Criteria for measuring size and growth

(a) Sales turnover or value of output
This is often used as a measure of size – especially when comparing firms in the same industry. It is less effective when comparing firms in different industries because some might be engaged in ‘high-value’ production, such as precious jewels, and another might be in ‘low-value’ production, such as cleaning services.
This measure is needed to calculate market share (below).

(b) Number of employees
This is the simplest measure. It is easy to understand, for example it is obvious to everyone that shops with just the owner or the family are small. It is also clear that a firm employing many staff is likely to be large – as labour is not a cheap resource. But there are problems. How about the businesses that employ few people because they are highly automated (capitalised)?
Example: There are two soft drink firms in the same town. One uses traditional methods of production, using 108 people to make 300,000 litres of drink a week. The other is totally automated and produces 1 million litres a week with just ten staff.

(c) Market share
This is calculated using the following formula:

\[
\text{Market share} = \frac{\text{Total sales of business}}{\text{Total sales of industry}} \times 100
\]

This is a relative measure. If a firm has a high market share it must be among the leaders in the industry and comparatively large. However, when the size of the total market is small, a high market share will not indicate a very large firm.

(d) Capital employed
This measures the total value of all long-term finance used in the business. Generally, the larger the business enterprise the greater the value of capital needed for long-term investment. Again, comparisons between firms in different industries may give a rather misleading picture. Two firms employing the same number of staff may have very different capital equipment needs, such as a hairdresser and an optician.

The latter will need expensive diagnostic and eyesight measuring machines.

Other measures that can be used
These will depend very much on the industry. The number of guest beds or guest rooms could be used to compare hotel businesses. The number of shops could be used for retailers. Total floor sales space could also be used to compare retail businesses.

Market capitalisation
This can only be used for businesses which have shares ‘quoted’ on the Stock Exchange (public limited companies). It is calculated by this formula:

\[
\text{Market capitalisation} = \text{current share price} \times \text{total number of shares issued}
\]

As share prices tend to change every day, this form of comparison is not a very stable one. For example, a temporary but sharp drop in the share price of a company could appear to make it much ‘smaller’ than this measure would normally suggest.

Which form of measurement is best?
There is no ‘best’ measure. The one used depends on what needs to be established about the firms being compared. This could depend on whether we are interested in absolute size or comparative size within one industry. If an absolute measure of size is required then it is almost certainly advisable to test a firm on at least two of the above criteria and to make comparisons on the basis of these.

Advantages and disadvantages of small firms versus large firms with respect to:

(a) Size and financial requirements
Small or ‘micro’ enterprises can often be started with very little capital. An entrepreneur planning to set up a house-cleaning service will need a means of transport and some cleaning materials. The finance for these items could come from personal savings. It is common for small firms to operate on a cash basis, paying for supplies and being paid by customers in cash.
reduces the need for working capital to finance substantial stocks or unpaid invoices (debtors).

On the other hand, small firms can face considerable disadvantages when attempting to raise capital for expansion. They may have only a short trading history to present to banks or other potential investors. There may be few assets to offer as collateral to guarantee loans. For both of these reasons, the cost of borrowed capital can be substantially greater, in the form of higher interest rates, than for larger businesses. In addition, many small firms have not been incorporated into limited companies so there is no prospect of selling shares in the business to raise long-term capital. Finally, small firms often make relatively low profits and this limits the internal finance that will be available for expansion. These are the main disadvantages for small firms in raising capital to meet their financial requirements.

Large firms usually need more capital – both set-up capital and continuous, day-by-day, working capital. Generally, larger business organisations have a greater choice of sources of finance than smaller ones. If they have an incorporated legal structure, then shares may be sold to raise long-term capital – but shareholders will only be encouraged to invest if the prospect of profits is good. Banks will be keen to lend finance to large and successful businesses, but collateral may be asked for if the capital is to be used for a risky project. Finally, if the firm is profitable, these profits could be retained in the business to finance expansion plans.

