the hope of attracting a collection, or 'crowd' of investors, who each contribute an amount of money to the business until the business reaches its target amount of finance. Each investor is rewarded with a small stake in the business. For businesses reluctant to sacrifice equity, **peer-to-peer lending** is a similar arrangement, but investors loan the business money that is repaid with interest rather than take a stake in the business.

Show the analysis

A major benefit of financing growth through internal sources of finance is that it does not place the business into debt. Unlike some of the methods of external finance, owner's capital, selling unwanted assets and retained profits raises finance organically – the business does not have to repay anyone for the finance raised and there is no interest on the borrowing. However, each of these sources does have limitations to consider. The more capital the owners of the business inject into the business, the more they can potentially lose if the business fails. In addition, there is the opportunity cost associated with investing money into a business rather than spending it in their personal life.

Selling unwanted assets is good in the sense that it raises funds from an asset the business is not currently utilising, but it means that if circumstances change and it becomes apparent that the asset might now be of use, the business no longer owns it.

Retained profits may seem like a source of finance with no drawbacks, but this may not be the case. This is because retaining profit in the business means depriving the owners of drawings or dividends. This may not concern sole traders as much, but in organisations with shareholders, the managers of the business need to strike a careful balance between their desire to raise finance to grow the business and the need to make sure shareholders are content with the returns they are making from the business.

Borrowing from banks through loans and mortgages, the issuing of debentures and peer-to-peer lending all allow considerable sums to be raised that can fund substantial growth. They can also raise funds relatively quickly. However, repaying these debts places a financial burden on the business and can affect liquidity, although an overdraft facility may lesson some of this burden. Businesses with unlimited liability may be particularly cautious about raising finance through borrowing.

Selling share capital or crowdfunding may be preferable to taking loans as it does not involve borrowing or interest payments. Selling shares to business angels or to venture capital firms comes with the added benefit of being able to access their expertise and contacts to help grow the business. The main limitation of raising share capital is that the owners have to sacrifice a stake in their business, meaning that both profits and control are now shared with the new investors.

Grants have the benefit of not having to be repaid but they are often for smaller amounts of money and the business will have to meet certain criteria in order to be eligible for grants.

The verdict

How should businesses finance growth?

When advising businesses on how to fund growth, consider the circumstances of that organisation. One key consideration is the priorities of the owners. Options such as share capital, business angels, venture capital and crowd funding usually require the owners to part with a percentage of the ownership of their business. In exam answers, don't overlook the magnitude of having to sacrifice a stake in the business someone has founded and spent years developing. You need to appraise whether the growth the business is planning is adequate compensation for relinquishing some of the control of the owner's business.

Another key consideration is the amount of finance the business is looking to raise. More modest growth might be able to be financed through internal sources, such as retained profit or the sale of assets. However, more ambitious growth is likely to require the use of an external source of finance.

The financial position of the business is also a determinant of how to finance growth. Does the business generate sufficient profits to retain some in the business? How highly geared is the business? Is there capacity for further borrowing or would this be too risky?

9 Decentralisation

Edexcel 1.4.3 **AQA** 3.6.3 **Cambridge International** 2.4.6 *(A level only, not AS)* **Eduqas** Component 1 **OCR**✓

Knowledge recap

In any organisation there is a need for people to make decisions. One of the factors that distinguishes businesses from one another is who has the **authority** to make decisions in the organisation.

In some organisations, the authority to make key decisions is retained by the senior leaders at the top of the hierarchy. In global businesses, this might mean that strategic decisions are made by the head office and satellites or branches of the business around the world have decisions dictated to them. This style of decision making is known as having a **centralised** structure and is a traditional approach to decision making that is still widely used.

A contrasting method is to adopt a **decentralised** approach to decision making. A decentralised organisational structure relies on **delegating** the authority to make decisions further down the organisational hierarchy. This might involve allowing more junior managers to make strategic decisions or it may require individual branches of the business to make more localised decisions based on the needs of the communities and customers they serve.

Decentralisation often requires businesses to make amendments to their financial structures. If junior managers or individual branches of the organisation are going to be granted greater autonomy and decision making responsibility, they will also require the financial resources to fund their ideas and strategies. This might mean the business develops **profit centres,** with each branch of the business being accountable for the revenue generated and the costs incurred.

In reality, most organisations adopt some degree of decentralisation, but the question is how much? Business academics have long debated whether it is more advantageous for the majority of decisions to be made centrally, at the top of the organisation's hierarchy, or whether all businesses would benefit from a more decentralised approach.

Show the analysis

Because centralisation and decentralisation are opposite approaches to the organisation of a business, the benefits of one are the limitations of another.

For example, one of the key benefits of adopting a centralised approach is that strategic decisions are made by the people that are most senior in the organisation. Presumably, these people have risen to these positions of power because they possess the greatest skills, experience and knowledge and have demonstrated the wisest judgement. By ensuring that these senior figures preserve the responsibility to make all key decisions, the business is hoping that this will lead to better decisions being reached. This may mean that more successful strategies are developed in the business, that resources are used in the most efficient way, that costly mistakes are minimised and that profitable opportunities are spotted and capitalised on.

