1.4 - Making the Business Effective

Topic overview

In this topic students need to continue to relate the concepts to the contexts in which an enterprise and an entrepreneur will be operating. They must be aware of the local and national business environment and how this might impact on a small business. Students must be aware of this topic's relationship with the other topics in this theme and how this might affect business decision-making.

Section	Key things to learn
The options for start-up and small businesses	Limited and unlimited liability Business ownership: sole trader, partnership and private limited company Franchise operations
Business location	Factors effecting business location
The marketing mix	Definition of marketing mix Balancing the marketing mix Impact of change on the marketing mix
Business plans	Content of a business plan Purpose of a business plan

Business organisation

Before the different forms of legal structures of a sole trader, partnership and a private limited company are considered, the very important issues of "unlimited liability" and "limited liability" will be discussed.

Unlimited liability

There is a big risk when operating as a sole trader or a partnership. It occurs because, in the eyes of the law, **there is no difference between the person running the business and the business itself.** When it comes to money owed by a business, the sole trader or partners have to use their own personal funds to pay these debts, if there is not enough money in the business to do so. The sole trader or the partners are, therefore, **liable** for any **debts** that the business incurs. This is called **unlimited liability.**

As the sole trader or partners are personally responsible for any debts run up by the business, this means their homes or other assets owned by the entrepreneur(s) may be at risk if the business runs into trouble. This does happen and each year thousands of people become personally bankrupt, many of them through failed businesses. Some businesses have however, a lower risk of failure, where the owner avoids running up debts through buying and selling in cash, meaning there is no need to borrow large amounts of money.

Limited liability

Shareholders may be individuals or other companies. **They are not responsible for the company's debts**. Shareholders may only lose the money they have invested in the company if a business goes bankrupt, to help pay off any outstanding debts or liabilities. This means that the liability of shareholders is limited to the value of their investment into the company's shares. This concept is called **limited liability.**

It costs very little to set up a business as a private limited company and it can be set up very quickly. A summary of the benefits to the business of limited liability are:

- ☑ **Investors encouraged** – the owner who normally owns shares, and all other investors who purchase shares, are protected in the way that they can only lose the money they have put into the business, not their personal possessions and property. This should encourage more people to invest in the business, as there is less risk.
- ☑ **Legal separation** – a company has a separate legal identity to the business owners, unlike a sole trader or a partnership where the business is seen as the same as the owners in the eyes of the law. With limited liability any action against the business is taken against the company, not the owners

Remember: LIMITED LIABILITY is only a benefit to private (and public) limited companies. Sole traders and partnerships do not benefit from this. They have UNLIMITED LIABILITY. This is a common area of confusion, which needs revising carefully.

Forms of Business ownership

The vast majority of start-ups and small businesses in the UK choose to operate either as a sole trader or set up as a private limited company. A very small proportion of new businesses set up as a partnership and a small proportion of small businesses grow to become public limited companies.

Sole traders

Most businesses in the UK are small businesses, owned and operated by one person. In most cases, these businesses operate as a **sole trader**.

Look at Yell.com or Yellow Pages (a local free business listing posted through your letterbox). You will see lots of examples of people operating as a sole trader in your area. Many traders in the service sector e.g. hairdressers, gardeners, plumbers and electricians, use the sole trader option, as do people who run part-time or seasonal businesses.

A **sole trader** is a popular form of business organisation, as it is simple and cheap to set up and operate. Most importantly the sole trader gets to keep all the profits! The sole trader, also takes all the risk and has **unlimited liability**, as already discussed.

Do not forget that a sole trader can and do employ other people to work in their business!

Partnerships

A partnership is formed where a business is **started and owned by more than one person.** Common examples of partnerships are doctors, solicitors or vets.

A legal document called a **Partnership Agreement** is always recommended and sets out how the partnership is run, which covers areas such as:

- How profits are to be shared
- How much each partner has to invest into the business
- How decisions are to be taken
- What happens if a partner wants to leave the partnership or dies

The partners own the business and have **unlimited liability**.

Private limited company (Ltd)

A company is formed when a business is set up to have a **separate legal identity** from its owners. In the vast majority of cases, the type of company created is a **private limited company (ltd).** These are very common and can include small and very large businesses. There are many well-known examples of ltd companies, such as Iceland, Virgin, John Lewis and Clarks shoes.