Even large businesses will have to justify the need for capital to the potential providers of it. There will have to be a good trading record and clear reasons given for the need for new finance. The potential benefits to the firm of investing additional capital will also need to be explained. If very large sums are required, then lenders could ask for very detailed accounting information, and demand to be kept informed of the progress of new projects. Selling a large number of additional shares may even change the controlling balance that existed, and there could be a loss of control by existing shareholders and directors.

(b) The economies of scale (internal and external) and diseconomies

The decision to expand the scale of operations of a business cannot be taken lightly. There are likely to be considerable costs involved – purchasing land, buildings, equipment, employing more staff – and the capital needed for this will always have alternative uses. Business expansion by employing more of all the factors of production is referred to as an increase in the 'scale of production'. Firms expand not only to increase capacity to avoid turning business away but also to benefit from the advantages of large-scale production – these are called economies of scale.

Economies of scale These are the reductions in a firm's unit (average) costs of production that result from an increase in the scale of operations. The cost benefits can be so substantial in some industries that smaller firms will be unlikely to survive due to lack of competitiveness such as in oil refining or soft drink production. They arise for five main reasons:

1. Purchasing economies – often known as bulk buying economies. Suppliers will often offer substantial discounts for large orders. This is because it is cheaper for them to process and deliver one large order rather than several smaller ones. In addition, they will obviously be keener to keep a very large customer happy due to the profits made on the large quantities sold. Big firms employ specialist 'buyers' who may travel the globe to strike the best possible deals at the lowest possible prices for materials and components. Recently there has been a growing trend towards firms buying supplies over the internet, and this process is known as ‘B2B’ (business to business) marketing. Cheaper deals are always offered for greater quantities ordered.

2. Technical economies There are two main sources of technical economies. Large firms are more likely to be able to justify the cost of flow production lines. If these are worked at a high capacity level then they offer lower unit costs than other production methods. The latest and most advanced technical equipment – such as computer systems – is often expensive and can usually only be afforded by big firms. Such expense can only be justified when
output is high so that fixed costs can be spread ‘thinly’ – a small firm, even if it could afford the equipment, would be unlikely to keep it operating for very long each week and this would raise the unit fixed costs. It is often the case that such equipment is ‘indivisible’ – this means that it cannot be purchased in smaller models with a lower total capacity.

3 Financial economies. Large organisations have two distinct cost advantages when it comes to raising finance. Firstly, banks and other lending institutions often show preference for lending to a big business with a proven track record and a diversified range of products. Interest rates charged to these firms is often lower than the rate charged to small, especially newly formed, businesses. Secondly, raising finance by ‘going public’ or by further public issues of shares for existing public limited companies is very expensive. Professional advisers’ fees, prospectus publishing costs and advertising charges will not vary greatly whether it is a large or a small issue of shares. Therefore, the average cost of raising the finance will be lower for larger firms selling many millions of dollars’ worth of shares.

4 Marketing economies. Marketing costs obviously rise with the size of a business, but not at the same rate. Even small firms will need a sales force to cover the whole of the sales area. They may employ an advertising agency to design adverts and arrange a promotional campaign. These costs can be spread over a higher level of sales for a big firm and this offers a substantial economy of scale.

5 Managerial economies. Small firms often employ general managers who have a variety of management functions to perform. As a firm expands so it should be able to afford to attract specialist functional managers who should operate more efficiently than general managers. The extreme case of a small firm not benefiting from this economy would be a sole trader managed by just the owner. The skills of specialist managers and the chance of them making fewer mistakes because of their training is a potential economy for larger organisations.

Economies of scale – external External economies of scale are efficiency gains or reductions in average production costs made by an individual firm resulting from growth of the whole industry. It is most common for these external economies to be experienced when an industry expands within a relatively small geographical area.

One of the best international examples is that of ‘silicon valley’ in California. The development of a substantial concentration of IT-focused industries within this region of the USA offers all IT businesses within the area the following potential advantages:

- Easy access to availability of suppliers of materials and components.
- Easy access to potential customers. For example, producers of processors can have access to several local computer assembly firms that need to purchase such components.
- Good supply of skilled workers, as people with the necessary IT skills are attracted to the region by the wide range of employment opportunities on offer.
- Banks and other finance providers in the region will have detailed knowledge of the particular requirements of this industry.
- Local Colleges and Universities will usually offer specialist training courses to help provide the qualified workforce that this particular industry needs.

