Image Image

1.1 The nature of business activity

Business activity aims to satisfy people's needs. In order to do this, it requires resources. Businesses operate in a constantly changing world, but the purpose of business owners and managers remains the same: to add value to resources while meeting people's needs.

Purpose of business activity

A business is an organisation that uses resources to meet the needs of customers by providing a product or service that they demand. There are several stages in the production of finished goods. Business activity at all stages involves adding value to resources, such as raw materials, and making them more desirable to – and valued by – the final purchaser. Without business activity, we would all be entirely dependent on the goods that we could make or grow ourselves, as some people in virtually undiscovered native communities still are. Business activity uses the scarce resources of our planet to produce goods and services that allow us all to enjoy a much higher standard of living than would otherwise be possible if we remained entirely self-sufficient.

==customers:== an individual consumer or organisation that purchases goods or services from a business.

What do businesses do?

- Businesses identify the needs of customers.
- They purchase necessary resources to allow production to take place.
- They produce goods and services which satisfy customers' needs, usually with the aim of making a profit. Business activity exists to produce goods or services that meet the needs of customers. Many of these customers will be consumers who purchase consumer goods and consumer services.

==consumers:== an individual who purchases goods and services for personal use.

==consumer goods:== the physical and tangible goods sold to consumers – these include durable consumer goods, such as cars and washing machines, and non-durable consumer goods, such as food, drinks and sweets, that can be used only once.

==consumer services:== the non-tangible products sold to consumers that are not intended for resale – these include hotel accommodation, insurance services and train journeys.

The factors of production needed by businesses

All businesses need resources to be able to operate and produce goods or services. These resources are called factors of production. There are four factors of production:

==factors of production:== the resources needed by business to produce goods or services.

- Land – this general term includes not only land itself but all the renewable and non-renewable resources of nature, such as coal, crude oil and timber.
- Labour – manual and skilled labour make up the workforce of the business.
- Capital – this is not just the finance needed to set up a business and pay for its continuing operations, but also all the manufactured resources used in production. These include capital goodsthe physical goods used by industry to aid in the production of other goods and services, such as machines and commercial vehicles., such as computers, machines, factories, offices and vehicles.
- Enterprise – this is the initiative and coordination provided by risk-taking individuals called entrepreneurs. They combine the other factors of production into a unit capable of producing goods and services. Enterprisethe action of showing initiative to take the risk to set up a business. provides the managing, decision-making and coordinating roles.

Figure 1.2: Timber is a natural resource Figure 1.2: Timber is a natural resource

Figure 1.3: All businesses need labour Figure 1.3: All businesses need labour

Figure 1.4: Capital equipment can be very complex Figure 1.4: Capital equipment can be very complex

Businesses have many other needs before they can successfully produce the goods and services demanded by customers. Figure 1.5 shows the wide range of these needs.

Figure 1.5: The resources that businesses need Figure 1.5: The resources that businesses need

The concept of adding value

All businesses aim to create value by producing goods and services and selling them for a higher price than the cost of bought-in materials: this is called adding value. If a customer is prepared to pay a price that is greater than the cost of materials used to produce a good or service, then the business has been successful in adding value. The difference between the selling price of the products sold by a business and the cost of the materials that it bought in is called added value. Without adding value, a business will not be able to survive as other costs have to be paid and the people investing in the business also expect a financial return.

==adding value:== increasing the difference between the cost of bought-in inputs (materials) and the selling price of the finished goods.

==added value:== the difference between the cost of purchasing bought-in inputs (materials) and the selling price of the finished goods.

The concept of adding value can be illustrated by an example taken from the building industry (see Figure 1.6).