If a business becomes a private limited company, it can raise funds from investors, such as friends and family, but not from the general public, as its shares are not listed on the stock exchange. Every private limited company must have at least one shareholder. Any money raised from new shares is permanently invested in the business.

In this type of business, the company's finances are separate from the owner's personal finances. The owners are known as **shareholders**, who each own shares in the company. They receive a share of the profits, known as a **dividend**, as a reward for being a shareholder. These are paid in proportion to the number of shares that they own. If the company goes bankrupt, shareholders are protected by **limited liability**.

The business will be run by a Board of Directors, appointed by the shareholders. The shareholders may also act as the directors. The Board of Directors runs the company on a day-to-day basis and makes all the important decisions.

Comparing limited companies with sole traders and partnerships

The main differences between the different types of business ownership can be summarised as follows:

	Advantages	**Disadvantages**
Sole trader	☑ Quick and easy to set up – the business can always be transferred to a limited company once launched ☑ Simple to run – owner has complete control over decision-making ☑ Decision-making is quick, important in changing, fast moving markets with lots of competition ☑ Owner gets to keep all the profits ☑ Minimal paperwork	☒ Full personal liability i.e. "unlimited liability" ☒ Harder to raise finance – sole traders often have limited funds of their own and few assets against which to raise loans ☒ The business is the owner – the business suffers if the owner becomes ill, loses interest etc ☒ Limited life as the business is the owner – lack of continuity ☒ Stressful – long hours, no division of labour, no support with decision-making
Partnership	☑ Quite simple for two or more people to form a business together ☑ Minimal paperwork once Partnership Agreement set up ☑ Partners can provide specialist knowledge and skills ☑ Jobs can be shared, so less	☒ Unlimited liability ☒ Partners have to live with decisions of others; a poor decision by one partner damages the interests of the other partners ☒ Decision-making can take longer, as disagreements can occur ☒ Harder to raise finance than a

	Advantages	Disadvantages
	stressful than operating as a sole trader ☑ Greater potential to raise finance compared to a sole trader, as each partner provides investment ☑ Any losses will be shared	company ☒ Short life, as if one partner leaves or dies the partnership ends ☒ Profits have to be shared
Private Limited company	☑ Limited liability - protects the personal wealth of the shareholders ☑ Easier to raise finance as can sell shares ☑ Stable form of structure – the company continues to exist even when shareholders change ☑ Original owners are likely to retain control	☒ Shareholders have to agree about how profits are distributed ☒ Greater administrative costs than setting up as a sole trader or partnership ☒ Finance limited to "friends and family" ☒ Less privacy - public disclosure of company information, but not as extreme as for a plc ☒ Directors' legal duties are stricter

Choosing the most suitable legal structure for a business

There will be several factors that will influence the type of structure chosen by a business:

- **Size of business** – start-up businesses often start as sole traders, as they are easier and quicker to set up compared to a Ltd. There is less paperwork involved.
- **Type of business** – some business structures relate to the type of good or service provided. If specialist expertise is involved such as doctors, vets or lawyers they are more likely to be partnerships than sole traders. If significant risk is involved, the business is more likely to become a private limited company.
- **Lender requirements** – if a bank loan is needed to start a business, the bank may prefer a small business to be set up a sole trader or partnership, to make sure they can be paid back by the individuals if the business fails.
- **Investment protection** – a private limited company may be chosen, so the investors in a new business or an expanding business can be protected by limited liability.
- **Control** – the owner, as a sole trader or a shareholder, holding the majority of shares in a company, has total control of the business. This is shared in a partnership and at risk in a company with a minority shareholding.

Franchising

A business idea for a start-up does not have to be original. Many new businesses are formed with the intention of offering **an existing business idea.** The use of **franchises** is a great example of that.

The basic idea for a franchise is this. A franchisor grants a licence, the franchise, to another business, the franchisee, to allow it to trade using the brand or business format. There will be restrictions on the franchisee regarding its goods or services and its sources of materials, but it is a low risk and relatively low cost of option that does allow a franchisee to have some independence and freedom.

Remember that the **franchisor** is in charge - the franchisor is the original owner of the business idea.