These are the main reasons why many industries become heavily concentrated within a relatively small geographical area.

Diseconomies of scale – big can be inefficient too

If there were no disadvantages to large-scale operations, nearly all industries and markets would be dominated by huge corporations. Some are, of course, as with oil exploration, refining and retailing – the benefits of large-scale production are so substantial that smaller firms find it increasingly difficult to operate profitably. In many other industries, the impact of ‘diseconomies of scale’ prevents one or just a few firms from being able to completely dominate. Diseconomies of scale are those factors that increase unit costs as a firm’s scale of operation increases beyond a certain size. These diseconomies are all related to the management problems associated with trying to control and direct an organisation with many thousands of workers, in many
separate divisions, often operating in several different countries.

There are three main causes of these management problems:

1. **Communication problems in larger organisations.** Large-scale operations will often lead to poor feedback to workers, excessive use of non-personal communication media, communication overload with the sheer volume of messages being sent and distortion of messages caused by the long chain of command. These communication inefficiencies may lead to poor decisions being made, due to inadequate or delayed information. Poor feedback reduces worker incentives. Communication overload is ‘noise’ that may prevent the really important messages being acted upon first. All of these factors will reduce management efficiency.

2. **Alienation of the workforce.** The bigger the organisation the more difficult it becomes to directly involve every worker and to give them a sense of purpose and achievement in their work. They may feel so insignificant to the overall business plan that they become demotivated and fail to give of their best. As was identified above, larger manufacturing firms are the ones most likely to adopt flow line production and workforce alienation is a real problem if new ways of organising this method are not employed. The use of cell working and team working and other job enrichment methods have gone a considerable way to minimise this problem but the danger of staff alienation is ever present in large businesses.

3. **Co-ordinating the business.** Business expansion is often associated with a growing number of departments, divisions and products. The number of countries a firm operates in often increases too. A major problem for senior management is to co-ordinate and control all of these operations. Co-ordination really means that all divisions of the business are aiming to achieve the same objectives by adopting similar ethical standards and by producing goods that are consistent with each other. So, if one division of an oil company in one country adopts a weaker ethical stance on issues such as pollution than the divisions in other countries, then poor publicity for the whole operation could be the result. Another problem could be the existence of more than one research department with wasteful duplication of research into similar products. These are all issues that result from poor co-ordination. They could lead to substantially higher production costs than for a smaller business with much tighter control over operations.

**Large-scale production – unit costs of production**

The combined effect of economies of scale and diseconomies of scale on unit (average) costs of production is shown in Figure 3.1.

It is important to point out that there is not a particular point of operation at which economies of
Activity

Read the case study below and then tackle the exercises that follow.

Case study – Expansion plans at Bookworm Ltd

Bookworm started seven years ago as a single shop selling books and magazines. It was owned by just one person with a passion for books – Aymen Galim. He employed three assistant staff to help him in the shop but he undertook all management tasks himself. He selected and ordered all stock, negotiated prices and delivery dates with suppliers, recruited and selected his assistants, kept accounting records and decided selling prices and promotional strategies such as window displays. All stock was manually recorded in a stock book and this was adjusted on each delivery and with sales data at the end of each week. The business did not have its own transport and Aymen delivered large orders once a week using a hire van. Finance for the business had been obtained from his own savings and bank overdraft on which a high interest rate was charged. Advertising was rarely undertaken as Aymen found that the charges expected by a radio or newspaper company for just designing and preparing an advert were too high.