In contrast, decentralisation requires less senior and less experienced managers to assume greater responsibility. If they have less experience, they may display poorer judgement. They may be less experienced when it comes to managing budgets, leading to overspending, or less experienced when it comes to assessing market trends and identifying new opportunities. At best, such managers may require expensive, costly training to ensure they have the skills to cope with the increased responsibility. A centralised approach leaves decision making in the hands of those that are already qualified to formulate effective strategies.

Centralisation also allows for a greater level of consistency across the organisation. Decisions formulated by head office can be disseminated across the entire organisation, ensuring each branch or each region that the business operates in offers consumers the same experience, adheres to the same level of quality and provides the same high standards of customer service. This may develop the brand identity of the business as well as securing satisfied, brand loyal customers. Senior managers can also ensure that all decisions made are compatible with the values, vision and objectives of the organisation. This may not be the case in decentralised organisations, where more distinct differences between different branches of the business may develop. Some branches of the business will inevitably operate more effectively than others, with poorer performing sections of the business potentially damaging the overall brand.

However, decentralisation can be motivational for junior managers and employees lower down the organisation and the concept supports theories of motivation such as Herzberg's Two Factor Theory. Motivated employees may reward the organisation with greater levels of productivity, whereas in more centralised organisations, a greater number of employees may feel dictated to and undervalued and like there are no mechanisms inside the business that allow them to offer ideas and exercise their judgement and creativity. In addition, decentralisation ensures a greater number of people in the organisation are making decisions. This means there are more potential ideas created inside the business, a greater likelihood of intrapreneurship and more potential for innovation and creativity that the business might be able to utilise and profit from. In a centralised business, the innovation and creativity of employees further down the organisation may be less likely to materialise.

It is also possible that decentralisation may give rise to a faster, flexible and more responsive decision making framework. Often, more junior employees are in a better position to make immediate decisions, rather than having to refer decisions back to head office or wait for the approval of senior managers before decisions can be signed off. The customer experience may be better in organisations where more junior staff, who commonly have greater contact with consumers, are afforded the responsibility to make decisions because they are able to act more swiftly, finding more immediate solutions to customers' concerns. It may also be the case that junior managers are in a more knowledgeable position to make decisions in the business because of their more localised knowledge and more regular contact with the customers they serve. Senior figures may be more removed from the end consumer and find they are less in touch with developments in consumer trends.

The verdict

Should businesses adopt a more decentralised structure?

When deciding on the appropriateness of decentralisation, an important factor is how the business is currently performing. A different approach to decision making may be more pertinent to a business experiencing falling sales, profits and market share. A centralised business that is performing well may decide that the risk of increasing the autonomy of junior, less experienced employees is too great.

In addition, it is critical to assess the employees of an organisation when making recommendations about decentralising. Businesses with a roster of skilled and highly qualified employees may benefit from empowering these workers and providing them with greater autonomy. However, a business whose workforce comprises less qualified, lower skilled staff potentially on temporary or part-time contracts, may consider preserving a centralised approach.

Finally, the cost of decentralisation needs to be factored in. Will decentralisation require expensive training programmes to increase the skills of junior managers? Will junior managers expect salary increases? Is this affordable?

10 The Marketing Mix

Edexcel 1.3.1 – 1.3.4 **AQA** 3.3.4 **Cambridge International** 3.3 **Eduqas** Component 1 **OCR** ✓

Knowledge recap

Marketing is the process of identifying what the needs of consumers are and meeting those needs in a way that allows the business to benefit. The process of meeting the needs of customers requires business managers to make many decisions about what they will offer consumers. These decisions are known as the **marketing mix.** Some exam boards categorise these decisions as 'the **4 P's** of marketing', whilst other exam boards use an extended model known as 'the **7 P's**'.

The 4/7 P's of marketing:

- **Product/service** — Decisions about the design, features and image of products
- **Promotion** — How information about the product will be communicated
- **Pricing strategy** — Deciding the price point the business will adopt in the market
- **Place (distribution strategy)** — Determining the locations the product will be available from
- **People** — Developing the systems used by staff delivering the customer experience
- **Process** — Designing the method of ordering and delivering the product
- **Physical environment** — Designing the environment the customer experiences during their purchase

Two common exam questions about the marketing mix require students to either consider which factors might have the greatest influence on the marketing mix the business designs or consider which of the four (or seven) P's might be the most important element of the marketing mix to a business.

Show the analysis

There are a wide range of factors that might influence the marketing mix that managers design. One of the most important is the **market position** the business has identified. Market positioning refers to how the business wants customers to perceive the product. Do they want it to be perceived as high quality and technologically superior? Do they want it to be perceived as luxurious and exclusive? Would they rather it was perceived as budget friendly? Depending on the market position the business is trying to take up, different marketing mix decisions will need to be made. For example, a business wishing to be seen as luxurious will select a very different pricing strategy to a business trying to position itself as a discount retailer.

For many businesses, their marketing mix is influenced by the marketing decisions of **competitors.** This may be particularly true in industries where firms are competing against each other on the prices they charge, where the price takers in the market are constantly reacting to the movements of the price maker. In markets where competition between firms is intense, companies that do not respond to the marketing mix decisions of rivals may quickly find that they are uncompetitive and experience falling sales and market share.

