# Understanding business activity

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Business activity

1.1 The purpose and nature of business activity

- Business involves organizing and combining resources into firms to produce goods and services to satisfy needs and wants of consumers.
- Resources, or factors of production, are used to make goods and services.
- Resources are scarce. There are not enough to produce everything we need and want. We must choose between alternative resources.
- Resources include land (natural resources), labour (human effort), capital (man-made resources) and enterprise (the knowledge and skills people need to own and run business organizations).
- Resources are inputs to productive activity and products (goods and services) are outputs from productive activity.
- Specialization involves individuals and business organizations focusing resources on the limited range of productive activities they perform best. Without specialization, far fewer goods and services would be produced. There would be far fewer business and employment opportunities and incomes and living standards would be much lower.
- Business activity adds value to resources by using them to produce goods and services that are more desirable to consumers.
- Firms owned by private individuals are private enterprises. Most firms aim to make a profit but some, like charities, engage in non-profit making activities.

Consumers – people and organizations who are willing and able to buy goods and services.
Consumption – the using up of goods and services to satisfy consumer needs and wants.
Production – using resources to make goods and services to satisfy consumer needs and wants.
Factors of production – productive resources used to make goods and services.
Firms – organizations that produce goods and services.

Entrepreneur – a person with the know-how and willingness to take the risks and decisions necessary to set up and run a business.
Opportunity cost – the benefit lost by not consuming or producing the next best alternative product.
Specialization – focusing production on a single or limited range of products in order to make the best use of scarce resources.
Division of labour – the dividing up of a production process into a number of sequential tasks, with each one completed by a different worker or group of employees.

Customers – consumers who buy goods or services from business organizations.
Revenue – proceeds from the sale of goods and services to customers.
Profit – a surplus of revenue over costs of production.
Value added – the difference between the price of a product and the cost of the natural and man-made materials, components and resources used to make it.
ACTIVITY 1.1

Look at the pictures below. Use them to discuss with your fellow students.

- Which pictures show items you need for survival and which show items you simply want to enjoy?
- Which pictures show someone consuming a good or service?
- Which pictures show someone producing a good or service?
- What do you understand by the term "business"?

What is business?

Have you used or bought any goods or services recently? Some food perhaps, new clothes, a book or a computer game? Did you buy these items from a shop or purchase them from an online retailer using the Internet? Without business activity many of the goods and services we buy and enjoy would not be available.

Few people are self-sufficient and able to make all the things they need or want for themselves. Instead we rely on business activities to provide the goods and services we need and want. The food we eat, the houses we live in, the roads we travel on, the schools we attend, the television programmes we watch, the health care services we use are all examples of goods and services provided by business activity.

People and organizations consume goods and services

We are all consumers because we demand goods and services to satisfy our needs and wants.

When we consume food we are satisfying our need to eat. Similarly, when we listen to music we are satisfying our want for entertainment.

In the same way, business and government organizations consume power and use machinery and component parts to make other goods and services.

Consumption therefore involves using up goods and services to satisfy our needs and wants.
Productive resources are used to make goods and services

Production involves using resources to make goods and services that satisfy our needs and wants.

Resources are the inputs to productive activity while products are the outputs of productive activity. Products can be physical goods such as cars and clothes, or services including banking, health care and retailing.

The resources used to produce goods and services are also known as factors of production. There are four factors of production.

- **Land** or all natural resources, including plants, animals and fish, forests and water, oil and gas, metals and other mineral and ore deposits. For example, sand is used to make glass and oil is used in petroleum, plastics and paints.

- **Labour** is the human effort needed to make goods and services.

- **Capital** refers to man-made resources, such as machinery, computers and tools, that are used in the production of other goods and services.

- **Enterprise** refers to the knowledge, skills and desire some people have to own and run business organizations.

People who run or work in business organizations are producers.

Resources are organized into firms to produce goods and services

One day you may want to start your own business and become an entrepreneur. If your business is successful it will earn you a profit.

Entrepreneurs are producers with enterprise. They have the know-how and willingness to take the risks and decisions necessary to set up and run a business. They combine and organize resources into firms to produce goods and services.

A firm is an organization involved in productive activity.

There are many millions of different firms in the world today. Some are small and run by just one person called a sole trader. Other firms may be very large and have many thousands of owners called shareholders spread across many different countries.  

![Diagram of productive resources and business activity]
Private and public enterprises provide goods and services

Lilliana owns and runs a self-service laundry on a small island in the Caribbean. She used all her savings to buy the washing machines, laundry dryers and other equipment she needed to start her business. Lilliana’s laundry is an example of a **private enterprise**.

In contrast, the government of her country supplies water to households and businesses using equipment and other resources it owns or employs. A government-owned water supplier is an example of a **public enterprise**.