That was seven years ago. Aymen was still surprised by the speed at which his business had grown. He now had twenty shops. He had taken his two brothers into the business – initially as partners but now as fellow directors in a private limited company. One was an accountant who managed the financial affairs of the business so well that the overdraft limit was never reached. The other had a degree in marketing and had introduced many new promotional ideas. Aymen was convinced that there were still areas of his country away from city regions, that offered great demand opportunities and he wanted to expand the business even further. Additional capital would be required to finance additional premises, stock and to purchase larger vans to replace the three that the company now owned. A new stock management computer system would also be needed. This would allow for computerised cash tills to automatically record each sale. Staff numbers would have to increase again – possibly up to around 300 – and a new level of middle management would be introduced to take some of the burdens off the three brothers.

The directors had discussed the merits of seeking a stock exchange listing to allow for a public issue of shares. The good economic news being released by the government convinced the brothers that now was the right time to expand the business’s scale of operation.

0 marks, 40 minutes)

Using this case as an example, outline the cost and efficiency disadvantages often experienced by small firms. (6)

Using the principle of economies of scale, explain how the expansion of the Bookworm business might result in lower average costs of selling each book. (15)

Examine the potential diseconomies of scale that could result from continued expansion of the business. (9)

(c) Strategies for business growth

The owners of many businesses do not want the firm to remain small – although some do for reasons of remaining in control, avoiding taking too many risks and preventing work loads from becoming too heavy. Business growth can be achieved in a number of ways and these different forms of growth can lead to various effects on stakeholder groups, such as customers, workers and competitors.
The different forms of growth can be grouped into internal and external growth. Figure 3.2 illustrates this. **Internal growth** means expansion of a business by means of opening new branches, shops or factories. This growth can be quite slow. However, it can avoid problems of excessively fast growth, which tends to lead to inadequate capital (overtrading), and management problems associated with integrating two businesses together that often have different attitudes and cultures.

**External growth** is achieved by means of merging with or taking over another business, from either the same or a different industry. This form of growth is often referred to as 'integration' as it involves bringing together two or more firms. This form of growth can lead to rapid expansion, which might be vital in a competitive and expanding market. However, it often leads to management problems. These are caused by the need for different management systems to deal with a bigger organisation. There can also be conflict between the two teams of managers—who will get the top jobs?—and conflicts of culture and business ethics.

Table 3.2 provides an easy to refer to guide to the different types of integration, their common advantages and disadvantages, and the impact they often have on stakeholder groups.

<table>
<thead>
<tr>
<th>Type of integration</th>
<th>Advantages</th>
<th>Disadvantages</th>
<th>Impact on stakeholders</th>
</tr>
</thead>
</table>
| **Horizontal** — with firms in the same industry and at same stage of production, e.g., a food retailer takes over another food retailer. | • Eliminates one competitor.  
• Possible economies of scale.  
• Scope for rationalising production, for example concentrating all output on one site as opposed to two.  
• Increased power over suppliers. | • Rationalisation may bring bad publicity.  
• May lead to monopoly investigation if the combined business exceeds certain size limits. | • Consumers now have less choice.  
• Workers may lose job security as a result of rationalisation. |
| **Vertical** — forward integration with a business in the same industry but a customer of the existing business, e.g., an oil drilling/refining business takes over a chain of petrol stations. | • Business is now able to control the promotion and pricing of its own products.  
• Secures a safe outlet for the firm's products — may now exclude competitors' products | • Consumers may suspect uncompetitive activity and react negatively.  
• Lack of experience in this sector of the industry — a successful manufacturer does not necessarily make a good retailer. | • Workers may have greater job security because the business has secure outlets.  
• There may be more varied career opportunities.  
• Consumers may resent lack of competition in the retail outlet because of withdrawal of competitor products. |
### Table 3.2 continued

<table>
<thead>
<tr>
<th>Type of integration</th>
<th>Advantages</th>
<th>Disadvantages</th>
<th>Impact on stakeholders</th>
</tr>
</thead>
</table>
| Vertical integration | - Greater control over quality, price, and delivery times of supplies.  
- Encourages joint research and development into improved quality of supplies of components.  
- Business may now control supplies of materials to competitors. | - May lack experience of managing a supplying company – a successful steel producer will not necessarily make a good manager of a coal mine.  
- Supplying business may become complacent due to having a guaranteed customer. | - Possibility of greater career opportunities for workers.  
- Consumers may obtain improved quality and more innovative products.  
- Control over supplies to competitors may limit competition and choice for consumers. |
| Conglomerate integration | - Diversifies the business away from its original industry and markets.  
- This should spread risk and may take the business into a faster-growing market. | - Lack of management experience in the acquired business sector  
- There could be a lack of clear focus and direction now that the business is spread across more than one industry. | - Greater career opportunities for workers.  
- More job security because risks are spread across more than one industry. |