Whereas the marketing decisions of rivals is an **external influence** on the marketing mix of a product, there are **internal influences** as well. For example, the marketing mix of a product can be affected by the stage of the

product life cycle the product is at. When a product is in the formative stages of its lifecycle, a different marketing mix might be used compared to when the product is more mature. For example, some products may be more heavily promoted when they are first launched than they might be during the maturity phase of the life cycle or some products may not be distributed as widely during the early stages of the lifecycle as they are when the product is more mature. Businesses that try to adopt the same marketing mix for a product as it moves through the stages of the product life cycle may not maximise the sales and profits of that product.

The marketing mix of a product will also be influenced by the intended **target market** for the product. For example, a fashion retailer targeting consumers aged 14-25 is likely to create a different marketing mix to a fashion retailer supplying the 50+ age group. Each company is likely to supply different products depending on the tastes of the target market they are catering for, use different promotional strategies to appeal to each age group and may even deploy a different place strategy, as firms targeting younger target markets often invest more in e-commerce and other digital platforms.

The question of which element of the marketing mix is most important can be viewed in two different ways. It could be argued that all elements of the marketing mix are of equal importance – they must all complement each other to create a coherent marketing mix in order to appeal to customers. Accordingly, there is no room for weakness in any aspect of the marketing mix. Each aspect is important in forming the overall offering to the consumer.

Alternatively, it could be argued that in different scenarios, one aspect of the marketing mix is more critical to success than the others. In industries such as home building, luxury cars or electronics, the product might be considered the most important aspect in determining a sale in a market where place and price are less differentiated between competing firms. Contrastingly, in some markets firms are competing against each other selling generic, undifferentiated products, such as stationary, cleaning products or certain foodstuffs such as milk. It could be argued that for such items, place might be the most important aspect of the marketing mix. This might be because customers value convenience when buying such items, so firms need to make sure their products are stocked in locations that are convenient for different market segments.

The verdict

What is the greatest influence on the marketing mix of a business?

It is possible to argue that any of the main influences on the marketing mix are the most important, but the target market is definitely worthy of consideration when writing conclusions. This is because of the wide range of marketing decisions that are dependent on the market being targeted. When designing the product, deciding on the promotional mix and pricing strategy and creating the distribution strategy, careful consideration must be given to ensure that decisions are being taken that match the needs of the target market.

What is the most important element of the marketing mix?

It is vital to acknowledge that all aspects of the marketing mix are important – a firm risks being uncompetitive if one of the elements of the mix does not complement the others as this can confuse consumers. For firms pursuing a low cost producer strategy, this might elevate price to being the most important element, as the firm positions itself as offering superior value to customers. In markets where there is little by way of price competition and where products are more standardised, such as the beverages market, promotion becomes an important aspect of the marketing mix, as it becomes the main way of differentiating your brand from rivals. However, many commentators would suggest that product is the most important aspect of the marketing mix for most firms. This is because it is the design and features of a product that often determine the other aspects of the marketing mix but also because it is commonly the product that influences consumers' purchasing decision.

11 E-Commerce

Edexcel 1.3.4 **AQA** 3.3.4 **Cambridge International** 3.3 **Eduqas** Component 1 **OCR** ✓

Knowledge recap

E-commerce is when transactions between businesses and consumers take place over the internet. E-commerce has grown in significance over the last two decades, with online transactions evolving from being worth millions of pounds, to billions of pounds to the point where e-commerce is now responsible for trillions of pounds worth of business activity each year.

E-commerce has grown as advancements in technology have occurred. People have access to devices now that did not exist 20 years ago, such as smartphones, smart TV's and tablets. These internet enabled devices mean that consumers can shop from any location, at any time of day. This convenience is one of the main contributors to the growth of e-commerce.

However, the convenience of e-commerce has also helped create changes in society and how people live their lives that has further fuelled the growth in online consumerism. Society is more time-poor than in previous decades and many people are less patient. Before the turn of the century, consumers may have patiently allowed weeks to pass whilst they created shopping lists of items that they desired. They would then have devoted time to visiting shopping malls or town centres where they would spend hours browsing different stores and comparing items before making their purchasing decisions. This is now less common. Rather than create lists of items we will purchase next time we go on a shopping excursion, we now use the nearest device to order an item within moments of deciding we want it.

As e-commerce has grown in importance, different forms of online selling have evolved. Many retailers complement their 'bricks & mortar' high street presence with an online platform. This is an example of **Business-to-Consumer (B2C) e-commerce,** as is the growth in online **e-tailers,** who sell exclusively via the internet. Suppliers that don't sell to the end consumer also make use of virtual selling through **Business-to Business (B2B) e-commerce.** The popularity of the internet has also led to the growth of **Consumer-to-Consumer e-commerce,** where individuals trade privately with each other, usually in second hand goods.

A significant area of growth in e-commerce is in the number of transactions that are taking place using smartphone technology. The amount of sales taking place through this platform is so great that this form of e-commerce has its own name: **m-commerce** (mobile commerce).

Show the analysis

E-commerce clearly has great benefits for consumers but it also has advantages for a business too. When analysing the benefits of e-commerce, a useful starting point might be the long term cost savings it can generate for firms that have an existing 'bricks and mortar' presence. Running high street stores is expensive. A costly, prominent location is required, large numbers of sales staff may be necessary and the firm will have to invest in décor that matches the image they are trying to create. E-commerce minimises these costs. When selling on line, the business can be run from a cheaper, less prominent location. Fewer employees on lower wages may be required to manage and dispatch orders from a warehouse than would be needed to staff a chain of retail outlets. Also, less will need to be invested in décor, facilities and displays. These costs savings are important because they may enable a business to become more price competitive, passing the savings they can achieve by closing non-essential stores on to consumers in the form of lower prices.

