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FOREWORD

WHO IS THIS BOOK FOR?

This book is aimed at students sitting the AS/A levels run by Edexcel in either Business Studies or Economics & Business. The book covers Unit 1 of both courses, which is named Developing New Business Ideas. This is the core Unit for the AS year, and is compulsory for both AS levels. Those doing the pure Business Studies AS level go on to study Unit 2a, Managing the Business, while those doing the Economics & Business AS level go on to study Unit 2b, Business Economics.

WHAT IS ITS PURPOSE?

Students who read this book carefully should know and understand all the content that they need for the examination, as well as getting a thorough grounding in the subjects of Business Studies, and Economics. It is a textbook rather than a revision guide, and so seeks to explain the concepts in detail, and with plenty of real-life examples. It does not focus on examination technique, neither does it provide examination practice. These important subjects are covered in the author's Unit 1 Revision Guide and Unit 1 Topic Tests, both of which are available from www.anketelltraining.com.

This textbook also provides an introduction to the whole of the A level courses in Business Studies and Economics & Business. It does this by going into greater detail than is required just for the Unit 1 examination, and by making frequent references to these other Units, both at AS and A2 level. The student who successfully masters the content will be in a position not only to do well in the Unit 1 examination, but will also have laid a foundation for successful completion of the AS and A2 courses.

WHAT DOES IT CONTAIN?

The 16 chapters cover the 16 sections of the Unit 1 specification. In addition, there is a substantial Introduction which sets the scene by looking at entrepreneurship around the world. The book concludes with a glossary of technical terms used in the book, and which have been written in bold the first time they are used.

Within each chapter, you will find:

- An excerpt from the Edexcel specification. This tells you precisely what is needed for the Unit 1 examination.
- A list of everything you should be able to explain, having read the chapter.
- Frequent references to real-life businesses, both small and large, to illustrate the points made.
- Questions for Thought. These are designed to test whether students have fully understood the content by seeing if they are able to apply it in new directions. Open-ended by design, they have something to offer AS level students of all abilities. The questions have not been given a number of marks, but each question could be answered over half a side to one side of A4.

WHAT IS THE STRUCTURE OF THE WHOLE COURSE?

The Business Studies A level consists of four Units. The first two Units complete the Business Studies AS level (Edexcel reference: 8BS01) and the last two are the A2 Units. All four Units combine to form the complete A level (reference: 9BS01). The Unit titles are as follows:

- Unit 1 Developing New Business Ideas
- Unit 2a Managing the Business
- Unit 3 International Trade
- Unit 4a Making Business Decisions

The Economics & Business A level also consists of four Units. The first two Units complete the Economics & Business AS level (reference 8EB01), with the last two being A2 Units. All four Units combining to form the complete Economics & Business A level (reference 9EB01). The Unit titles are as follows:

- Unit 1 Developing New Business Ideas
- Unit 2b Business Economics
- Unit 3 International Trade
- Unit 4b The Wider Economic Environment and Business

As you can see, these two AS/A levels share a common core. At AS level, the common core is Unit 1 Developing New Business Ideas – and it is this core which is covered in this book. Whichever of these two courses you are doing, you should find this book equally useful. Both sets of students sit the identical Unit 1 examination.

Chapter 3
Leadership styles

EXTRACT FROM THE SPECIFICATION FOR CHAPTER 3

"Use of appropriate leadership style for situation or for dealing with employees: autocratic, paternalistic, democratic, McGregor's Theory X and Theory Y."

At the end of this chapter you should be able to explain:

- Why entrepreneurs need to develop good working relationships with a range of stakeholders, including customers, suppliers and employees
- Why the relationship with employees demands great commitment on both sides, particularly if leadership is paternalistic
- The meaning of democratic and autocratic leadership, and when each style is most likely to be successful
- Douglas McGregor's Theory X and Theory Y accounts of how managers view staff, and why Theory Y is becoming more dominant

Introduction

Many entrepreneurs start their businesses with no employees, so the question of leadership does not arise – at any rate at first. Rather, the first people skills they are likely to have to develop are those of dealing with customers, and potential customers. These skills will include building up rapport, and developing relationships of trust. With many small businesses, customers are buying into the proprietor, the owner, as much as they are buying into the product itself. Then the art of persuasion must also be learned. Interest in products must be created, deals must be closed, and goods paid for. Of course, some businesses such as those that sell exclusively online may not rely on the development of such personal relationships, but most will.

The next group of stakeholders with whom they will need to develop relationships are suppliers. For a handyman, the key supplier relationship might be with a local DIY store. Perhaps he will develop a relationship with one particular member of the staff and/or open an account with the store, whereby he pays for everything at the end of the month. For the more common service-based industries, early suppliers will be stationers, web designers, marketing consultants and other people who work for you on an occasional basis. In this set of relationships, the entrepreneur is the customer. Rather than trying to satisfy others, suppliers have to satisfy you, the entrepreneur. After all, you are the person handing over the money.

However, if the new business start-up grows, then one of the key set of decisions to be taken will revolve around employing staff. An employee is in essence another type of supplier. However, rather than selling you goods or services on an occasional basis whenever you happen to pick up the phone, they sell you their labour for a fixed number of hours per week, and often work from your premises. There has to be a formal **contract of employment** outlining, among other things, what their responsibilities are, and how much they get paid. There are several thousand pages of employment law, which makes the relationship a much more serious one than a simple contract for services performed, such as you might make with someone to paint your house.

An employment contract is a much bigger commitment on both sides. On the part of the employer, the wage becomes an overhead. You now have to ensure you have enough work to pay the employee's wage. So taking on the first staff member is a big step in any start-up's history, and should be indicative of a new level of seriousness on the part of the entrepreneur. On the part of the employee, the contract may make it difficult to earn money doing anything else, particularly if it is a full-time contract for 40 hours a week or so. The employee may come to depend on the wage, and enter into other long-term contracts (such as marriage, or taking out a **mortgage** to buy a house) at least in part on the security of the employment relationship.

The business relationship between employer and employees is then likely to become one where both sides have a major investment, both in terms of the likely length of the relationship and what both sides gain from it. And managing this relationship becomes critical to the success of any business which grows to the size where employees are needed. This is where leadership comes in. Managing that relationship between yourself and your employees (also known as 'workers' or 'staff') is what leadership is all about.

Much has been written about leadership. It is a subject of interest not only to entrepreneurs, but also to managers in established companies – indeed, anywhere where a group of people work together. This could be anything from a political party or a charity to a town hall or an army unit. Whatever the context, leaders need determination and character – qualities also needed by every entrepreneur. There will be days when things go badly, and employees will look to you for reassurance. This point was made by Field Marshal Slim (1891-1970), a British military leader in World War II. He is credited with saying:

When I'm in charge of a battle and everything's going well and to plan and I'm winning – I'm a great leader, a real good lad. But you find out whether you can really lead or not when everything's going to [pieces] and you are to blame.[1]

When business is booming, it's relatively easy to lead. Your decisions include things like whom to promote in the growing organisation, to whom you should give a pay rise now that you can afford them, and whether you should expand into market A or market B. But when business is poor, leadership involves the opposite set of decisions such as which people to make redundant, and explaining why expected promotions have to be postponed, and wages frozen. Steve Ballmer himself illustrates this principle. During the heady growth days of the 1990s, Microsoft's second-in-command was widely admired. Now that the company is becalmed – outshone in the IT sector by Google, Apple, Amazon and Facebook – the mood has changed. Steve Ballmer, in the top job since 2000, has an approval rating among his employees of just 40%, and "ranks last among the top dozen tech companies", according to Glassdoor.com in December 2010.[2] By contrast, Mark Zuckerberg and Eric Schmidt, leaders of rapidly growing Facebook and Google respectively, both bask in employee approval ratings of 96%.

The military is often viewed as an excellent training ground for leadership and this is not surprising. To persuade a group of followers to come with you in a course of action which may well result in their deaths needs leadership of a particularly high order. In the accompanying Case Study are some thoughts from General Colin Powell, who became America's Secretary of State (i.e. Minister for Foreign Affairs) between 2001 and 2005 after a successful military career. Delivered in retirement, he reflects upon what he has learned about leadership.