### Synergy and integration

Synergy literally means that the 'the whole is greater than the sum of parts'. When two firms are integrated the argument is that the bigger firm created in this way will be more effective, efficient and profitable than the two separate companies. Why might this be the case? Firstly, it is argued that the two businesses might be able to share research facilities and pool ideas that will benefit both of the businesses. This is only likely to be the case if the two firms deal with the same kind of technologies. Secondly, economies of operating a larger scale of business, such as buying supplies in large quantities, should cut costs. Lastly, the new business can save on marketing and distribution costs by using the same sales outlets and sales teams. In practice, many mergers and takeovers fail to gain true synergy, and shareholders are often left wondering what the purpose of the integration really was.

Figure 3.3 gives a summary of external forms of growth.

![External forms of growth](image-url)
Management of Business – Unit 1

(d) Management and control
The control of most small businesses is the responsibility of the owner (sole trader) or the partners. Even in most private limited companies, which are often family-based enterprises, the directors are often the main shareholders in the company. When the owner of a business also control and manage it, there is no divorce or split between ownership and control. This is an important advantage for small firms compared with most large ones. There will be no conflict of objectives between owners and managers. There will be no need to hold meetings between these two groups to explain how the managers are controlling the business and for the owners to indicate their satisfaction or disapproval of the management. On the other hand, as has already been explained in the economies of scale section, small firms cannot usually afford to employ skilled and experienced specialist managers who could improve the performance and profitability of the business.

In contrast, many large firms, including nearly all public limited companies, employ professional managers who are not the major shareholders or owners of the business. These professional directors should have the skills and experiences to drive the business forward to achieve growth and profits, and their specialist management knowledge will often justify the high salaries they usually earn. However, these managers may have rather different objectives to the owners of the business and this can lead to conflict resulting from the ‘divorce between ownership and control’.

Managers may focus on business growth rather than maximising returns to owners through high profits. Managers who achieve business growth have high status and can justify asking for higher salaries – but business growth is not always profitable, at least not in the short-term. Expansion requires finance – and this might come from reducing returns to shareholders to keep more profits in the business. Expansion may take years to pay back the initial investment, so shareholders may be kept waiting for future profits. They may adopt a ‘short-termism’ view of wanting profits now, whereas the directors may prefer the ‘long-term’ view of expansion now with the probability of higher profits in the future. If shareholders really disapprove of the directors’ objectives for the business, they can either sell their shares or vote in new directors at the next Annual General Meeting – both of which could be disruptive for the business.

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Over-to-you

Revision questions

(60 marks, 1 hour)

1. What are the main features of a free market economy? (3)
2. State THREE examples of state intervention in the economy in a typical mixed economy. (3)
3. Give TWO disadvantages of a planned economic system. (2)
4. Does the government in your country provide all or most of the following goods and services:
   - public transport,
   - secondary schools,
   - health services,
   - telecommunications? (4)
5. Distinguish between a ‘traditional economy’ and a ‘free market economy’. (3)
6. Examine whether the economy of Trinidad and Tobago would benefit from more or less government ownership (nationalisation) of businesses. (8)
7. (a) State THREE measures used for comparing the size of businesses. (3)
   (b) Discuss which of these measures would be most appropriate for comparing the size of two soft drinks manufacturing firms. (5)
8. Two supermarket businesses, with several shops each, agree to merge.
   (a) What type of integration is this called and why? (2)
   (b) Analyse TWO economies of scale that could result from this merger. (6)
   (c) Explain why average costs of the newly merged businesses could increase. (4)
9. Explain TWO advantages that small businesses might enjoy over large firms. (6)
10. Discuss why some industries, such as building, decorating and hairdressing are still dominated by small firms and not by large ones. (10)
17 Micro- and macro-environmental factors which affect small businesses