E-commerce also offers the opportunity for lower start-up costs for new businesses, as an online platform can be cheaper to establish than a physical presence. This reduces the barriers to entry firms face when initially setting up, making it easier for new firms to enter the marketplace.

Another advantage of e-commerce is the 'reach' it allows a business to create. When operating from physical premises, most businesses are restricted in the times that they can open. This might be because of the cost of opening a store 24 hours a day or because there are not enough customers that would be willing to travel to purchase a business's goods at obscure times of day. However, with an e-commerce trading platform a business can sell its products 24 hours a day, 365 days per year. This creates greater sales potential for the business at little or no extra cost. This makes it possible to generate greater revenue and profits. Furthermore, an internet presence increases the size of the market a business can serve. An entrepreneur starting a business venture operating from a retail outlet may only draw customers from the surrounding area. However, a business with an electronic presence may attract customers nationally or even internationally. Again, this generates greater sales and profits.

Despite the attractions of e-commerce, there are limitations. For smaller business ventures, developing an online platform may be beyond the expertise of the entrepreneur starting the business, so they may need to invest in a professionally designed website capable of accepting online orders. In addition, without a retail outlet to operate from, entrepreneurs will need to find an alternative location to store their stock. If it is not practical to store it in the entrepreneur's own home, they may need to rent warehouse space, which increases the costs of running an online business.

There are also issues surrounding the security and consumer perception of online trading. Businesses trading online will need to invest in systems so that customers' payment details are securely protected. There is also the issue of whether an online business that consumers cannot physically visit appears as trustworthy and reliable. Some customers feel it is more secure to purchase from a business with a high street presence, so online businesses may not attract certain market segments.

The verdict

To what extent do all businesses need to embrace e-commerce?

It might be assumed that the growth in online sales means all businesses must invest in e-commerce to remain competitive. In some industries this may be true, but there are scenarios where a business is able to be competitive without trading electronically. Many small businesses are successful without relying on e-commerce. Businesses such as plumbers, butchers, window cleaners, florists, hairdressers, caterers or bakers remain competitive because of factors such as the specialist skills they offer, the convenience they provide, the footfall they have or the high levels of bespoke customer care or localised knowledge they provide.

It is not just small businesses that have demonstrated they can compete without relying on e-commerce. The nature of the goods they sell means that larger businesses selling products like food and beverages or manufacturers of consumer items with a strong need to 'try before you buy' such as cosmetics companies rely on contact with consumers. Even in industries where e-commerce is widely used, such as fashion retailing, there are examples such as Primark, who have continued to grow whilst refraining from selling online. The appropriateness of e-commerce is also questionable for luxury brands and suppliers of high-quality items, such as Rolex or Morgan Motors for example. The in-store service and customer care they provide is an essential part of their branding and e-commerce may detract from the added value such businesses are able to create.

Therefore, whilst the benefits of e-commerce are vast and in some industries competitiveness may hinge on an electronic presence, there are many examples of businesses that remain successful without adopting e-commerce.

12 Labour Turnover

Edexcel 3.5.3 *(A level only, not AS)* **AQA** 3.6.2 **Cambridge International** 2.3.2 **Eduqas** Component 1 **OCR** ✓

Knowledge recap

Labour turnover is a measurement of the percentage of the workforce that leave a business over the course of a year. Staff may leave a business for a variety of reasons. Some may **retire.** Some staff leave their job to **relocate** to another part of the country. In rare instances, staff may have been **dismissed** due to their conduct. Such reasons for leaving a job are less of a reflection on the business because they are associated with the circumstances of the employee concerned.

However, other employees may leave to work for another organisation, either to secure a **promotion** or because they are unhappy in their current job. Perhaps they feel they are underpaid or undervalued or that the business has a poor corporate culture. Other staff may leave if they grow disillusioned with the lack of leadership in the business that they work for. These reasons for staff leaving are of more pressing concern for an organisation because they are more directly under the control of the business.

This is why organisations are keen to monitor their labour turnover rate. The labour turnover formula is:

$$\frac{\textit{Number of employees leaving during a period of time}}{\textit{Average number of employees over a period of time}} \quad x\ 100$$

For example, if during the course of a year, 102 employees were to leave an organisation and over that period the business had, on average, a workforce of 816 employees, the labour turnover rate would be 12.5%

Show the analysis

It is important to recognise that some turnover of staff is beneficial to a business. When staff leave an organisation, it creates the opportunity to recruit new people. If this recruitment is internal, then labour turnover creates opportunities for promotions, which may motivate employees. If this recruitment is external, then labour turnover creates the opportunity to bring new talent into the business, people that may bring fresh skills and greater knowledge, experience and contacts into the organisation that existing employees do not possess.

However, high rates of labour turnover can be damaging. One of the main reasons why labour turnover can be harmful is because of the financial cost. When employees leave an organisation there is the cost of advertising vacancies in the business. There may also be the cost of hiring a temporary worker to fulfil the role until a permanent replacement can be found. In addition to the financial cost, there may be a productivity costs as well, as managers have to devote time to the recruitment process rather than their core work. There is also the issue that new starters may not be as productive when they first join the business as the employee that they are replacing.