Most of the points he makes are not controversial. However, the speed with

Case Study

General Colin Powell on Leadership – address to the students of Colgate University, 2009

Have a clear sense of purpose ... your organisation has to have a purpose ... so when you take over an organisation whether it's an office of three or an army of three million, make sure you convey throughout the organisation a sense of purpose. What are we here for, not just to make money but to make this a better society? The best leaders I've known are those who can convey this sense of purpose down to every single person in the organisation.

The second thing was, take care of the troops, take care of the followers – they will get the job done for you. Train them, give them the skills they need, make sure they're ready for the task ahead. Give them the equipment they need, whether weapons, computers, knowledge – whatever they need to get the job done. If you're a real leader, you'll make sure they have what they need. You will never look away from those needs ...

Make sure also that you commend them when they have done good things. It's not just a matter of promotions or salaries, sometimes it's nothing more than [a hug, and] "I'm so proud you're a part of my team!"

But if you want to be a leader, you've also got to be ready to discipline people, and fire people when they're not getting the job done. Don't work around them, don't give the work to somebody else. The good followers know who the bad followers are, and they're waiting for you to do something about it. So my young friends, make sure you develop the fortitude to be realistic and not turn away from problems, but to deal with problems when they come along – and if it means hurting someone's feelings for the good of the organisation you have to train yourself to be able to do that.

But it's all about human connections, all about conveying to the followers that you believe in them, you're going to support them, and we are all in this together.[3]

See Question 3.6 at the end of the chapter

which unsatisfactory employees are fired is very much a reflection of national culture, and varies widely from country to country. Within the UK, underperforming employees working for private companies are – as a general rule – fired more quickly than those in the public sector. Here, the emphasis is more on ensuring that the employee has had every chance to improve, and that his rights have been respected at every stage of the disciplinary process. Strong public sector unions may defend the employee and ensure that he has had every consideration to which he is entitled, and that the correct disciplinary procedure has been followed to the letter. In many instances, the sheer difficulty of firing someone means that the effort is never made, and a culture of underperformance and diminished expectations becomes entrenched within the government department concerned.

The USA is well-known for having a more robust attitude. You only have to read Colin Powell's speech to understand why the United States is one of the richest societies on earth. An economy made up of performance-orientated organisations, large and small, which encourage and equip their employees but are not afraid of getting rid of people who do not measure up is almost certain to succeed. We might also expect such a society to have a large gap between rich and poor, between the performers and the underperformers – and this is indeed the case.

At the other end of the spectrum is Japan, which was the second-largest economy in the world, until recently overtaken by China. The tradition since at least the Second World War is that employment is for life, promotion is slow, and that wage levels are based on length of service rather than on performance. Unsatisfactory performance is dealt with through social pressure rather than through dismissal. Within traditional Japanese companies, there is a strong sense of corporate identity, and the absence of effective trade unions which might provide a rival focus of loyalty. Such a **leadership style** is described as **paternalistic leadership**, in other words acting like a father. The employee is never fired when a mistake is made but rather gently encouraged to do the right thing, following the example of the boss.

Such a relationship is long-term by design and in reality, and only ends when the retirement age is reached. In return for this security, the employee is expected to be totally flexible and be prepared to do whatever tasks the company requires. Another feature of the Japanese system is the high proportion of **remuneration** which is paid out in bonuses rather than as a base wage. This gives the company flexibility when business suffers a downturn. By not paying a bonus one year, they can reduce wage costs by (say) 30%. By contrast, the American approach is individualistic. Their method of dealing with an equivalent slump in business is to lay off 30% of the workforce. Both approaches save the same amount of money, but in totally different ways.

During the 1960s-1980s, Japan enjoyed rapid growth rates similar to those enjoyed by China from 1980 to the present. The 'Japanese economic miracle' was held in awe by Westerners, and their paternalistic management style with its emphasis on the achievements and welfare of the group was held by many to be superior to the more individualistic American approach. However, since 1989 Japanese growth rates have been entirely average and if anything Japan has moved closer to the American model than the other way round. Performance-related pay (known as 'seikashugi') has become common, and the declining number of permanent, full-time employees have been matched by a growing number of workers on fixed-term or part-time contracts.[4]

The point to be made is that there is not simply just one way of being an effective leader. The cultural assumptions of the country in which you operate, the character and skills of your employees and the leader's own experience and personality will all have a bearing on how leadership works out in practice. In the sections below, we look at two common models of leadership, which are known as 'democratic' and 'autocratic' styles.

Democratic leadership

It's 1975 and two college dropouts are racing to create software for a new line of "hobbyist" computers. The result? A company called "Micro-Soft"—now the fifth-most-valuable corporation on earth. In an adaptation from his memoir, the author tells the story of his partnership with high-school classmate Bill Gates, until its dramatic ending in 1983.[5]

So begins the May 2011 edition of the magazine, Vanity Fair, at the start of an article by Paul Allen, co-founder of Microsoft. The article is based on his book Idea Man, published in 2011, and charts the early course of Microsoft, of which the author was a 36% shareholder to Bill Gates' 64%.

In the early days of Microsoft, a handful of very clever people worked impossibly long hours to seize the opportunity that they saw opening up before them. The majority were programmers, the people who write the software that was – and is – the core business of the company. This is what Paul Allen says about Gates' leadership style:

Good programmers take positions and stick to them, and it was common to see them square off in some heated disagreement over coding architecture. But it was tough not to back off against Bill [Gates], with his intellect and foot tapping and body rocking; he came *on like a force of nature. The irony was that Bill liked it when someone pushed back and drilled down with him to get to the best solution. He wouldn't pull rank to end an argument. He wanted you to overcome his scepticism, and he respected those who did. I saw this happen again and again. If you made a strong case and were fierce about it, and you had the data behind you, Bill would ... look down and mutter, "O.K., I see what you mean," then try to make up. Bill never wanted to lose talented people. "If this guy leaves," he'd say to me, "we'll lose all our momentum."*[6]

This is what is known as a **democratic leadership** style. Bill Gates didn't insist on everyone falling into line behind a decision that he alone had taken. Rather, he had the confidence to believe that out of a free discussion the best solution to any particular problem would emerge. John Wood in Leaving Microsoft to Change the World explains how he took the same lesson from his time at Microsoft and used it in his charity Room to Read:

[At Microsoft] employees had carte blanche [permission] to argue with anyone, about anything, regardless of where each person sat in the corporate food chain... [At Room to Read] I was sometimes taken aback when new team members challenged me. But I reminded myself that we had hired smart people, and that any decision arrived at after vigorous debate would be better than one decided by simple fiat of the top dog...[7]

This shows that one reason for allowing employees to argue the case with you is that you are much more likely to arrive at the best solution if everyone in a position to contribute has the opportunity to do so. But there are other reasons too. Leadership is not just about arriving at the best decisions, but also about encouraging your most able people to stay with you rather than go and work somewhere else. And able people are unlikely to stay if their views are consistently over-ridden. After all, what is the point of being capable of taking effective decisions if you are rarely given the opportunity to do so? John Wood puts it like this:

At Microsoft I had learned that the only way to grow quickly, but sustainably, was to hire smart people with strong work ethics, give them bold and specific goals, and stay out of their way.[8]

This element of democratic leadership is known as **delegation**, the handing over of decisions to those occupying a less senior position than you do. Without a willingness to delegate on the part of the entrepreneur, no business can grow very far. The reason should be obvious. As a business grows there comes a time when one person is simply unable to know every detail and take every decision. Yet many entrepreneurs are unable to let go. The business landscape is full of companies which should be growing but have hit a ceiling. They are dominated by the founder, who insists on deciding every detail personally. Any talented person who goes to work there soon discovers there is little opportunity to use their abilities, and quits. James Caan describes the delegation principle perfectly, "If a job is worth doing, get somebody really good to do it". Here he gives an example from early on in his career:

I was never going to enjoy a detailed analysis of the numbers. Thankfully, there was a woman called Penny working with me who loved that kind of detail, and so I made it her job to work out the margins or the commission. It has been one of my strengths always to recognise my weaknesses, and another of my strengths is being able to find people like Penny.[9]

Underlying the principle of democratic leadership is the concept of equality. This doesn't mean that people have equal abilities (they don't), nor that they should earn equal amounts of money regardless of their contribution. Rather, it means that, at a fundamental level, you recognise people as sharing a common humanity, and treat them accordingly. John Wood speaks admiringly of his Microsoft boss in the 1990s, Steve Ballmer. Despite the fact he was worth in the order of $10,000 million, he took a personal interest in, and showed a care for, his immediate employees. John Wood comments:

Too many executives demand allegiance from their employees without making the effort how best to earn it ... I try to show loyalty through a large number of small acts. It might be dropping by an employee's birthday party, or surprising Emily, a fellow wine nut, with a great bottle of South African Pinotage. Writing an anniversary card. Buying books that team members might enjoy. I hope that my gang knows that I am thinking about them, and paying attention to *their satisfaction in working at Room to Read. Steve Ballmer's lesson – that loyalty is a two-way street – will permeate Room to Read for as long as I run it, and hopefully even after I hand over the reins.*[10]

It might be thought that a democratic leadership style means that you are soft. Aren't bosses meant to be tough? Indeed they are – and some decisions cannot properly be shared nor delegated. But it takes courage to open decisions to question and debate, and strong leaders will be prepared to do this on the many daily occasions when employees have something to contribute to the discussion. The decisions will be better, and the boss will gain respect, not lose it. Having said that, there is no escaping responsibility. If a decision is yours to make then you carry the responsibility for it, no matter how many people you consult along the way.

Autocratic leadership

The opposite of democratic leadership is **autocratic leadership**, a situation where decisions are taken by one person, the autocrat. In political terms, such a leader is known as a dictator. Dictators are, in the popular imagination, associated with immense egos and ruthless behaviour – with a Hitler or a Stalin. As the nineteenth century historian and politician, Lord Acton, famously said, "Power tends to corrupt, absolute power corrupts absolutely".[11] However, in a business setting an autocratic style may well be successful. One exceptionally talented and hard-working individual with a clear vision of what he or she wants to achieve may be able to drive a business forward with exceptional speed. Staff will still be used as information-gatherers for the boss, but the boss alone retains all significant decision-making powers.

There are limits to a democratic management style. The more people who participate in a decision, the more likely it will be that a compromise will emerge, a decision whose chief virtue is often that no-one dislikes it rather than that it charts a new and daring course of action. A decision regarding the best way to write a piece of software may benefit from discussion among a small group of experts from which a consensus emerges. By contrast, a decision that involves closing down a company's IT department, laying off the staff and outsourcing the work is much more difficult to arrive at on the basis of a wide-ranging discussion. People will get hurt, and the temptation will be to go for a compromise solution.

Robert J Herbold, an executive with a career at Proctor & Gamble and then Microsoft, puts it like this:

Effective leaders must be bold enough and brave enough to make tough choices. Sounds simple enough. Yet chances are that you have experienced a situation where, as a manager of a group (or department, division or whole company), you know what you have to do, but you also know that these steps will be unpopular ... People might lose their jobs. Your boss might not be happy. And so on. A lot of managers face these tough issues and waffle, becoming paralysed with indecision. They delay, analyse further, make massive compromises, ignore the whole thing, or employ another tactic to deal with the whole situation. This lack of courage, this total inaction action, is what destroys companies.[12]

There are always going to be situations where quick thinking and decisive action are required for the sake of the company's long-term success. Somebody has to decide what to do, perhaps in a relatively short space of time. The person who has to make the decision will need to gather the facts, almost certainly ask for input from other senior management – but ultimately make their own decision. The example below comes from the aftermath of the September 11th 2001 terrorist atrocity, when airline passengers abandoned flying in droves and all airlines faced significant losses in revenue. Richard Branson of Virgin had some difficult decisions to make:

Decent leadership is about explaining clearly and unemotionally why a decision has been taken ... we had to relay the bad news. Reluctantly, we were letting 1,200 Virgin Atlantic people go. It was the first mass redundancy in Virgin's history. We offered our people *part-time work, job sharing and unpaid leave. We also tried to find them work in other parts of the business. Our managers made tough decisions that hurt many people, but we promised to get them back on board as soon as conditions improved – and, thankfully, most returned.*[13]

The reality is that there is less difference between a democratic and an autocratic style than is sometimes supposed. If democratic leaders are to avoid being simply weak, then they will have to make tough choices all the time, and sometimes very quickly. Consultation may well take place with some – but it can never be with everyone, once the company has more than a handful of employees. Similarly, autocratic leaders never operate entirely on their own. There is always a trusted inner circle of advisers on whom the autocrat relies for information and for ideas. The difference may boil down to a matter of personality and presentation. Does the leader want to keep an emotional distance from their staff, to project a certain mystique in order to engender a healthy respect, or even fear? Or do they want to come across as approachable, always ready to engage with people, their reputation as a leader depending on their open performance rather than on hidden powers?

Finally, another way of looking at leadership styles is to identify the different types of decision that lend themselves to one style rather than the other. For example, the quicker a decision has to be taken, the fewer people will be consulted along the way. Equally, a major strategic decision can only properly be taken in consultation with others while a less important day-to-day operational decision may be best taken by one person with relevant experience. Figure 3.1 gives some examples of these principles.

Democratic decisions more likely when:	**Example**	**Autocratic decisions more likely when:**	**Example**
Making a new decision	Move to new office premises	Enforcing an existing decision	Give staff a deadline by which to pack their desks
Decision requires skilled input	Company draws up plans for a new Headquarters with architects	Decision requires limited skills	Site manager given architect's plans and told to get on with it
Strategic (long-term) decision taken	Move into China	Operational (short-term) decision taken	Buy some Mandarin Chinese phrase books
Senior management involved	A basic employment contract is drawn up for staff	Middle management involved	An individual holiday request is approved or rejected
There is plenty of time	New office stationery is designed	Time is short	Order new stationery supplies when in danger of running out
Decision does not adversely affect existing staff	Working out whether new staff need to be hired	Decisions which might adversely affect existing staff	Deciding if staff need to be made redundant

Figure 3.1 Autocratic and democratic decision-making

However, a lot still depends on the personalities involved. All the decisions in the 'democratic' column could be taken by just one person. Equally, all the 'autocratic' examples could be taken after extensive consultation. Only when time is *really* short, such as when a fire breaks out, or an aeroplane is off-course, are decisions made instantly (and autocratically) by the person authorised to do so.

The story is told in the time of ancient Greece of a man travelling from Sparta to Athens, two cities some 150 miles apart. On the way he met a man travelling in the opposite direction who asked him, "Tell me, sir, what are the Spartans like?" The man from Sparta replied, "First, tell me what the Athenians are like." "Alas", the Athenian said, "they have little to recommend them. The best are lazy, the worst dishonest. They are a surly bunch with a tendency to see the worst in everyone. It makes living there quite trying. Indeed, it is on account of their bad habits that I have decided to leave my native birthplace, and try my luck in Sparta. I hope you have a better account to give me of life there?" "On the contrary", the man from Sparta replied, "I regret to inform you that you will find the Spartans exactly the same."

Leaving his chance acquaintance somewhat discouraged, the man from Sparta proceeded on his way to Athens. A little further along the road, he met another man from Athens – and he too wanted to know what the Spartans were like. "First, tell me what the men of Athens are like", the man from Sparta said. "Why, a more delightful set of people you will never meet", he replied. "Once you make friends with them, nothing is too much trouble. They have a great love of life and will debate any subject endlessly over a flagon of wine. It is a thousand pities that my business means that I must leave Athens for a while. But you were going to tell me what the men of Sparta are like?" The man from Sparta replied, "I am happy to inform you that you will find the Spartans exactly the same."