This chapter covers Unit 2, Module 3, Section 4. On completion of this chapter you should be able to:

- identify and explain the internal factors that affect the success of small businesses
- identify and explain the external factors that affect the success of small businesses

Introduction
This chapter identifies and analyses the internal and external factors that help determine the success of small business start-ups. Clearly, the skills of the entrepreneur are a very important determinant of the success of a new business but this chapter is concerned with issues other than these skills. These other factors can be categorised as being micro or macro. Micro-factors are internal and can be controlled or influenced by the entrepreneur. Macro-issues are large-scale societal factors that are out of the control of the individual entrepreneur.

Internal factors affecting small businesses

Lack of record keeping
The need for accurate records was explained in the last chapter. Many entrepreneurs fail to pay sufficient attention to this need as they either believe that it is less important than actually meeting customers needs or they think they can remember everything. This will be quite impossible, after a period of time. How can the owner of a new, busy florist shop remember:

- When the next delivery of fresh flowers was booked for?
- Whether the flowers for last week's big wedding have been paid for?
- If the cheque received from the government department for the display of flowers in its reception area has been paid into the bank yet?

- How many hours the shop assistant worked last week?

There are many other examples that could have been given to illustrate the crucial importance of keeping accurate and up-to-date records of business transactions and other matters.

With the falling costs of computing power, most businesses, even newly formed ones, keep records on computer. It is always advisable to keep paper records too, when these exist, for example receipts from suppliers or details of big deliveries. These not only act as a check or back-up system if the computer should fail, but also provide evidence to, say, the tax authorities if they dispute the entrepreneur's own tax calculations.

Working capital deficiencies
Running short of capital to run the day-to-day business affairs is the single most common reason for the failure of new businesses to survive the first year of operation.

Capital is needed for day-to-day cash, for the holding of stocks and to allow the giving of trade credit to customers, who then become debtors. Without sufficient working capital, the business may be unable to buy more stocks or pay suppliers or offer credit to important customers. All of these factors could lead to the business closing down.

Serious working capital deficiencies can usually be avoided if several simple, but important, steps are taken as the business is being established:

- Construct a cash flow forecast so that the liquidity and working capital needs of the business can be...
assessed, month by month. Keep this updated and show it to the bank manager too.

- Inject sufficient capital into the business at start-up for the first few months of operation when cash flow from customers may be slow to build up.
- Establish good relations with the bank so that short-term problems may be, at least temporarily, overcome with an overdraft extension.
- Use effective credit control over customers accounts – do not allow a period of credit which is too long and regularly chase up ‘late payers’.

**Poor management skills**

Most entrepreneurs have had some form of work experience – but not necessarily at a management level. They may not have gained experience of:

- leadership skills,
- cash handling and cash management skills,
- planning and coordinating skills,
- decision-making skills,
- communication skills,
- marketing, promotion and selling skills.

They may be very keen, willing to work hard and with undoubted abilities in their chosen field, e.g. an entrepreneur opening a restaurant may be an excellent chef, but management skills may be lacking. Some learn these skills very quickly, once the business is up and running – but this is quite a risky strategy. Some organisations exist to provide support for new entrepreneurs in the form of advice and training. Some entrepreneurs ‘buy in’ the experience by employing staff with management experience – but how many newly formed businesses can afford this expensive option?

It is wrong to think that just because a business is new and small, that enthusiasm, a strong personality and hard work will be sufficient to ensure success. This may prove to be the case, but often it does not. So potential entrepreneurs are usually encouraged to attend training courses to gain some of these skills before putting their hard earned capital at risk or to seek management experience through employment first.

Read the case study below and then tackle the exercises that follow.

**Activity**

* Read the case study below and then tackle the exercises that follow.