Firms owned by private individuals are called **private enterprises** but some business organizations are owned and controlled by governments. Different local, regional and national government authorities may combine and organize resources to produce goods and services, including building roads and bridges, providing hospital care and national defence. Business organizations that are wholly or partly owned and controlled by government are **public enterprises**. > 1.2.2

Needs, wants and scarcity

**Productive resources are scarce**

The news headlines to the left all highlight a major problem: there is just not enough land, labour, capital or enterprise in the world to make everything we need and want.

We all need food, clean water and some shelter from the extremes of weather in order to live safely and to survive. But we also want fashionable clothes, DVD and music players, cars, overseas holidays, insurance and banking services and much more. Just imagine if we could list everything that everyone in the world wanted. The list would go on forever!

Our wants are without limit, and as the world population grows so too our demands grow for different goods and services. Yet there is only a limited supply of factors of production available to public and private enterprises to make goods and services. That is, resources are scarce compared to our needs and wants.

**People and organizations must choose what to produce and consume**

As there are not enough resources to produce everything we need and want we must make choices.

Consumers must choose what goods and services they want to consume.

Producers must choose what goods and services to produce, the best way of producing them and who to produce them for, as there will not be enough to satisfy the needs and wants of everyone.

Every business and every country in the world must therefore choose how best to use scarce resources to satisfy as many needs and wants as possible.
Opportunity cost is the cost of choice

The true cost of something is what you have to give up to get it. This cost is called the opportunity cost.

For example, before Lilliana opened her self-service laundry in the Caribbean she had to choose between using all her savings and the small plot of land she owned to build a house and using them to build premises and buy the washing machines, laundry dryers and other equipment she needed to start her business. Before she decided to invest her savings in a laundromat, Lilliana had also considered opening a small bakery.

Lilliana therefore had to choose between a number of alternatives. First of all she decided not to use her plot of land and savings to build a house. She then decided against buying the mixers, ovens and other resources she needed to start and operate a local bakery. In both cases Lilliana gave up these opportunities to start a laundromat instead.

This is because Lilliana wanted to be her own boss and thought if she worked hard and provided a good service to local people she would make more money each year from her laundromat than she would from working in an office or a shop or from owning and running another business.

In exactly the same way, a government may have to choose between using scarce productive resources to build a new road and using them to build a new school. If the new road is built it will benefit many motorists and businesses, but many children will have to go without the benefit of a local school.

Because we do not have enough resources to satisfy all our needs and wants we are always forced to choose between alternatives. The benefit we go without by not producing or consuming the next best alternative is our opportunity cost.

Like Lilliana, we all must choose how best to use scarce productive resources.
The importance of specialization in business and production

Most modern producers specialize in the production of a single or limited range of goods or services

As resources are scarce it is vital that we make the best use of them to produce as many goods and services as possible and therefore to satisfy as many needs and wants as we can. To do this most modern producers specialize in the production of only those goods or services they are best able to given their skills and interests.

- Businesses specialize in the production of one particular good or service. For example, a car manufacturer specializes in the production of cars, a bank specializes in the provision of financial services and a supermarket specializes in buying and selling food and household goods to consumers.

- Workers specialize in a particular occupation or skill. For example, a teacher specializes in the provision of educational services, a bricklayer specializes in construction and a mechanic specializes in the repair of motor vehicles. In return they earn wages and salaries they can use to buy the goods and services they need and want but are unable to produce themselves. > 2.1.2

In contrast, many of our ancestors had to be self-sufficient, for example by growing and hunting the food they needed, making their own tools, building their own shelters, weaving cotton and wool to make clothes and producing cooking pots from clay. As a result they produced very little of each because it took so long to produce each item from start to finish and because they lacked all the different skills, equipment and resources they needed.

For example, just to make a spade our ancestors had to find, collect and cut the wood they required by hand, make rope to bind the different parts together or shape metal to produce the blade separately and make some nails to fix it to the handle. The entire production process was very slow and could take many days, even a week or more, before a finished spade was ready to dig soil to plant seeds to grow food.

It was not long therefore before people began to recognize how difficult it was trying to do so many different things at the same time. People had different skills and abilities and access to different resources. It was far better therefore for each of them to concentrate on the productive activities they were best able to perform.

For example, some people were better at making spades and pots while others were more skilled at hunting and fishing. Similarly, some villages were located on good farmland while others were located in woodland areas able to supply wood or in areas capable of being mined for iron and tin.

People and communities therefore began to specialize in different productive activities. As a result they were able to produce far more than they did before. They would then trade their different goods with each other so that each person or community could obtain the items they needed or wanted but could not produce for themselves.
**Specialization** therefore required trade and so businesses began to develop, such as bakeries that produced bread and cakes for sale, butchers selling meats and also toolmakers and shoemakers. As output expanded further and different goods and services became available, trade increased and more and more businesses formed and expanded.