High labour turnover rates also mean the business is haemorrhaging quality staff members. This may create skills shortages in the business and can affect the quality of decision making and customer service. This can be particularly harmful if the business has invested finances in training and qualifications for employees that go on to leave the business. This might be amplified if employees take their skills to rival organisations.

Furthermore, high labour turnover can make recruitment more challenging. If a firm becomes known as a business that employees spend a short period of time at it will make the firm less appealing to new applicants, who may justifiably have concerns about whether the business is a good employer if so many of their existing staff members are leaving the business. This might mean the field of applicants a business attracts for vacancies is of lesser quality, leading to the business making job appointments of lower calibre. There is also the issue of how high labour turnover rates impacts on longer-serving members of staff, who's own motivation and productivity may suffer if they are frequently losing skilled and valued colleagues.

Consequently, managers may try to implement strategies to reduce the labour turnover rate of the business. How they go about achieving this is rooted in motivational theory. If managers perceive high labour turnover is caused because of dissatisfaction over pay, they may try to amend the monetary rewards on offer to staff. This could be as simple as increasing the basic wage or salary of employees or could involve more intricate measures, such as bonuses for achieving a certain number of years' service in the organisation. It is important to remember that, although this may reduce labour turnover, it may also increase costs.

However, if managers perceive high labour turnover to be the result of non-financial factors, they may try to change the nature of people's jobs, perhaps introducing measures such as job rotation or job enlargement. If they feel employees are frustrated by a lack of career progression, then they may invest in better training or restructure the organisation to create clearer promotional pathways. Or, if employees are leaving due to a lack of challenging work, managers may use techniques such as job enrichment or greater empowerment. Such methods may not incur the same financial costs as changing the pay and rewards of staff but they may alter the organisational structure and the culture of the business, which may create its own challenges.

The verdict

How harmful is high labour turnover?

Perhaps the main factor to consider when assessing how harmful high labour turnover is could be the human resource strategy the business is pursuing. For firms investing in a 'soft' or 'staff as an asset' HR strategy, high labour turnover is incredibly damaging. This is because the business has declared its staff to be its greatest asset. It will have invested in training its employees, in nurturing their talents and try to foster an environment where people feel valued and trusted and capable of achieving promotions. If employees are responding to this by leaving the organisation, then not only is it extremely costly to the business but it implies that the HR strategy they are pursuing is not working.

However, if the business is pursuing a 'hard' or 'staff as a cost' approach, then it may view high labour turnover as justifiable. It may be considered natural for staff to leave the organisation in higher volumes if they are on lower rates of pay, receive less training and may be on temporary or part-time contracts.

How should a business reduce labour turnover?

Firstly, it should be noted that a business pursuing a 'hard' HR strategy may not wish to reduce labour turnover, as methods to do so would conflict with the low-cost strategy it is pursuing. If managers do wish to reduce labour turnover, then the method they should use requires the careful diagnosis of why staff are leaving – which links to managers' interpretation of what motivates staff. In industries or businesses where managers believe employees are motivated by financial reward, reducing labour turnover would require a review of how employees are financially remunerated.

However, if managers interpret that non-financial factors such as the higher levels of Maslow's hierarchy of needs or Herzberg's 'motivators' are the key determinant of motivation, then greater attention to factors such as job design may be the best solution to high labour turnover.

13

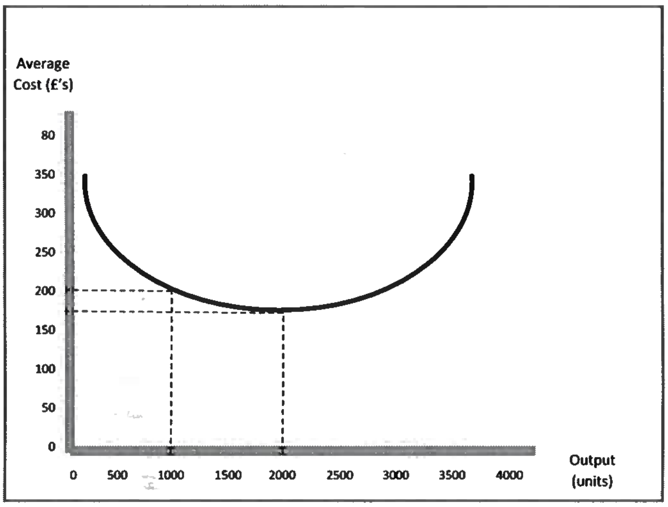
Efficiency

Edexcel 2.4.1 **AQA** 3.4.3 **Cambridge International** 4.1.2 **Eduqas** Component 1 **OCR**✓

Knowledge recap

An important measure of business activity is the **average cost.** This measures how much, on average, it costs to produce one unit of output for the business. For example, it might cost a car manufacturer £3000 on average to produce a vehicle or a sportswear company £8 on average to produce a pair of trainers.

The average cost is an important concept because it indicates the **efficiency** of the business. For example, imagine two rival electronics manufacturers produce TV's of comparable quality and selling price. If Company A can produce a TV set for an average cost of £200 but Company B can produce their TV sets for £175, then Company B is the more efficient business. It is likely that Company A's managers will want to implement strategies to try and improve the efficiency of their operations.