The lesson is, of course, that our view of our fellow citizens is often reflected back to us. If we think of them as unreliable and untrustworthy we will often have our views – or our prejudices – confirmed. Equally, if we expect to find openness and generosity our expectations will become a self-fulfilling prophecy more often than not.

With regard to leadership, our approach to employees will in part be determined by our view of human nature. If our attitude is that employees are essentially out for maximum money for minimum effort, then our leadership style will be strong on close supervision, disciplinary procedures and establishing a distance between ourselves and the workforce. We will be more autocratic in our approach. In terms of Maslow's hierarchy of needs, mentioned at the beginning of Chapter 2, this view sees employees as being motivated primarily by their bodily, financial and security needs: the sorts of needs that are met by a pay cheque, by their wage. Alternatively, if our general view of employees is that they are eager and willing, seeking to use their talents and develop new ones, then our leadership style will be one of seeking to involve them in decision-making and encouraging them to take on more responsibility. Our leadership style will be more democratic, as we recognise (in terms of Maslow's hierarchy) that our employees are being motivated by their need to be respected and to find creative outlets for their abilities.

It is, of course, important to be realistic. A leader or manager may well join a new company, and find that the employees are very much less willing and helpful than he or she is used to. However, it is also the case that our attitudes to others are often reflected back to us, and the manager who takes a risk in the responsibility given to an employee is often rewarded, as the employee rises to the challenge. That is the lesson of the story of the man from Sparta.

The modern application of this principle to business was first made over half a century ago by **Douglas McGregor** in 1957, in his article The Human Side of Enterprise.[14] He referred to the management approach based on an underlying mistrust of employees as **Theory X**, and the approach based on a more positive view of human nature as **Theory Y**. Basing his analysis on the work of his colleague Abraham Maslow (see Chapter 2), he reasoned that the Theory X approach failed to work because human beings whose basic bodily needs have already been met were no longer primarily motivated by the need to keep a roof over their head and food in their stomachs. Unless managers – so he said – recognised that employees were looking for an outlet for their creative abilities at work, then managers would never get their best performance:

Management by direction and control ...fails under today's conditions to provide effective motivation of human effort towards organisational objectives. It fails because direction and control are useless methods of motivating people whose physiological [bodily] and safety needs are reasonably satisfied and whose social, egoistic, and self-fulfilment needs are predominant.[15]

McGregor thought that the required change in management approach would take time. If employees were used to being told what to do, then it would at first be difficult for them to rise to new challenges:

Theory X places exclusive reliance upon external control of human behaviour, whereas Theory Y relies heavily on self-control and self-direction. It is worth noting that this difference is the difference between treating people as children and treating them as mature adults. After generations of the former, we cannot expect them to shift to the latter overnight.[16]

The differences between Theory X and Theory Y as summarised by McGregor[17], are shown in Figure 3.2.

Theory X	Theory Y
The average man is by nature indolent [lazy] – he works as little as possible ... He lacks ambition, dislikes responsibility, prefers to be led.	The motivation, the potential for development, the capacity for assuming responsibility ... are all present in people.
He is inherently [naturally] self-centred, indifferent to organisational needs.	People are not by nature passive or resistant to organisational needs. They have become so as a result of experience in organisations.
He is by nature resistant to change.	Management should be a process of creating opportunities, releasing potential, removing obstacles, encouraging growth, providing guidance.

Figure 3.2 McGregor's Theory X and Theory Y, as told by himself

Douglas McGregor's fundamental principle was that "a satisfied need is not a motivator of behaviour". Where it is necessary for people to work long hours in a factory simply to have enough food to eat, then their concentration and energies will be focussed on their task, and Theory X will provide an adequate explanation of their behaviour. We may see this at work in the large-scale factories and call centres of poor countries today, where the obedient repetition of a set task produces the required result both for the company in terms of profits, and for the worker in terms of survival.

But equally, where these fundamental needs have been met, workers will look for more from their jobs and a wise management will seek to ensure that that 'more' is forthcoming. This will benefit both sides. Staff will be more fulfilled in their work, and owners will get staff who are engaged in that work at a deeper level.

In conclusion, we may see the growing dominance of the Theory Y approach as a natural consequence of economic growth similar to the dominance of service industries in advanced economies. On the one hand, as countries grow richer so the number of purely routine jobs falls and an ever greater proportion of jobs demand real initiative on the part of their holders. On the other hand, increasing educational levels and the meeting of basic material needs mean that workers themselves have a psychological need for those greater levels of responsibility. It is testimony to the enduring power of McGregor's thesis that it remains as relevant today as when it was first introduced over 50 years ago.

One of the best summaries of leadership is provided in Robert Ashton's book The Entrepreneur's Book of Checklists[18]. The 'ten things the best bosses have in common' are:

- Big ears – good bosses not only listen, they take a genuine interest in their staff.
- Long legs – be seen to be interested and involved; walk around the place, visit customers.
- White teeth – smiling bosses make people happy. If the problem is not one your staff can help you solve, keep it to yourself.
- Dirty hands – in most small businesses, there are always grotty jobs like unblocking toilets. If you lead from the front, others will follow.
- An open door – at times you need to be left alone and not everything you do can be shared, but being accessible is the best way to know what's happening.
- Good vision – people only follow leaders who know where they're going.
- Tongue control – emotional responses, such as shouting and ranting, have their place but not if it means humiliating your staff. Sometimes it's best to hold your tongue.
- Strong stomach – remember how officers led their men to certain death in the battles of the Somme? Like them, you must not let your fears show.
- Firm hand – you are the boss. You are expected to make unpopular decisions where necessary and to be firm with those who don't pull their weight.
- Love – we are all human. We all like to be loved; good bosses show true love and compassion. Being heartless and brutal will not make you rich.

Questions for thought

3.1 If you ever run a company yourself, would you like a Japanese-style level of commitment between yourself and your workforce, or would you prefer a more arms-length, American-style contractual relationship? Explain your reasoning.

3.2 In the romantic comedy *You've Got Mail*, Tom Hanks is asked by his business partner whether to hire Meg Ryan as a store manager. "She lacks the killer instinct", Tom Hanks replies, "when did she ever fire anyone?" Is a streak of ruthlessness a necessary characteristic for every potential leader? Why (not)?

3.3 The spectrum of leadership behaviours between the autocratic and democratic poles has been described as *Tells, Sells [i.e. Persuades], Consults, Shares and Delegates*. Where do you think your natural style of leadership lies within this range? Ask some friends the same question about yourself. Comment on any differences in view.

3.4 McGregor's view was that Theory X amounted to "treating people as children". Should we deduce from this that a Theory X approach on the part of teachers will produce the best results in the school classroom?

3.5 Does Robert Ashton's ideal boss sound autocratic or democratic? A believer in Theory X or Theory Y? Explain your answer.

3.6 Looking at the Case Study, would you a) like to employ someone with General Colin Powell's philosophy to run a company you owned, and b) work under someone with his philosophy? Explain your reasoning.

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Chapter 14
Break-even revenue level

EXTRACT FROM THE SPECIFICATION FOR CHAPTER 14

"Identification of the contribution from a potential range of products or services. Identification of break-even revenue. Assessment of whether the break-even revenue level is achievable. Desired margin of safety."

At the end of this chapter you should be able to explain:

- What the break-even sales level, and the break-even revenue level mean
- What is meant by the contribution, and the gross profit margin
- The formulas for the break-even sales level, and break-even revenue level
- A break-even sales revenue / sales level graph
- The connection between the break-even revenue level, and the
  - salary of the entrepreneur
  - size of the overheads
  - size of the contribution
  - amount of start-up finance required
- How you would assess whether break-even is attainable, and what would be a sensible margin of safety

Introduction: G Wizz Courier Services Ltd

When discussing the sources of finance in Chapter 12 we introduced the concept of breaking even, of making neither a profit nor a loss. Achieving the break-even level of sales is an important milestone for a new company. Typically it takes time to build up sales after the initial launch, and there is an uncomfortable period during which losses are being made, and the business is reliant on external finance.