Specialization is now widespread in every modern economy. It involves individuals and organizations focusing their resources on the limited range of productive tasks they perform best in order to maximize their productive efficiency. It is important because without specialization far fewer goods and services would be available to trade today, there would be far fewer business and employment opportunities, and incomes and living standards would be much lower.

Increased specialization in modern business has been made possible for the following reasons.

- We now exchange goods and services for money which has made trade much easier.
- Specialized machinery and equipment has been developed and is widely available to improve the quality of goods and services as well as the speed at which they are delivered. > 3.3.5
- The production of many goods has become automated using computer-controlled machinery and industrial robots to carry out specific tasks.
- People have developed more and more specialized skills.
- International specialization and trade means we are now able to buy many different goods and services from all over the world. > 6.3.1

**Specialization involves the division of labour into specific tasks**

Modern specialization involves dividing up the production process for any given good or service into a number of sequential tasks.

Doing this has helped increase the speed and quality of many production processes and greatly increased the amount of goods and services that can be produced with scarce resources. This is because each task in a given production process can be performed by different machines, equipment and workers devoted to that particular task. This is called the **division of labour.** > 4.1.2

By completing the same task over and over again each worker becomes more and more skilled at doing so. For example, in the early days of the car industry one employee would put together an entire engine. Then Henry Ford decided to divide up the work involved into 84 different operations, so that 84 employees were needed to build a whole engine instead of just one person. However, it meant many more engines and therefore cars could be built each day. The very first Model T Ford car was produced in 1907 and took over 12 hours to assemble. After Henry Ford had divided up his production process and labour into a set of sequential tasks, a completed Model T Ford rolled off the assembly line at the rate of 1 every 10 seconds each working day. As output increased, the price of cars came down and the wages of the workers and profits of the manufacturers went up.
While the division of labour has many clear advantages it also has a number of downsides that can harm production and profitability in modern businesses.

<table>
<thead>
<tr>
<th>Advantages of labour specialization</th>
<th>Disadvantages of labour specialization</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Employees can make best use of their particular talents and skills.</td>
<td>✗ Individuals must rely on others to produce the goods and services they want but cannot produce themselves.</td>
</tr>
<tr>
<td>✓ Employees can increase their skills and experience by repeating tasks.</td>
<td>✗ Workers can become bored doing the same job or completing repetitive tasks. The quality and efficiency of their work may fall.</td>
</tr>
<tr>
<td>✓ Employees can produce more output and reduce business costs if they concentrate on the same job or tasks.</td>
<td>✗ Many repetitive manual tasks are now undertaken by computer-controlled machinery and robots. This has reduced job satisfaction for many workers and reduced employment opportunities for many low-skilled workers.</td>
</tr>
<tr>
<td>✓ More productive employees can earn higher wages.</td>
<td></td>
</tr>
</tbody>
</table>

**How business adds value to productive resources**

**Value is added by satisfying customer needs and wants**

Business involves organizing and combining resources to make final outputs that are more desirable to consumers. Each business specializes in the production of a single or limited range of goods or services it is best able to supply to consumers given the skills and resources available to it. In this way, a business adds value to the resources it uses.
The **value added** by a business activity is the difference between the price paid for a product by a consumer and the cost of natural and man-made materials, components, tools and equipment used to make it.

For example, Java Crafts in Indonesia adds value to solid teak and mahogany wood, and to other resources such as tools, glues, waxes and varnishes, by making high-quality handmade and antique reproduction furniture that is sold to consumers all over the world.

The skilled designers and furniture makers at Java Crafts buy the wood, waxes and other resources they need to make furniture from other businesses. Imagine that it costs Java Crafts $400 to buy the resources it needs to produce a dining table and four chairs. If Java Crafts can sell the table and chairs for $1000 the business will have added $600 to the value of these resources.

The consumer who pays $1000 to buy the set of furniture becomes a personal customer of Java Crafts. However, there are many different businesses producing tables and chairs so Java Crafts must compete with them to attract customers. Offering better value and service than rival firms can help the furniture maker achieve this. > 1.5.1

A business that fails to attract customers will be unable to sell its products and will not add any value to the resources it has used.

### ACTIVITY 1.2

**BP** is one of the world’s largest petroleum and petrochemicals businesses. It employs many thousands of people and owns drilling platforms, pipelines, oil tankers, refineries, petrochemical plants and retail outlets all over the world.

