TYPES OF BUSINESS ACCORDING TO ACTIVITIES

Learning Objective

- To compare and contrast the types of business according to activities

Key Understanding

- Understanding the types of business according to activities including the advantages, disadvantages, and business requirements of each type

Key Question

- What are the types of business according to activities?

Three Major Types of Business

- A *business* is an organization that converts inputs or resources such as material, labor, and overhead into outputs which are usually either goods or services.
- There are three major types of business. These are:
  1. Service companies
  2. Merchandising companies
  3. Manufacturing companies

Service Companies

- **Service companies** are firms that generally use their employees to provide intangible products or services to customers, including professional skills, advice, expertise, and other related products. The primary source of revenues of service companies is the performance of services, often referred to as *service revenues.*
- A law firm is an example of a service company as it provides legal advice to its clients. A school is also considered a service company as it relies heavily on its employees (i.e., teachers) to educate its students. A bus company is a service company though it invests heavily on equipment which are used to perform transportation services. Other examples of service companies are banks, accounting firms, and hospitals.

Service Companies

- For service companies, the major phases of their *operating cycle* include paying out money for employees and other operating expenses, performing the services, and collecting cash payments from customers.
- To illustrate, consider FDG & Co. which is an accounting firm. In order to conduct its business, it hires its employees who are highly skilled accountants and who will carry out engagements with the firm's clients. FDG & Co. makes sure that its employees are compensated properly and are given adequate trainings. These employees perform audit, consulting, and tax services for the clients. Consequently, the clients pay for the services rendered. The operating cycle ends when FDG & Co. receives the payment in the form of cash.

Service Companies

Operating Cycle of Service Companies

Cash on hand
Pays employees and other expenses
Performs services
Receives payment from customers

One of the advantages of a service company over the other types of business is the absence of inventory or tangible goods held by the company. Holding inventory entails proper management and control measures which make it costly. Moreover, because service companies produce intangible products, they do not require production facilities and that frees up cash for other important business matters.

Merchandising Companies

- Unlike service companies, **merchandising companies** sell tangible products. This type of business buys finished or almost finished goods from their suppliers and resells the same to customers.
- Merchandising companies primarily earn revenues from the sale of the goods or merchandise, also known as *sales revenue* or *sales*.
- There are two types of merchandising companies – *retailers* and *wholesalers*. A merchandising company that sells goods directly to customers is called a **retailer**. A **wholesaler** is a merchandising company that sells goods to retailers. For instance, the retailer National Book Store buys school supplies from the wholesaler Pilot.

Merchandising Companies

- The *operating cycle* of a merchandising company is typically longer than that of a service company. It starts with the purchase of goods to be held for resale, also known as *inventory*. The company eventually sells the inventory to customers. The cycle ends with the receipt of cash payments. As you can see, the purchase of inventory and its subsequent sale lengthen the cycle.
- As an example, National Book Store buys school supplies from various suppliers such as Pilot, Cattleya, Crayola, and 3M. These school supplies which are inventory of the company are put on the store racks and are sold to customers afterwards. The cycle ends when the cash payments are received by the company.

Merchandising Companies

Operating Cycle of Merchandising Companies

Cash on hand
Buy goods
Stores goods as inventory
Sells inventory
Receives payment from customers

The existence of a tangible product provides a leeway to merchandising companies to make customers notice their products, thereby promoting sales. Relative to service and manufacturing companies, these companies generally consume less conversion time, effort, and cost.

As stated earlier, holding inventory involves cost and this becomes a disadvantage to merchandising companies.

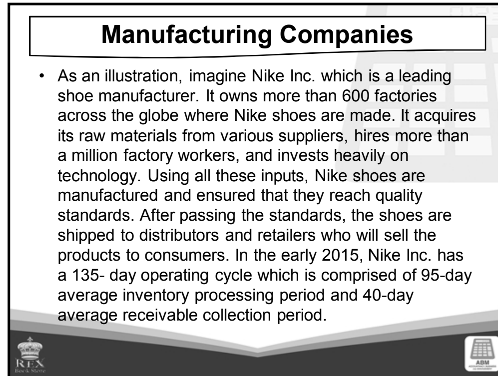
Manufacturing Companies

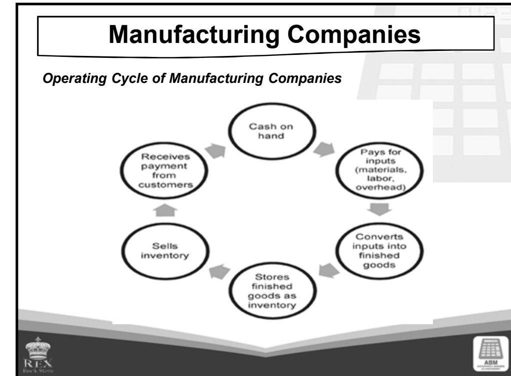
- **Manufacturing companies**, or simply *manufacturers,* are relatively complicated organizations than service and merchandising companies. As the name suggests, manufacturers create their own products. They use raw materials, components, or parts which are processed using machines, computers, and labor to produce finished goods.
- Manufacturers typically employ large-scale production which is done in manufacturing plants. Similar to merchandising companies, they earn revenues primarily from the sale of manufactured products.

Manufacturing Companies

- The products of manufacturing companies can be sold directly to consumers, retailers, and other manufacturers.
- For example, Toyota builds cars and sells them to customers through their dealers nationwide. Meanwhile, Unilever manufactures its products like Dove and Cream Silk and sells them to retailers such as SM and other supermarkets. 3M manufactures adhesives which are bought and used by aircraft manufacturers in creating their own products.

Manufacturing Companies
• Since a manufacturing company produces its own products, its operating cycle generally has the longest period compared to service and merchandising.
• The cycle has an additional phase which is the production of goods. These goods are also held as inventory and later sold to its customers. Likewise, the operating cycle of a manufacturing company ends with the collection of cash payments.


Manufacturing Companies
• As an illustration, imagine Nike Inc. which is a leading shoe manufacturer. It owns more than 600 factories across the globe where Nike shoes are made. It acquires its raw materials from various suppliers, hires more than a million factory workers, and invests heavily on technology. Using all these inputs, Nike shoes are manufactured and ensured that they reach quality standards. After passing the standards, the shoes are shipped to distributors and retailers who will sell the products to consumers. In the early 2015, Nike Inc. has a 135- day operating cycle which is comprised of 95-day average inventory processing period and 40-day average receivable collection period.


Manufacturing Companies
Operating Cycle of Manufacturing Companies
Cash on hand
Pays for inputs (materials, labor, overhead)
Converts inputs into finished goods
Stores finished goods as inventory
Sells inventory
Receives payment from customers

Manufacturing Companies
• One of the advantages of manufacturing one's product is quality control wherein manufacturing companies can ensure that their products meet the standards set. Multiple quality inspections are carried out to detect spoilage and prevent low-quality goods from falling into the hands of the customers. Just like merchandising companies, manufacturers benefit from having products that are easily noticed by customers, thus promoting sales.
• Manufacturers generally need initial capital outlay to run production facilities and that requires large sum of money. In converting the inputs to finished goods, overhead costs such as utilities and rent expense are incurred. These costs require frequent monitoring to make sure that the companies are not overspending or wasting resources. Also, manufacturers need to finance their quality control procedures to avoid product failure costs. Moreover, the existence of inventory implies further costs of managing, handling, and storing manufactured goods.