Figure 1.6: dding value by building a house from bought-in materials Figure 1.6: dding value by building a house from bought-in materials

The value added by the business is not profit as other costs must be paid for, such as labour and rent. However, if a business can add value without increasing its costs, then its profit will increase. Here are two examples of how different businesses could add value to their products:

1. Jewellery shop: a well-designed shop window display, attractive shop fittings, well-dressed and knowledgeable shop assistants, and beautiful packaging for each jewellery item. These features might allow for an increase in jewellery prices greater than the extra costs involved.
2. Sweet manufacturer: extensive advertising of the brand of sweets to create an easily recognised name and brand identity, attractive packaging, and selling through established confectionery shops rather than widely available vending machines. Higher prices as a result of successful brandingthe process of differentiating a product by developing a symbol, name, image or trademark for it. should add value.

Economic activity and the problem of choice

We live in a world of great wealth and great scarcity. People with lower levels of income are unable to obtain the basic requirements of life: food, clean water, shelter. They have many unsatisfied needs and wants. Even rich people may not be able to satisfy all of their wants for luxury goods and services. There are insufficient goods to satisfy all of our needs and wants at any one time. This is known as the economic problem.

The purpose of economic activity is to provide for as many of our wants as possible, yet we are still left wanting more. This shortage of products, and the limited supply of resources needed to make them, force us to make choices. As we cannot satisfy all of our wants, we must choose those which will satisfy us now and those which we are prepared to give up. If we are careful and rational, we will choose those things that give us the greatest benefit, leaving out those things that provide less value to us.

This need to choose is not exclusive to people as consumers. All economic decision-makers have to make choices: governments, businesses, workers, charities, and so on.

Opportunity cost

This need to choose the goods we want leads to the important principle of opportunity cost. In deciding to purchase or obtain one item, we must give up other goods as they cannot all be afforded. The next most desired product which is given up becomes the lost opportunity or opportunity cost. This concept exists for all economic decision-makers: consumers, businesses and governments.

==opportunity cost:== the next most desired option that is given up.

Figure 1.7: If consumers choose to buy the smartphone, then the trainers become the opportunity cost Figure 1.7: If consumers choose to buy the smartphone, then the trainers become the opportunity cost

Figure 1.8: If government chooses to build the fighter plane, then the hospital becomes the opportunity cost Figure 1.8: If government chooses to build the fighter plane, then the hospital becomes the opportunity cost

The dynamic business environment

Setting up a new business is risky because the business environment is dynamic, or constantly changing. In addition to the problems and challenges referred to below, there is also the risk of change, which can make the original business idea much less successful. This problem can be made worse if the business plan is too inflexible to deal with changes.

Changes in the business environment include:

- new competitors entering the market
- legal changes – examples include new safety regulations or limits on who can buy the product
- economic changes that leave customers with less money to spend
- technological changes that make the products or processes of the new business outdated. There are many other examples of changes, indicating that the business environment is very dynamic. This can make owning and operating a business quite risky. The changing business environment is a major reason why some businesses succeed and why others fail.

  KEY CONCEPT LINK The dynamic business environment is a major cause of change within businesses. Decision-making by entrepreneurs is often focused on responding to change.

Why do some businesses succeed?

These are the main reasons why some businesses thrive and achieve success in meeting their objectives:

- good understanding of customer needs – leads to sales targets being achieved
- efficient management of operations – keeps costs under control
- flexible decision-making to adapt to new situations – allows investment in new business opportunities
- appropriate and sufficient sources of finance – prevents cash shortages and allows for expansion.

Why do some businesses fail?

Success in business is never certain. This is particularly true when starting up a new venture. The following are the most common reasons why new businesses fail. Most of these reasons also apply to the failure of established businesses.

Poor record-keeping

The lack of accurate records is a common reason for business failure. Many small companies fail to pay sufficient attention to record-keeping. They either believe it is less important than meeting customers' needs or think that they can remember everything. For example, how can the owner of a new, busy florist shop remember:

- when the next delivery of fresh flowers is due?
- whether the flowers for last week's big wedding have been paid for?
- when or even if a business customer has paid for the display of flowers in its reception area?
- how many hours the shop assistant worked last week? With the falling cost of computing power, most businesses, even new start-ups, keep records on computer. It is always advisable to also keep hold of paper records, such as receipts from suppliers, or details of big deliveries. Paper records act as a check or back-up system if the computer should fail. These records can also provide evidence to the tax authorities if they dispute the company's own tax calculations.