It is essential that, during the planning stage, the entrepreneur comes to a very clear understanding of what the break-even level of sales is likely to be, and how long it is likely to take to achieve that level of sales. Only then can he work out how much finance he is going to need to cover that period. We discuss these vital issues with reference to G Wizz Courier Services Ltd, which is introduced in the accompanying Case Study. The figures used are for illustrative purposes only: they are not the actual figures of the company.

Using the figures from the Case Study, how many parcels does G Wizz Courier Services Ltd need to handle to break even, to get to a position where it is neither making a profit nor a loss? If it does no business at all, then it bleeds cash at a rate of £720 per working day, paying for an office and an office staff to sit around doing nothing. But then every

Case Study

G Wizz Courier Services Ltd

Note: the figures contained in this Case Study and subsequently are for illustrative purposes only and do not represent the actual figures of G Wizz Courier Services Ltd.

Andy Laidler left school with 3 A levels, and then studied Music at Newcastle University. Partially sighted from childhood, he worked as a musician in a church for seven years, before spending one year in the NHS as a Transport Planner. He then lost virtually all his sight, and can now only distinguish light from darkness.

In 2010, he launched G Wizz Courier Services Ltd after 18 months of careful planning. He needed approximately £200,000 for the venture since he planned to employ 4 staff from the launch date in an office equipped to handle up to 700 orders per day.

The business model is that of a 'freight forwarder'. Small enterprises and residential customers book their parcel delivery online through the G Wizz Courier Services Ltd website at www.gwizzcouriers.co.uk ; and then a major national delivery company such as UPS or City Link both collects and delivers the parcel. UPS/City Link offer very large discounts to G Wizz in recognition of the volume of business sent their way; and G Wizz takes a cut in return for finding the work, managing the customer and providing insurance. UPS/City Link need a massive volume of parcels to justify their national network, but – having set up that network – the additional cost of handling extra parcels is very low. This is why they are prepared to offer G Wizz such low prices and why they in turn can add on a profit margin and still offer a really good deal to the final customer.

Most of the £200,000 required came from Andy's own resources and those of his family. The business also received £36,000 in grants. FIN (Financial Inclusion Newcastle), a North East government agency, provided £3,000 for computers; while the North East of England Investment Centre (NEEIC) provided government cash for marketing consultancy (such as design of logo, website and development of the brand), and legal and accountancy set-up costs. Obviously this type of money is only available to someone with a serious business plan in the first place, and significant additional financial resources.

Furthermore, as a visually impaired person, Andy could get the additional financial support required on account of his disability. This paid for sophisticated computer software that would read out to him any computer screen, and also taxis and a guide when he is out of the office visiting businesses which Andy hopes to sign up for the service. This support is available through Access to Work, a government scheme designed to help people with disabilities in the workplace.

The cost of running the office for a year comes to £180,000, or £720 for each of the 250 working days in the year. These expenses include salaries for Andy and his staff together with employers' National Insurance contributions, office rental and equipment lease, utilities and business rates - and a high-powered internet connection that can deal with a large volume of traffic.

A typical job might be one where the customer is charged £10-00, and the unit variable costs for G Wizz Courier Services Ltd come to £7-00. These might consist of £6-00 for the national delivery company and £1-00 for insurance - leaving G Wizz with £3-00 for every parcel handled. Within seven months of launch, G Wizz had broken even.

See Questions 14.1 and 14.2 at the end of the chapter

time an order comes in, G Wizz Courier Services Ltd makes £3.00 on the deal. In order to break even, it needs enough orders for these surpluses of £3.00 to add up to

£720.00. In other words, it needs £720 ÷ £3 = 240 parcels per working day. This amounts to one parcel every two minutes over an eight hour (480 minutes) day.

How can they handle that volume of business with just four staff in the office? This is where the magic of IT comes in. The customer has to enter all the details of the sender, the recipient, the parcel and the credit card payment on the G Wizz Courier Services Ltd website. Depending on how often the customer sends parcels this might take anything from three to ten minutes – but the important thing is that it is not the G Wizz staff who are spending their time on this task of data entry. The information will then be automatically transferred to the computer system of the relevant national courier such as UPS or City Link. Then their computer will automatically assign the pick-up to a particular van at a particular time, and work out the van's best route around all its pick-ups. The staff at G Wizz will never have to spend any time at all on the vast majority of parcels. They are there to deal with any problems, queries or complaints, while Andy is there to market the service to potential customers, manage the business on a daily basis and set the strategic direction of the company.

How to calculate break-even

THE BREAK-EVEN SALES LEVEL

From the above example, it is relatively straightforward to arrive at a formula for the **break-even sales level**. The pieces of information we have to know are just three. We need to know the fixed costs, or overheads, of the business. Then we need to know the price at which the goods sell, and their unit variable cost. From these last two pieces of information we can work out the **contribution** that each sale makes towards meeting the fixed costs. So in the case of G Wizz Courier Services Ltd, the price of delivering a typical parcel was £10.00 and the unit variable cost was £7.00, leaving a contribution of £3.00. We then work out how many lots of £3.00 is needed to make up £720 by dividing £720 by £3. The formula is as follows:

BREAK-EVEN SALES LEVEL = OVERHEADS ÷ CONTRIBUTION

So in this case we get,

BREAK-EVEN SALES LEVEL = £720 PER DAY ÷ £3 = 240 PARCELS PER DAY

We can check this answer by working out what the costs and revenues at this sales level actually are. The variable costs will be £7 x 240 = £1,680. Add those to the overheads (fixed cost) of £720, and we get daily total costs of £2,400. Now the revenue is the price of one parcel (£10) multiplied by the volume of parcels sent (240), giving a daily revenue of £2,400. The costs and the revenue balance exactly, so the profit is zero. The company has just broken even.

We do of course need to be careful that we stick with the same time period throughout. In this case we worked out the break-even sales level on a daily basis. However, we could equally well have worked it out on an annual basis by multiplying the overheads by 250, which is approximately the number of working days in the year. Then we would get:

Break-even sales level = £180,000 per year ÷ £3 = 60,000 parcels per year

This is, of course, the same figure as you would get if you multiplied the daily break-even sales level of 240 by the number of working days in a year of 250.

THE BREAK-EVEN REVENUE LEVEL

Another way of looking at break-even is to express the concept in terms of the turnover, or revenue, of the business, rather than the number of physical units sold. We have already seen in the case of G Wizz Courier Services Ltd that if they shift 240 parcels a day at £10 each, then they achieve their **break-even revenue level** of £2,400 a day. The formula for working out the break-even revenue level is simply:

BREAK-EVEN REVENUE LEVEL = (OVERHEADS ÷ CONTRIBUTION) X PRICE

Using the annual figures for G Wizz, this becomes:

BREAK-EVEN REVENUE LEVEL = (£180,000 ÷ £3) X £10 = 60,000 X £10 = £600,000

They need to sell over half a million pounds worth of parcel deliveries a year simply to avoid making a loss. However, if this appears daunting it is worth looking at the upside. What does G Wizz Courier Services Ltd stand to gain if sales volumes rise significantly beyond break-even? To look at this, we look at the costs and revenues of G Wizz at different sales levels. Figure 14.1 is similar to Figure 13.1 from the last chapter, but with sales measured in parcels-per-day rather than cakes-per-week.

Parcels per day	Revenue £	Variable cost £	Fixed cost £	Total cost £	Profit £	Annual profit £
40	400	280	720	1,000	-600	-150,000
140	1,400	980	720	1,700	-300	-75,000
240	2,400	1,680	720	2,400	0	0
340	3,400	2,380	720	3,100	300	75,000
440	4,400	3,080	720	3,800	600	150,000
540	5,400	3,780	720	4,500	900	225,000
640	6,400	4,480	720	5,200	1,200	300,000

Figure 14.1 Potential profits for G Wizz Courier Services Ltd (daily figures, except final column)

You can see here the penalty for failing to achieve break-even. At 40 parcels per day the office might seem busy but the business is dead in the water, running through its cash at a rate of £150,000 a year. Unless business picks up it will soon have used up the £200,000 initial investment. Even at 140 parcels per day, the business is in a situation that cannot be sustained in the long term.