Franchises are a significant and increasing part of business life in the UK. Based on the BFA/NatWest franchise survey (2015) here are some quick statistics that illustrate this fact:

- Percentage of units profitable (including new businesses): 97%
- Franchises generated annual sales of £15.1 billion in the UK in 2015, selling through 44,200 franchised outlets, employing 621,000 people
- There are over 901 different franchisor brands in the UK, with new franchise ideas becoming available every year
- Average turnover or revenue continues to rise; in 2015 over half had an annual turnover of more than £250,000
- Start-up costs may not be too expensive and can be as little as £10,000 and are typically about £50,000
- In 2015, over 97% of franchises, including new businesses, were profitable
- Franchises are particularly popular in the service (tertiary) sector. Franchises offering property services, for example estate agency, cleaning, gardening, food etc are the most popular

Examples of well-known businesses that use franchising to expand their operations include:

- Subway
- McDonalds
- Starbucks
- Pizza Hut
- Thorntons
- KFC
- Europcar

You might have noticed from the list above that nearly all those businesses provide **services** rather than produce **goods.** Franchising is particularly suitable for service businesses.

Advantages of running a franchise

For a start-up entrepreneur, there are several advantages to investing in a franchise:

- ☑ It is still the franchisee's own business – even if they are paying royalties to the franchisor!
- ☑ The investment should be in a tried and tested format and brand
- ☑ The franchisee gets advice, support and training. The franchisor will also supply key equipment, such as IT systems, which are designed to support the operation of the business
- ☑ It is easier to raise finance - the high street banks have significant experience of providing finance to franchises
- ☑ No industry expertise is required in most cases
- ☑ The franchisee benefits from the buying power of the franchisor
- ☑ It is easier to build a customer base – the franchise brand name will already be established and many potential customers should already be aware of it
- ☑ The franchisee is usually given an exclusive geographical area in which to operate the franchise – which limits the competition, since operators of the same franchise are not in direct competition with each other

Overall, investing in a franchise is a **lower risk method** of starting a business and there is a lower chance of **business failure.**

Disadvantages of running a franchise

There are several disadvantages for the franchisee:

- ☒ Franchises are not cheap! The franchisee has to pay substantial initial fees and ongoing royalties and commission. He/she may also have to buy goods directly from the franchisor at a mark-up
- ☒ There are restrictions on marketing activities, for example not being allowed to undercut nearby franchises, and on selling the business
- ☒ There is always a risk that the franchisor will go out of business
- ☒ The franchise needs to earn enough profit to satisfy both the franchisee and franchisor - there may not be enough to go round!

There are many good franchise opportunities available for a start-up, but some poor ones too. There is therefore, still a need for the entrepreneur to conduct market research into the franchise before deciding to invest in one.

A franchise is a kind of "halfway house" for a keen entrepreneur. It is a lower risk method of entering a market and it is often easier to raise finance. However, running a franchise does not offer the same kind of long-term financial rewards that owning a business outright can.

Business location

Where to locate is an important decision for all organisations. This is especially true however, for a new business. Should it be based at home or located in a nearby office, shop or industrial unit? How will new technology impact on this decision?

Location is also important for existing or growing businesses. Should they stay where they are? Do they need bigger premises? Would it be an advantage to relocate to somewhere else, either in this country or to a different country? Can the business use modern technology to create a “virtual business,” so that its employees are all working from home?

Not every kind of start-up business can be based at home. For a new coffee shop, for example, a strong location is vital to ensure enough customers visit the store.

One of the most important considerations about location for any business will be **cost**. A start-up business is likely to have limited financial resources and therefore will want to minimise its set-up costs, whereas an existing business is likely to have competitors and will want to keep costs low, in order for it to have the opportunity to compete more effectively on price. Having premises will mean that a business will have to pay rent, rates, insurance and many other **ongoing costs,** as well as the **rental deposit or purchase costs**.

Other factors determining location

Whatever the business, there are several general factors, in addition to cost, that influence the choice of location. These are:

Raw materials	The business may depend on supplies of a particular raw material, so costs will be lower if the business is located near the supplier, for example where the raw material is grown or where a distributor is based. This factor tends to be more important for **primary** and **manufacturing** businesses, rather than businesses in the **tertiary** (service) sector.