Crude oil is a raw product produced by drilling into natural reserves deep underground. It is a complicated mixture of different natural chemicals. These can be isolated and produced for sale by heating up or refining the crude oil. They include diesel fuel, jet fuel, gasoline, grease, heavy fuel oil (used in boilers and to “fire up” coal-burning power stations) and a product called “Naphtha” that is used to make many different petrochemical products including resins and solvents.

1. Give examples of natural and man-made resources used by BP to produce petroleum and petrochemical products.

2. What evidence is there about how BP “adds value” to the resources it uses to produce petroleum and petrochemical products?
Understanding business activity

Value is added by providing employment and incomes

If a business can sell its products for much more than the cost of the natural materials and man-made items used to produce them then it can use this money to employ workers and still make a profit for the business owners.

Business organizations pay people wages and salaries to work in their factories, offices, shops and other places of production to produce and sell their goods and services. In this way value is added to their labour. This is because if they were unemployed they would not be productive and would not be paid wages or salaries.

Business activity therefore “adds value” to labour by creating jobs and incomes for people.
The purpose of business activity

Combining and organizing resources to produce goods and services

We have now looked at all the reasons for business activity. Here is a summary of why business activity is needed.

- Few people are self-sufficient and able to make all the goods and services they need and want. We therefore rely on business activity to produce goods and services to satisfy our needs and wants.
- Productive resources need to be combined and organized to produce goods and services.
- Productive resources are scarce and we cannot produce enough to satisfy all human needs and wants. Businesses therefore help to determine what goods and services to produce, how to produce them and who to produce them for.
- A business can add value to the resources it uses by specializing in the production and supply of one or more goods or services that consumers want and are willing to pay for.
- Businesses pay the owners of factors of production to supply their resources, including the payment of wages and salaries for labour. People use their income to buy the goods and services they need and want from different business organizations.
The purpose of most business activity is to make a profit

How do entrepreneurs earn an income from owning and running a business?

Unlike labour, entrepreneurs do not get paid a wage or salary. Instead they aim to make a profit by selling the goods or services they make at a price greater than the total cost of producing them including wages and other payments to employees. Profit motivates entrepreneurs to run businesses.

1.5.1

- **Costs** are incurred by a business because it must buy or hire the resources it needs in order to produce goods and services.
- **Revenues** are earned by a business when it sells goods and services to customers.
- **Profit** is achieved when revenues from selling goods and services exceeds the cost of their production.
- A business will make a loss if its revenues are not enough to cover its costs.

If an entrepreneur makes a loss he or she will be losing the opportunity to earn a profit from producing another good or service instead. Alternatively, an entrepreneur could close the loss-making business and earn a wage or salary as an employee of another business organization. 

2.1.2
Some business organizations do not aim to make a profit

Not all businesses aim to make a profit. Some businesses are non-profit making and have other goals or objectives.

- Charities aim to help people or animals in need, or to protect the natural environment. They rely on donations or gifts of money to pay for their costs.
- Local social or sports clubs are organized and run by their members. They may pay a small membership fee to cover the costs of newsletters and the hire of venues.
- Government organizations may provide public services free of charge, including free health care and bus travel for elderly people and people on low incomes. The cost of their provision is funded from tax revenues.  

Exam PREPARATION 1.1

Sanyu is an apprentice in a large manufacturing company. As well as training on-the-job, he must also attend college one day each week to learn engineering and business skills. Sanyu has read in his business textbook that for a business to be successful and profitable it must add value to the resources it uses. Table 1 is a task from his textbook.

Table 1: Adding value in production

<table>
<thead>
<tr>
<th>Type of business</th>
<th>Raw materials</th>
<th>How value is added</th>
<th>Final product</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paint manufacturer</td>
<td>Minerals to provide different pigments (colours)</td>
<td>Grinding and mixing the minerals with solvents and other chemicals</td>
<td>Cans of paint</td>
</tr>
<tr>
<td>Food processor (ready-made meals)</td>
<td></td>
<td></td>
<td>Meal</td>
</tr>
</tbody>
</table>

a Complete table 1 by identifying one example of a raw material a food processor would use in the production of ready-meals and one example of an activity, method or process the business would use to add value to raw materials. [2]
b What is meant by “added value”? [2]

c If the cost of materials used by Sanyu’s uncle to produce each shirt is $10 and each shirt sells for $30, calculate the value added. [4]
d Identify and explain three ways in which Sanyu’s uncle could try to increase the value added by his business. [6]
e If Sanyu’s uncle is successful at adding value to the resources he uses to produce business shirts do you think that his business will be profitable? Justify your answer. [6]

Before you continue make sure you are able to understand the purpose and nature of business activity:

- the concepts of needs, wants, scarcity and opportunity cost
- the importance of specialization
- the purpose of business activity
- the concept of adding value and how added value can be increased.

Learning CHECKLIST