**Case study – ‘Returned next day, or nothing to pay’**

Wesley had been really pleased with himself six months ago. His business plan for a new laundry business had been well received by the bank manager. She had agreed to lend him £30,000 – half of the capital he needed for starting the business. Wesley planned to offer a premium laundry service for local hotels and guest houses that did not have their own sheet and towel washing facilities. His promise was ‘returned next day, or nothing to pay’.

The number of customers was small at first, but news of Wesley’s service standards and next-day service soon spread. By the end of the third month, the laundry was working to full capacity and Wesley had recruited four workers to help him. At the end of the fourth month the bank manager asked to see him again. He was shocked by what he was told:

> You have reached your overdraft limit and cash coming in to the business is not enough to ensure survival. I want to see all of your accounting and sales records next week’, she told him.

Wesley knew that would be a problem. He had been so busy that his accounting records were three weeks out of date. Customers had not paid during this period – because he had not sent the bills out! Some customers were claiming that they should not pay anyway as their laundry had taken three days to be returned. Another problem concerned the workforce. They were always arguing because there were certain jobs that no one wanted to do – such as handling the chemicals used and cleaning the boiling tanks at the end of each day. Wesley had not allocated jobs clearly enough and the workers could not decide themselves.

In the evening after his visit to the bank, he sat down with all of the company’s paperwork and wondered why he had not gained some experience at computer controlled accounting. Wesley’s own business skills had mainly been gained in marketing – no wonder the sales of the laundry were doing so well!
Micro- and macro-environmental factors which affect small businesses

(20 marks, 30 minutes)

1 Identify FOUR problems that Wesley now faces in managing his business. (4)
2 Explain the skills that Wesley should have had from the start of the business that would have reduced the importance of these problems. (8)
3 Recommend to Wesley what steps he should now take to overcome the difficulties his business is experiencing. (8)

External factors affecting small businesses

Market demand

The size and scope of the market are beyond the control of any one business owner. All they can hope to do is to attract a large enough share of the market they are operating in to be able to survive, at first, and then expand and become more profitable.

The factors that influence the size of market demand are numerous and include:

- consumer tastes;
- size of population and its age structure;
- consumer incomes;
- government economic policy, e.g. tax rates and the level of interest rates;
- unemployment level, which can reduce disposable incomes.

It may be the case that the market being aimed at by a new business is actually too small to support this business profitably. Perhaps there was insufficient time spent on market research and the number of people willing to buy the product has been over-estimated.

Seasonality

This refers to the seasonal pattern of sales that many products experience. It is very common. Christmas cards and Easter eggs are typical examples, but many goods and services are more frequently bought by consumers at certain times of the year than others. Here is a list of such products: florists – demand at fête and religious festival periods; garden services – during spring and summer; soft drinks – summer; craft goods for tourists – main holiday seasons. You could probably add to this list. In contrast, other businesses are unlikely to experience seasonal variations in demand for their products, such as: car repairer; child minder; computer retailer; website designer.

The problems caused to small businesses by seasonality include:

- Production – can the good be stored to meet the period of high demand as with craft products?
- Human resources – can labour be employed flexibly so that they can be called in to work during busy periods, but not employed during ‘out of season’ periods?
- Working capital – if stocks are held, will the finance be available to finance these stocks?
- Cash flow – irregular sales patterns will lead to irregular cash flows, is there sufficient cash to pay for expenses even during the out-of-season periods?

Regulations and legislation

These external constraints were fully explained in Unit 1. They raise costs for all businesses and this can be critically important for small firms which may be struggling to survive. Examples of the costs that a small business in the food preparation or retailing industry would have to incur to satisfy legal requirements include:

- Health and Safety at work: wash room and rest room facilities for staff; protective guards around machinery, fire escapes and fire extinguishers.
- Minimum wages: ensure that no workers are paid less than the legal minimum wage.
- Consumer protection: well maintained freezers and fridges for food production and retail businesses; staff training in handling of food products.

Expensive though these legal requirements might be, the expense of NOT following the laws could be even greater. For example, if a consumer fell ill from consuming a food product that had not been kept or handled safely and cleanly, the compensation costs and the loss of business reputation could be much more than the costs involved in following all legal requirements.