However, the productive capacity of the office-of-four is 700 parcels per day, so volumes up to this figure will be possible – provided Andy rushes around enough businesses signing them up for the G Wizz Courier Services Ltd parcel delivery service. And if G Wizz manages to hit 640 parcels each day, about 90% of its 700 parcels-a-day capacity, its owners will be making about £300,000 a year. Not bad for a £200,000 investment, and three or four years of very hard work.

Finally, is there any particular advantage in looking at break-even in terms of the break-even revenue as opposed to the break-even sales level? When, as in the case of G Wizz Courier Services Ltd, only one product is being sold then it is probably simpler to view the business objective in terms of the break-even sales level – in this case how many parcels per day need to be transported. However, where a company has a wide product portfolio then it is not practical to summarise the sales objective in terms of numbers of physical goods.

Consider the store manager, for example, who will think in terms of achieving a daily (or monthly) revenue rather than a daily or monthly number of goods sold. If, say, every £1 worth of goods sold costs the store 75 pence to buy from their suppliers, then the contribution is 25 pence per pound, which amounts to 25% of the selling price. This figure of 25% is also known as the **gross profit margin**, which is simply the contribution expressed as a percentage of the selling price. If the overheads were £10,000 a month, the break-even revenue level could be worked out from the following formula:

BREAK-EVEN REVENUE LEVEL = OVERHEADS ÷ GROSS PROFIT MARGIN = £10,000 PER MONTH ÷ 25%

Whichever formula is used for break-even revenue will give you the same result. So if, for example, the store in question was Poundland where everything sells for £1, then the break-even revenue level could also have been worked out as follows:

BREAK-EVEN REVENUE LEVEL = (OVERHEADS ÷ CONTRIBUTION) X PRICE = £10,000 PER MONTH ÷ £0.25) X £1 = 40,000 PER MONTH X £1 = £40,000 PER MONTH

BREAK-EVEN GRAPHS

Both the break-even sales level and the break-even revenue level may be illustrated with a simple graph showing sales levels on one axis and costs and revenues on the other.

In Figure 14.2, we plot the daily revenue and total costs of G Wizz Courier Services Ltd measured against the number of parcels sold per day. The numbers used are identical to those in the previous table.

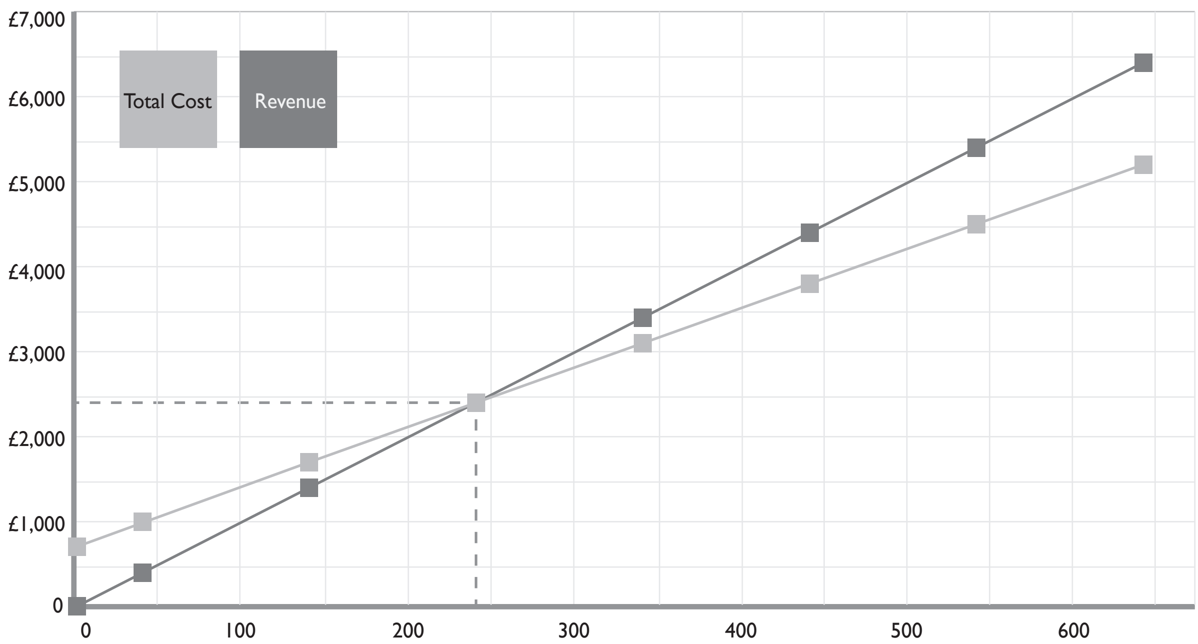

Figure 14.2 G Wizz Courier Services Ltd daily costs and revenues, measured against parcels per day

The continuous line measures revenues going from zero if no parcels are delivered that day up to £6,400 for 640 parcels. Costs, meanwhile, start at £720. Measured by the dashed line, this £720 is the daily fixed costs (overheads) of running the office even if no parcels are delivered. Then, for every parcel delivered, the total cost rises by £7, which is the amount of the unit variable cost.

The point where the lines intersect represents break-even. On the x-axis you can see that the break-even sales level is 240 parcels per day. On the y axis you can see that the break-even revenue is £2,400 per day – the amount of money G Wizz Courier Services Ltd receives for delivering those 240 parcels at £10 each.

Should the entrepreneur relax when break-even is reached? Not at all! No money has yet been made: indeed, the company will be nursing accumulated losses from the previous months. Reaching break-even is rather like achieving your target AS grades. It is an accomplishment justly to be celebrated –but one which only makes sense in the context of further goals yet to be achieved. As we have already mentioned, if G Wizz Courier Services Ltd manages to operate at close to full capacity then there is the potential to generate profits in the order of £300,000 a year.

THE TIME PERIOD OVER WHICH TO MEASURE BREAK-EVEN

In the case of G Wizz Courier Services Ltd, we looked at both daily and annual figures. Then for Poundland we used a monthly example, and for The Gosforth Cake Company weekly figures. Is there any benefit in choosing one time period over another? It all depends on the nature of your business. For a business relying on volume like G Wizz, hoping for a few hundred orders every day, then it makes sense to think of break-even in terms of daily and weekly targets. Especially in the early days when the business is not yet secure, the entrepreneur will want to know how well the company is doing on a daily basis.

If, on the other hand, your business relies on a few very big orders – a house builder, perhaps – then the monthly or quarterly (three monthly) sales figures might be more relevant. A few days or even weeks going by without taking any orders would be entirely normal. Equally, sales people who go out of the office to visit their prospective clients are normally given monthly sales targets: it would be a waste of time to insist on daily targets when one day might be mostly taken up with travel. On the other hand, someone involved in telesales might well be expected to hit daily and weekly targets.

It may be that during the pre-launch planning phase of a new business, entrepreneurs will think in terms of annual break-even sales or revenue levels. However, the problem with an annual target is that, by the time you fail to hit it, too much time has already been lost. If, for example, you are on course to fail your AS levels then discovering that next August is really too late! You need to know while there is still a chance to put things right. It is therefore advisable for entrepreneurs (and others) to break down long-term targets into much smaller chunks. Fifty weekly targets are usually easier to hit than a single annual target. Some businesses – like our house builder – will find this process harder to do than others. In such circumstances, a large part of the skill of management is setting realistic weekly targets so that everyone – staff and management alike – know whether they are on track.