Labour	When a start-up business needs to hire employees, then access to a reliable supply of skilled staff will be important. Businesses that are labour-intensive often look to locate in areas of traditionally low wages or higher unemployment, although this will depend on the skill level that the business needs and the availability of this type of worker. This factor is important for all businesses, but may be less significant if the business uses a lot of machinery.
Market - customers and population	Businesses may need to be located near particular centres of population. For example, if the product is targeted at a particular type of customer, for example older-aged people, then it is important to be located where they live. This is particularly important for businesses in the tertiary sector, as they provide a service.
Government assistance	This may be available to set up in a particular location. These “assisted areas” are considered to be the poorer parts of the country and may have less wealthy customers. They may however, have cheaper labour available. Assistance may come in the form of grants, loans, reduced tax burdens or use of government owned buildings.
Communications	This includes transport facilities (road, rail, air), as well as information and infrastructure. Transport links are particularly important if the business delivers products, uses a sales force or depends on imports and exports to function. The continued popularity of e-commerce makes transport links increasingly important, to ensure products can be delivered to customers in a timely manner. Information technology is less of an issue these days, as even new businesses can normally have fast and reliable broadband internet connections.
Competition	All businesses need to be aware of where their competitors are based when deciding on their own business location. This is particularly important if the business is providing a service. If a new business sees a “gap in the market” where there is no competitor, this might be a good reason to locate there. However, this might mean that this is not a profitable location for any business. In some cases it may be of benefit to be near a competitor, as customers may come to the competitor, but see another business that is nearby. This can be seen with the popularity of retailers located in retail parks or clothing stores being clustered together in shopping centres.

There is no magic formula which can be applied in deciding the most important factors in choosing a location. Sometimes the convenience of the location for the entrepreneur will be more important than even cost considerations.

The **type of business** (primary, secondary or tertiary) will also be important as primary industries will need to be located where their raw materials are and many tertiary businesses will need to be near their customers for the service to be provided. Manufacturing businesses will be influenced by many different factors such as availability of materials and labour, as well as distribution to their customers.

The **short term and long term objectives** of the business can also be significant, for example, will a business have enough room to expand if it needs to increase output in the future?

Marketing mix

Introduction to the marketing mix

The marketing mix consists of four elements and represents the way in which a business uses the following four factors to reach customers:

- ☑ **Product** - the good or service that the customer obtains
- ☑ **Price** - how much the customer pays for the product
- ☑ **Place (distribution)** – how the product is distributed to the customer
- ☑ **Promotion** - how the customer is found and persuaded to buy the product

It is known as a "mix" because each ingredient affects the others and the mix must overall be suitable to the target customer.

For example:

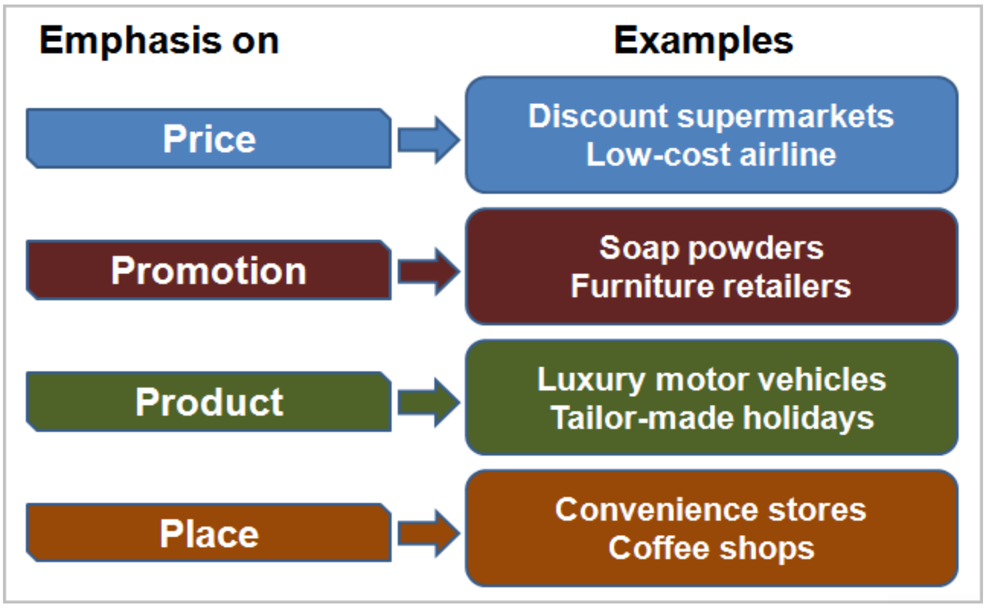
- High quality materials used in a **product** can mean that a higher **price** is obtainable
- An advertising campaign carried out in one area of the country, **promotion**, requires **distribution** of the product to be in place in advance of the campaign to ensure there are no disappointed customers
- **Promotion** is needed to emphasise the new features of a **product**