The average cost of producing a unit of output falls as a business increases the number (or volume) of products produced. This is because, although producing more items increases the total amount of variable costs incurred by the business, such as raw materials, the fixed costs of production remain unchanged. This means these fixed costs can now be divided between a greater level of output.

For example, imagine a business manufactures 1000 units a month, with the variable cost of producing each unit being £150. This would mean the total variable cost of producing 1000 units would be £150,000. The business also has fixed costs of £50,000 per month. This means the total monthly costs of the business would come to £200,000. If producing 1000 products costs £200,000, then the average cost of producing each unit is £200. However, if the business increases the volume of items produced to 2000 units, the average costs falls. By increasing output to 2000 units, total variable costs would increase to £300,000, but the fixed costs would remain at £50,000 a month. This would mean the total cost of producing 2000 units is £350,000. That's an average cost per unit of just £175. This illustrates that one way of reducing average costs is to increase output. However, this is only beneficial when a business has the demand to justify increasing the output produced and the excess capacity to produce more.

Show the analysis

What are the advantages of increased efficiency?

Reducing average costs presents managers with several options. The first is to maintain the current selling price as the average cost of producing a unit of output falls. This means the business achieves a greater profit margin on each sale, whilst demand is unaffected. This should increase the profits of the business, meaning shareholders can be rewarded with greater returns, or more profit can be retained in the business to fund further growth.

Alternatively, managers might view the fall in unit cost as an opportunity to reduce the selling price charged to customers. Although this would mean the business achieves the same amount of profit per sale, the business would become more price competitive compared to rivals, which leads to increased demand. This may increase the revenue of the business and, ultimately, the profits achieved. Managers are likely to consider the price elasticity of the product in question before deciding which of these options is most attractive.

However, there is a third option. Managers might decide to maintain the existing price level, but rather than use this to achieve a greater margin on each sale, they might elect to spend the cost savings they have achieved on another element of production. For example, if managers improve the efficiency of the business and the average cost of production falls, this might mean managers can improve the quality of components or raw materials used in the production process without having to raise the price of the product. This improves the value customers feel they are receiving from the business, which again should cause demand for the business's products to increase. This time, however, there may be the added benefit of improving the reliability and durability of the product, strengthening its brand name.

As mentioned above, one method of improving efficiency is increasing the level of output produced. Not only does the average cost fall because fixed costs can be split over more units of output, but this also creates the potential for greater purchasing economies of scale to be achieved.

An alternative method of driving greater efficiency is improving or updating the skills of employees through delivering training programmes. Training may mean workers can perform their jobs quicker or might mean they make less mistakes, creating fewer defects. Training will obviously create a financial cost to the business, so managers may calculate whether the financial benefits of increasing efficiency outweigh the financial costs of delivering training. However, training may also create additional benefits, such as improving the motivation of employees, who now feel more valued by the organisation. This may improve productivity, further increasing efficiency, as well as lowering labour turnover.

For more capital intensive firms reliant on automated assembly lines, investing in the latest production machinery and equipment may improve efficiency. The cost of purchasing, installing and maintaining the latest machinery may be high, but if managers believe the efficiency gains justify the costs incurred, it might prove a shrewd investment, as the latest technology may have the added benefit of improving quality and reducing defects.

In addition, efficiency could also be increased by finding ways of improving the management of employees to improve their effectiveness. Inefficiency may be caused because employees are not adequately supervised, potentially causing low productivity or soldiering, when workers are not working to their potential.

The verdict

How should managers increase efficiency?

One way to evaluate the best method of improving efficiency is determining whether the business is labour intensive or capital intensive. Labour intensive firms rely on a large workforce of employees to produce their good or service. Consequently, if labour is the main input into the production process, it may be pertinent to try and improve efficiency by concentrating on improving the quality of labour through training programmes. Conversely, capital intensive firms may be better served focussing on improving the quality of the machinery and equipment used in their production process in order to stimulate greater efficiency.

Another key factor when determining the most suitable method of improving efficiency is to try and judge what the business you are writing about can afford. Trying to create greater automation in the production process by investing in greater technology and machinery may seem appealing, but can the business afford the cost involved? Would shareholders accept the short term reduction in dividends for the promise of greater returns once efficiency has been increased?

It is also wise to be cautious when recommending increasing output as a means of improving efficiency. Although producing more units will reduce the average cost, managers need to be confident that there is sufficient demand to justify increasing production, otherwise they will be left with unsold stock.

14 Leadership

Edexcel 1.4.5 **AQA** 3.2.1 **Cambridge International** 2.1.3 **Eduqas** Component 1 **OCR** ✓

Knowledge recap

Successful businesses rely on good managers and leaders. These are two different roles - a manager is different to a leader. A manager is an employee in an organisation that is given the responsibility of overseeing a particular part of the business. A manager might be given responsibility for overseeing marketing activities, or the business's finances or put in charge of the development of a new product.

Whilst a manager oversees activities, implements company procedures, delegates tasks and organises people, a leader in an organisation is someone that inspires others, someone who has a vision of what needs to be achieved and develops strategies of how to achieve it. A leader sets goals whereas a manager monitors whether goals are being achieved. A leader creates rules and policies whereas a manager enforces them. A leader decides what roles are necessary in a business whereas a manager is responsible for recruiting people to those roles. Management is a position in the business's hierarchy whereas as leadership is a skill. Both roles are important.