BREAK-EVEN AND THE SALARY OF THE ENTREPRENEUR

In the case of small business start-ups it is often the case that the biggest overhead is the time of the entrepreneur. In such circumstances we cannot arrive at the break-even level without knowing what value to put on this time. When considering The Gosforth Cake Company, we assumed that the entrepreneur, Richard Linfoot, paid himself a salary of £500 a week with other overheads being £200, making £700 a week in all. With the cakes selling for £10 and a unit variable cost of £2.50, the contribution is £7.50. The break-even sales level is £700 per week ÷ £7.50, which rounds up to 94 cakes per week. However, if Richard was prepared to forego a salary, then the break-even sales level falls to £200 per week ÷ £7.50, which is just 27 cakes per week.

Which is the better way of looking at break-even? It really depends on whether Richard needs a salary from the business or not. If he was running the business in his spare time while holding down a full-time job then the lower figure of 27 cakes per week might make sense. Equally, if he had taken early retirement and was living on a pension then the same argument would apply – as it would if his spouse earned a big enough salary for the family, and he perhaps combined his work baking cakes with childcare.

However, if the only way he could avoid paying himself a salary was by running down his savings, then the situation would not be sustainable – unless he had enormous savings. The company accounts might be showing a profit, but this would only be achieved at the cost of his personal accounts unravelling.

In conclusion, the definition of break-even for small businesses depends crucially on what value is placed on the entrepreneur's time, and specifically how much of a salary he needs. Of course, in the case of more ambitious business models, where the entrepreneur's salary is only a small part of the total overheads then his salary becomes less significant in the calculation of break-even. G Wizz Courier Services Ltd, for example, has overheads in the region of £180,000 a year. It makes relatively little difference to the break-even sales level whether Andy Laidler pays himself an annual salary of £25,000 or £50,000.

BREAK-EVEN AND A MARGIN OF SAFETY

Achieving break-even is a vital landmark in the history of any company. Until it is achieved the business is loss-making, and therefore reliant on outside finance to keep trading. It is therefore common sense when planning a new business to factor in some margin of safety, so that you don't run out of cash before break-even has been achieved. Overheads might rise unexpectedly, and so might the variable costs. In the case of G Wizz Courier Services Ltd, £6 out of the £7 which makes up the unit variable cost is spent on just one type of supplier, the national delivery companies. There are not many of these, so G Wizz is heavily reliant on keeping on good terms with them. If they chose to increase their charges from £6 to £7.50, then G Wizz' contribution from each sale would halve from £3 to £1.50. Unless G Wizz increased its prices to get some of that contribution back, then its break-even sales level would double to (£720 per day / £1.50 =) 480 parcels a day.

This illustrates a general principle: companies with slim gross profit margins (in this case 30% – that is £3 out of every £10 order), are particularly vulnerable to increases in costs, or reductions in the price their customers are prepared to pay. In a literal sense, they do not have much 'margin' for error.

However, the major unknown for any new company is the rate at which sales will build up. G Wizz Courier Services Ltd achieved break-even after seven months well ahead of schedule; a year might have been a realistic target. The question then is, how much finance will be needed to cover the losses of the company until break-even is achieved? In the case of G Wizz Courier Services Ltd its annual overheads are £180,000, and it started off with £200,000 in the kitty. To keep the figures simple, let's suppose that just £20,000 of this was used for start-up costs (the actual figure is likely to have been rather larger), leaving £180,000 to finance the losses until break-even was achieved. If the company made no sales at all then it would have run through all its money in exactly a year. If, alternatively, it had taken a year to achieve break-even sales and had built up its sales steadily over that first year, then the average level of sales over the first year would have been exactly half the break-even level. It would have used £90,000 out of its £180,000 reserve. At that point, as sales continued to rise, the cash flow would turn positive and Andy Laidler could breathe a sigh of relief. The other £90,000 would never be needed.

In fact, it makes sense for a new business venture like this to have a cash reserve that is about double what you think you will need. So many things can go wrong with any new venture. Having got that cushion of extra cash in place, Andy very sensibly pulled out all the stops and raced to hit break-even as fast as possible.

Cost structures and breaking even

Given that achieving break-even is essential for the survival of any business, it is worth asking on what this break-even actually depends. With the formula showing that the break-even sales level equals the overheads divided by the contribution the answer is straightforward:

- The break-even sales level is proportional to the size of the overheads. So if you double the overheads then, other things equal, you double the sales you need to make before achieving break-even.
- The break-even sales level is inversely proportional to the contribution. So if

you double the contribution then, other things equal, you halve the sales you need to make before achieving break-even.

It is possible to classify businesses according to their cost structure, and this gives some idea of what revenue they will need to achieve to break even, as well as the scale of their initial financing requirement. In the sections which follow, we look at three common types of business.

ONE PERSON BUSINESSES OPERATING FROM HOME

Taken to its logical conclusion, a business with zero overheads will have a zero break-even sales level. This could be illustrated by a private tutor giving lessons at home, and being supported by a day job or a pension. Even if he gives no lessons one year he isn't out of pocket: the business has still 'broken even' – though we might question whether this was really a business at all. The moment he gives one lesson, the business has turned a profit – unless of course there were some minor overheads incurred in taking out advertisements to sell his services.

We have already seen how when an entrepreneur is running a one person business from home the size of the overheads – and so the break-even sales level – is primarily determined by the size of salary which the entrepreneur requires. As well as The Gosforth Cake Company, we have looked at a number of examples of this type of business. There was Jon Cook's Brown & Cook professional handymen business of Chapter 5, a Kumon franchise (Chapter 9), Lindsay Brown's writing business (Chapter 10) and Julie McGrane's Leading Learning (Education) Ltd (Chapter 11).

In each case, the definition of break-even essentially depends on what the entrepreneur considers to be a reasonable personal income. Financing costs to start up and achieve break-even for all these businesses are likely to have been small, in the range of £5,000 to £15,000.

BUSINESSES WITH SMALL PREMISES EMPLOYING A HANDFUL OF PEOPLE

Operating from business premises and employing people (other than on a casual basis) immediately changes the feel of a business. You are responsible for other people's welfare and income, and then there are leadership issues to consider, which we discussed in Chapter 3. Additionally, you have significant overheads and therefore need to achieve a much higher level of sales to make the business viable – in other words to hit the break-even sales level.

What sort of figures are we talking about? From October 2011, the UK National Minimum Wage was £6.08 per hour[1], roughly £243 for a 40 hour week or £12,600 a year. On top of this, the cost of employers' National Insurance contributions, renting their work space, paying business rates and leasing their equipment will probably double this to around £25,000. So if your business requires four full-time staff, together with premises, this is likely to cost you a minimum of around £100,000 a year in overheads. If you need your staff to have a range of skills commanding salaries above the bare minimum, then £200,000 a year would be more realistic.

What will your break-even revenue be then? If you are in a 'volume' business like G Wizz Courier Services Ltd (or a retail outlet for that matter) you are likely to have a relatively low margin. With a margin of 25%, a business with overheads of £200,000 will need a revenue of (£200,000 ÷ 25% =) £800,000 to break even. Other examples of this sort of business that we have looked at are Centre Space in Chapter 6 acting as brokers between shopping malls and exhibitors, and Spinnaka in Chapter 11 acting as brokers between mortgage lenders and surveyors. At the other end of the spectrum, a business with a high gross margin of perhaps 80% – like a private children's nursery – would need (£200,000 / 80% =) £250,000 to break even.

The point is this: even small businesses employing perhaps four people need an annual turnover (i.e. revenue) in the range of a quarter of a million to one million in order to break even, never mind making a profit. If a year's overheads are needed to finance the business up until break-even is achieved, then we would be looking at £200,000 to start such a business. Additionally, there is a serious risk of such a business never achieving break-even, and the money which has been invested being lost for good.

BUSINESSES THAT ONLY WORK IF THEY ARE LARGE

Tesco started life in 1919 when Jack Cohen sold groceries from a market stall in London and opened its first store in 1929. It now has over 5,000 stores worldwide.[2] Facebook started life in 2004 with membership restricted to Harvard students, and now has 750 million users.[3] At the time when they started their businesses they both hit break-even in the space of a year or two. Otherwise they would not have survived. However, it is doubtful whether any entrepreneur could now follow in their footsteps with the same business model which they adopted. In the case of Tesco, it is so much cheaper to buy food from farmers in bulk that there is no way that a supermarket with just one store could hope to compete. In the case of Facebook, social networking sites only work if large numbers of people are signed up to them, so it would be all but impossible to set up a site in direct competition.