An effective marketing mix is one which:

- Meets customer needs
- Achieves the marketing objectives
- Is balanced and consistent
- Allows the business to gain an advantage over competitors

The marketing mix for each business and industry will vary; it will also vary over time.

For most businesses, one or two elements of the mix will be seen as relatively more important than the others, as illustrated below:



Changes to the marketing mix

A good example of how changes take place over time is the use of e-commerce. Whereas the retail outlets for electrical goods used to be very important, nowadays price and how quick and conveniently delivery can be arranged is much more critical in getting a sale. Digitial communication has also changed many aspects of promotion, with the extensive use of websites and social media now playing a critical part of even a small business's marketing plans.

The popularity of online and price comparison sites have also made pricing more visible. Consumers are now able to compare very quickly different prices, reviews about the good or service, and then make an informed choice about which product to purchase within a matter of minutes. This means that businesses have to constantly be aware of the information being displayed on their wesbite, as to whether it is up to date and effective.

Customers' needs and wants will always be changing. This can be seen in the "keep fit" market, where new products are constantly being developed, launched and promoted. The Fitbit for example, is priced relatively high and has expensive promotion to support the product and the price. This often makes it difficult for small businesses to compete, which is why they will need to look carefully for a gap in the market or operate in a market niche where there are less competitors.

Business plans

In order to be successful businesses will need to plan. In most cases, this will be through the creation of a **business plan**. A well-used and famous saying is "failing to plan is planning to fail".

What is a business plan?

A business plan is a written document that describes a business, its objectives, its strategies, the market it is in and its financial forecasts. The business plan has many functions, from securing external funding, to measuring success within the business.

Although a start-up business will need a business plan, the existence of such a document will also be important for an existing business. In this case the plan might be for a longer period and will need to be reviewed on a regular basis.

Information that should be included in a business plan

A simple **business plan** is suitable for a start-up business and is written by the entrepreneur. It summarises the key aims and targets of the business and the actions required to achieve them. The plan will include areas such as:

- The idea - a simple description of the proposed business with its location
- Where the idea came from and why it is a good one
- Objectives and key aims for the business - sales, profit, growth (gives a sense of direction for the business) ideally for the next 3-4 years
- Finance required and sources of finance - how much from the owners, how much to be loaned over how long and from whom
- Market overview – results of market research, main segments, target market, market size (value, quantity), growth, market share of main competitors (if known)

- How the business will operate (location, premises, staff, distribution methods)
- Marketing mix – description of these four elements
- Cash-flow forecast (important to ensure the business does not run out of cash)
- Forecast revenue, costs and profits

The purpose of business plans

The main reasons why a **start-up business** should produce a business plan are:

- Provides a focus on the business ideas - is it really a good one and why?
- Produces a document that helps clarify thoughts and identify any gaps in information or research
- It encourages the business entrepreneur to focus on what the business is really about and how customers and finance-providers can be convinced to buy and lend the business money
- It helps test the **financial viability** of the idea by including forecasts of revenue, costs, profits and cash-flow
- A business plan will **minimise the risk** of failure - can the business achieve the required level of profitability and not run out of cash?
- The plan provides something which can be used to **measure** actual performance
- A business plan is essential to **raising finance** from outside providers, such as investors and banks, as it will provide evidence that any loans can be repaid

In addition **existing small businesses** will use this process:

- to review their current performance
- allows business objectives to be modified if required
- allows departments of the business to produce their own plans, for example marketing plan, human resources plan.
- to update their current business strategy or plans for the future, based on their current performance, changes to the business environment, over which they have little control, and revise objectives
- overall it will help the business make informed decisions