Many managers are also leaders. However, leaders don't always have a management role in a business. Sometimes, the most junior employee might have a vision for what the business needs to achieve and be able to inspire and motivate others in the organisation to achieve that goal.

People might approach leadership in different ways. One of the differences between people's approach to leadership is how they make decisions. An **autocratic leader** is someone that makes decisions independently, instructing others of the decision they have reached rather than including them in the decision making process. Autocrats demand obedience and don't like to delegate power. A variation of this approach is **paternalistic leadership,** where the leader is authoritative and makes decisions without consultation, but factors in the interests and needs of their employees, as a parent might when raising a child. In addition, they may take the time to explain to them why they have reached a particular decision.

By contrast, a **democratic leader** is one that includes others in the decision making process. They will consult with other members of the organisation and ask their opinions before reaching a decision. An extension of this approach is **laissez-faire leadership.** This is when leaders relinquish the role of decision maker and instead encourage people in the organisation to make decisions for themselves. This empowers employees to make decisions and exercise judgement rather than looking to the leader to make decisions for them.

Show the analysis

Each leadership style has its own merits. The strength of autocratic leadership is the speed and clarity with which decisions can be reached. Without the need to meet with and consult other employees in the organisation, the autocratic leader can be responsive and dynamic and make decisions without agonising over the conflicting needs of others. They can assess a situation and quickly pass a decision that they believe is the best one for the organisation. This approach may be invaluable in pressurised environments, such as areas of the medical profession or the armed forces, where one, authoritarian voice is preferable. It may also be effective in certain business scenarios, such as during a downturn in the economy, a liquidity crisis or responding to the actions of competitors. However, this style is criticised for being demoralising for those working with the autocratic leader and it can lead to poor morale and high labour turnover. There is also the risk that employees become dependent on the leader to make decisions and can't function effectively in their absence.

Some of the discontent associated with autocratic leadership may be overcome by paternalistic leadership, where leaders factor in the welfare of their subordinates when making decisions. This means decisions can still be made swiftly, but employees might recognise that their views have been accounted for and be more accepting of the decision made. This may result in higher levels of motivation and reduce concerns about labour turnover.

Democratic leadership is often considered more motivational, as employees' opinions are consulted before decisions are made, which might make people feel more involved in the business and invested in the decisions that are made. It is possible that democratic leadership may also lead to better decisions being reached, as subordinates might raise an issue or suggest an idea that the leader had not considered. However, democratic leadership relies on the leader possessing good communication skills and there is also the danger that subordinates may resent being consulted if the manager goes on to reach a decision that they do not agree with.

Laissez-faire leadership might be considered the most risky approach to decision making. It relies on the leader creating an environment where their subordinates have the resources and support to make decisions for themselves and can be ineffective if subordinates don't possess the skills and experience to make effective decisions. There is also the risk that employees may see the lack of supervision they receive as an opportunity to be less productive. However, laissez-faire leadership may be incredibly effective in industries where the business has highly qualified and skilled employees, who might relish the autonomy and empowerment of a laissez-faire environment. Such industries might include, the law, journalism, stockbroking or architecture, when employees consider themselves highly capable.

The levels of productivity, creativity and intrapreneurship achieved when a laissez-faire leadership style is implemented effectively might be difficult for other leadership styles to replicate. However, this style is also likely to result in the greatest problems for an organisation when it is implemented poorly.

The verdict

Which leadership style is most effective?

The most important factor when deciding which leadership style is most effective is the circumstances that the business finds itself in. When a business is facing a crisis, there are likely to be significant benefits to having autocratic or paternalistic leaders. The speed and decisive nature of these styles make them favourable during scenarios such as a PR crisis, the threat of business closure or a sudden change in the external environment.

However, businesses facing different circumstances may benefit from a different approach. If a business is experiencing industrial relations difficulties, poor motivation, declining productivity and rising labour turnover, it may be that a more authoritarian leadership style might exacerbate the situation. In such circumstances, the consultative nature of a democratic style might solve some of the issues the business is facing.

For a business that is reliant on attracting and retaining highly trained and qualified employees, it is possible that a laissez-faire approach might offer employees the freedom and autonomy they crave and the business might reap the productive and financial benefits of this.

When evaluating the appropriateness of different leadership styles, it is important to look for clues in the case study that suggest whether the styles used currently are effective. If data in the case study indicates the business is operating effectively, it may mean the leadership styles in use are suitable. If, however, the business is performing poorly, this provides evidence to support a change to the leadership style in the organisation.

Another factor to consider when appraising leadership styles is the organisation's approach to HR. Businesses pursuing a hard (staff as a cost) strategy may favour autocratic or paternalistic leadership, whilst firms embracing soft/staff as an asset HR may benefit from democratic or laissez-faire leaders.