What, then, would be the break-even sales level for a supermarket in Britain today? It is difficult to say, but we would probably be looking at one with a few hundred stores and a turnover of several hundred million pounds. The smaller supermarket chains which have been successful, such as Aldi and Waitrose, have done so by focussing on one particular end of the market, and even Waitrose has over 240 stores.

Once we are considering businesses with break-even revenues of several hundred million pounds, then we are no longer talking about a business opportunity available to any but the wealthiest entrepreneurs. Rather, the opportunities are most likely to be taken up by existing large and successful companies. Only they are likely to have sufficient assets and future income streams to be able to finance – whether internally or externally – the development of the new business idea until it breaks even. In Chapter 9, we saw how Mars was prepared to operate at a loss in China for a full 12 years in order to establish its position as the provider-of-choice in China's emerging market for chocolate. Only a large and profitable global company such as Mars could afford many tens of millions of pounds in losses, while taking a strategic view of where its future profits would come from.

The other potential provider of finance on this scale is the government. We have already mentioned in Chapter 9 how the Humber Bridge failed to break even as vehicle crossings fell far below expectations. Not that the government is alone responsible for poor investment decisions. The Channel Tunnel, which was built over 1988-94 and was privately financed, has never broken even due to a failure to calculate overheads properly. While the business model assumed it would cost £5 billion to build, the final bill came in at £9 billion. Largely financed by loan capital, the subsequent interest payments on the bigger-than-expected loan created a fixed annual cost of such a size that even 17 years later break-even has not been consistently achieved.[4]

CONCLUSIONS

You will need to consider the following questions before embarking on any business where there is a definite point of commitment, such as giving up regular employment or investing substantial sums of money. Before you 'burn your boats' ask yourself:

- What goods or services do I intend to sell?
- What are realistic prices for these goods, what will their variable cost be – and so what will their contribution be?
- What level of sales can be achieved, and how long will it take to get there?
- What will be the monthly fixed cost of running a business on this scale?
- What, therefore, will the break-even level of sales be?
- Taking account of any one-off start-up costs, and a substantial margin for safety, how much financing will be required and where will it come from?
- Assuming break-even is achieved, what is the potential upside in the business, and is it enough to make the risks worthwhile?

Unless you can come up with detailed and convincing answers to all these questions, then the gamble simply isn't worth it. You should pursue conventional employment, or look for a lower-risk business opportunity.

Questions for thought

14.1 G Wizz Courier Services Ltd started up with four full-time employees. Why do you think it was necessary to do this? Wouldn't it have made better sense to start off with one employee and wait for business to build up before employing others?

14.2 Why do you think the national delivery companies such as City Link and UPS are prepared to accept bulk business from G Wizz Courier Services Ltd at a knock-down price of £6 a parcel in return for G Wizz finding customers and looking after them? Wouldn't it make more sense for the national companies to do this work themselves, and take 100% of the customers' money?

14.3 Imagine you set up an online specialist monthly magazine which costs you £10,000 a month to produce. Variable costs are negligible.

a. Anyone can take out an online subscription for £8 a month. Using the formulae, work out the break-even sales level, and the break-even revenue level.

b. Now suppose you intend to make your site available free of charge and fund it by advertising. Every 10th visitor clicks on an advertisement and the advertisers pay you 20 pence per click. How many individual visits to the site do you now need each month to break even?

c. Comment on your answers to a) and b).

14.4 Under what circumstances might a business properly view the cost of staff salaries as a variable cost, rather than a fixed cost?

14.5 Are there any psychological and/or financial advantages in 'burning your boats' by committing to a business venture with a real possibility of substantial loss?

CHAPTER 14 ENDNOTES

1 *Direct Gov*, see http://www.direct.gov.uk/en/Employment/Employees/TheNationalMinimumWage/DG_10027201 as at 10 September 2011
2 *Wikipedia*, see http://en.wikipedia.org/wiki/Tesco as at 10 September 2011
3 *Wikipedia*, see http://en.wikipedia.org/wiki/Facebook as at 10 September 2011
4 *London South East*, see http://www.lse.co.uk/FinanceNews.asp?ArticleCode=alk3namntzrahy2&ArticleHeadline=FACTBOXKey_facts_on_Channel_Tunnel as at 22 September 2011

GLOSSARY

Introduction

The glossary contains about 300 common economics and business terms. These have been highlighted the first time they have been used in the main text. You need to know the the 200 terms with an asterisk (*) against them for the Unit 1 examination. The remainder will be helpful for your general understanding – and will be of use as you study further Units of your course – but are not essential for the immediate examination.

A

* For **adding value**, see **value added**.

Going into **administration** is an option for a company facing financial difficulty. The directors hand over the running of the company to a professional 'administrator', who is often an accountant. He will try to keep the company trading. If this is not possible, he will close the company, while seeking to pay back the firm's **creditors**.

Analysis paralysis is the tendency to avoid making decisions and acting on them by always seeking to acquire more information before deciding. This is a particular temptation for clever people.

The **Annual General Meeting (AGM)** is the annual meeting of shareholders within a business. It is the ultimate authority within the business, and may appoint and dismiss the **directors**, who run the company.

Ansoff's matrix is a summary of the four basic expansion options faced by any company. These options are created by considering expansion through new or existing products in new or existing markets. These result in **consolidation**, **product development**, **market development** and **diversification**.

* The **appreciation of a currency** is the rise in value of one currency in terms of other currencies.

* **Autocratic leadership** is the **leadership style** associated with one person making most of the decisions, with minimal consultation.

Bait pricing is an illegal **pricing strategy** based on offering goods for sale at a very low price, then saying they are sold out, and offering a more expensive alternative.

* The **Bank Rate** is the **interest rate** at which the Bank of England will lend money to commercial banks. These banks will then charge higher rates of interest to their customers.

* **Bias** describes the situation where the **sample** is not an accurate reflection of the **population**. This might either arise because there was a flaw in the method by which the sample was chosen, or because many of the chosen sample were not available for interview.

A **bias for action** describes the mind-set that seeks to arrive at decisions quickly, and then act on them immediately. It is an important quality for every entrepreneur, and the opposite of **analysis paralysis**.

Blue skies thinking describes creative thinking designed to expand the horizons of what is thought possible, without much thought for what is immediately practical.

* A **bond** is a piece of paper promising to repay money, which has been borrowed, on the **date of redemption**, and also to pay an agreed **interest rate**. Bonds may be issued by government to finance the **National Debt**. They are also issued by major companies to finance expansion, in which case they are called **debentures**.

* A **boom** is a period where the rate of **economic growth** is significantly above the underlying long-term trend.

* To **break even** is to sell just enough goods so that a loss is avoided, but no profit is made. One of the first targets of any new business is to achieve the **break-even sales level**.

* The **break-even revenue level** is the **sales revenue** a company needs to achieve in order to **break even**. The break-even revenue level equals the **break-even sales level** multiplied by the average price at which goods sell.

* The **break-even sales level** is the number of goods a company has to sell to **break even**, i.e. to avoid making a loss.

* A **budget** is a forecast of future income and expenditure. Any household or company may construct a budget, but ‘the budget’ normally refers to the government’s annual budget.

A **budget deficit** is the extent by which expenditure is forecast to be greater than income. Almost every year the UK government runs a budget deficit.

A **budget surplus** is the extent by which income is forecast to be greater than expenditure. In the case of the UK government, budget surpluses are unusual: a **budget deficit** is much more common.

* A **business angel** is a wealthy individual who is willing to invest money in new business ideas in return for a share of the **equity** of the business. Business angels are providers of **risk capital**.

* The **business cycle** is the irregular pattern of **booms** and **slumps**, which is superimposed on the underlying **economic growth** rate. Also called the **economic cycle**, it is a feature of every industrial economy.

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