15 Liquidity

Edexcel 2.3.2 **AQA** 3.5.4 **Cambridge International** 5.5.3 **Eduqas** Component 1 **OCR** ✓

Knowledge recap

A business's liquidity is its ability to honour its short-term financial commitments. To honour these commitments, businesses need **cash.** Without cash, managers may find themselves in a position where they cannot pay suppliers for stock, pay wages and salaries to employees, pay taxes to the government or repay loans to banks or other investors. A business that cannot repay its debts is described as being **insolvent.**

Because managers are keen to ensure that a business remains solvent, they measure the liquidity of their business using ratios such as the **current ratio** or the **acid test ratio*** and try to forecast periods when the business may experience liquidity problems using tools such as **cash flow forecasts.**

	Jun	**Jul**	**Aug**	**Sep**	**Oct**
Cash inflows	3000	3000	3500	4500	5500
Cash outflows	8000	6000	2000	2000	2000
Net cash flow	**(5000)**	**(3000)**	**1500**	**2500**	**3500**
Opening balance	4000	(1000)	(4000)	(2500)	0
Closing balance	**(1000)**	**(4000)**	**(2500)**	**0**	**3500**

However, when managers foresee periods of cash shortages they need solutions to these issues. There are many possible ways of solving a liquidity crisis, depending on whether managers wish to try and increase the cash entering the business, reduce the amount of cash leaving the business or access a source of external finance to cover periods of cash shortages.

**Note that the acid test ratio is not referenced on the AQA A level Business syllabus*

Show the analysis

If a cash flow forecast is produced far enough in advance of liquidity issues arising, the managers of the business may be able to avert the crisis from occurring by increasing the amount of cash entering the business. By increasing the inflows of cash into the business, it increases monthly net cash flow, resulting in an improved closing balance each month. One way of attempting to improve the amount of cash entering a business is to increase the level of advertising or other forms of promotion the business invests in. Effective advertising and promotions should increase awareness of the business and drive greater sales, allowing the business to release greater revenue each month. As long as these sales are not on trade credit, where customers are given long periods before they have to pay, then this will increase the amount of cash entering the business.

However, this strategy contains a degree of risk. This is because increasing expenditure on advertising and promotions also increases the costs of the business, meaning more cash will also be exiting the organisation each month. Managers need to be confident that increasing marketing expenditure will increase cash sales by a greater amount than it will increase outgoings, otherwise this strategy could worsen the business's liquidity issues.

Alternatively, managers could try and generate greater revenue by adjusting the pricing strategy they were intending to use. Increasing prices would mean more cash is generated per sale, whilst reducing prices may stimulate greater demand, meaning that although less revenue is made per sale, more revenue is generated overall. However, this strategy is also risky. If managers are not accurate in their assessment of the price elasticity of the goods and services they sell, they could make price changes that damage revenue and may also impact on the brand name of the products in their portfolio.

Rather than trying to increase the sales made by the business, businesses that offer trade credit to customers could try to bring cash into the business sooner by reducing trade credit periods, perhaps from 90 days to 30 days. By bringing cash into the business sooner, it may alleviate cash shortages during critical months. However, if trade credit is a key element of the business's sales strategy, there is the risk that customers may find an alternative business to purchase from where trade credit periods are more generous.

Managers may prefer to address potential liquidity problems by reducing cash leaving the business rather than increasing cash that is predicted to enter the business. Students often suggest in exams that this could be achieved by 'sacking workers' – something managers are unlikely to want to do, even if it were legal. A more measured response could be to suggest that managers could try to trim marketing costs, such as the amount spent on advertising and promotions. This might lower one of the business's major expenditures, however it might have a damaging impact on the cash entering the business if advertising or promotions such as sponsorship are a key catalyst for sales.

Instead, managers may prefer to reduce the cash leaving the business through reducing the amount spent on stock and raw materials. This could be achieved by sourcing stock from alternative suppliers at lower prices, reducing the cash exiting the business each month. However, the danger is that cheaper raw materials means the business cannot achieve the same level of quality of production, damaging sales and brand identity. As an alternative, managers may instead try to negotiate longer trade credit periods with their current suppliers. This might mean less cash is leaving the business during months that the business is sensitive to cash shortages.

Due to the potential risks involved in trying to improve liquidity by increasing cash inflows or reducing cash outflows, managers may prefer to source a form of external finance to soothe cash shortages. Overdrafts are an effective cure to short term liquidity issues, allowing the business to fund its financial commitments when it does not have sufficient cash by accessing its overdraft facility. If cash shortages are the result of large, one off expenditure on items such as equipment or machinery, managers might even consider financing these purchases externally rather than use cash reserves.

The verdict

How should managers solve a liquidity crisis?

The first consideration for managers and owners is how confident are they in the accuracy of their cash flow forecasts. Remember, they are a prediction of what people *think* will happen. Less experienced entrepreneurs may be cautious about making decisions such as changing their pricing strategy based on a cash flow forecast that could be inaccurate. If they are confident that a cash shortage is imminent, the best solution will depend on the circumstances of the business. If the shortage is only forecast for a short period of time, then overdrafts are a less risky solution. However, the business may not be eligible for an overdraft large enough to cover the cash shortage or if they have experienced liquidity problems in the past they may be refused an overdraft.

If an overdraft is not a viable option, then firms with a reputation for quality may refrain from reducing expenditure and prefer to try to increase cash inflows. Businesses selling less differentiated products may prefer to reduce cash outflows than take the gamble of trying to spend money in the hope of increasing cash inflows. It should also be remembered that restructuring trade credit periods with a business's own customers and their suppliers may also alter cash inflows and outflows sufficiently to avert a liquidity crisis, but this may not be a suitable suggestion for businesses that don't offer trade credit to their customers or rely on large amounts of stock to produce their product.