Lack of cash

Running short of cash so that day-to-day business operations become difficult is the most significant reason for the failure of businesses. Many new businesses fail to survive the first year of operation due to the lack of cash.

Finance is needed for day-to-day cash, for the holding of inventories, and to give trade credit to customers, who then become debtors. Without this working capital, the business will be unable to buy more supplies, pay suppliers or offer credit to important customers. All these factors could lead to the business closing down.

Cash flow problems can be reduced if:

- A cash flow forecast is made and kept up-to-date. The cash needs of the business can be assessed month by month.
- Sufficient capital is injected into the business at start-up allowing it to operate during the first months when cash flow from customers may be slow to build up.
- Good relations are established with the bank so that short-term cash problems may be financed with an overdraft extension.
- There is effective credit control over customers' accounts to make sure they pay on time.

Poor management skills

Most entrepreneurs have had some form of work experience, but not necessarily at management level. They may not have developed skills in:

- leadership and decision-making
- cash handling and cash management
- planning, coordinating and communication
- marketing, promotion and selling. Entrepreneurs are often enthusiastic, willing to work hard and have abilities in their chosen field. However, these qualities alone will rarely be enough to ensure success.

An entrepreneur opening a restaurant might be an excellent chef but may lack management skills. Some entrepreneurs manage to learn management skills very quickly once their business is up and running, but this can be a risky strategy.

To minimise the risks, a new entrepreneur could gain management experience beforehand through employment or obtain advice and training from a specialist organisation offering management support. Alternatively, some entrepreneurs buy in experience by employing people with management experience. However, as this can be expensive, many newly formed businesses cannot afford this option.

Local, national and international businesses

Local businesses operate in small, well-defined parts of a country. Their owners often do not aim to expand so do not make attempts to attract customers across the whole country. Typical examples are small building and carpentry firms, single-branch shops, hairdressing businesses and childminding services.

National businesses have branches or operations across a country. They make no attempt to establish operations in other countries or to sell internationally. Good examples include large car-retailing firms, retail shops with branches in just one country and national banks.

International businesses sell products in more than one country. This may be done by using foreign agents or online selling.

Multinational businesses have operations in more than one country. This means they have an established base for either producing or selling products outside their own domestic economy.

==Multinational businesses:== a business organisation that has its headquarters in one country, but with operating branches, factories and assembly plants in other countries.

1.2 The role of entrepreneurs and intrapreneurs

A new business idea might have the best available land and labour and be well financed, but without the enthusiasm and creativity of an entrepreneur or intrapreneur, it will almost certainly fail.

==intrapreneur:== a business employee who takes direct responsibility for turning an idea into a profitable new product or business venture.

New business ventures started by entrepreneurs or intrapreneurs can be based either on an innovative product idea or on a new way of offering a service. These ventures can be a new location for an existing business idea or an attempt to adapt a product in ways that no one else has tried before. The role of intrapreneurs in the ongoing success of a business is considered later in this section. The role of the entrepreneur when creating and starting up a new business is to:

- have an idea for a new business
- create a business plan
- invest some of their own savings and capital
- accept the responsibility of managing the business
- accept the possible risks of failure.

Qualities of successful entrepreneurs and intrapreneurs

It is not easy to start up a successful new business. The personal qualities and skills needed to make a success of a new business venture include:

- Innovation: The entrepreneur does not have to be an inventor in the traditional sense. They must be able to identify and fill a gap in the market, attract customers in innovative ways and promote their business as being different from others in the same market. This requires original ideas and an ability to do things differently. This is the skill of innovation.
- Commitment and self-motivation: It is hard work to set up and manage a new business. It may take up many hours of each day. Energy, focus, the willingness to work hard, to be keen and to have the ambition to succeed are all essential qualities of a successful entrepreneur.
- Multi-skilled: An entrepreneur will have to make the product (or provide the service), promote it, sell it and keep accounts. These different business tasks require someone who has many different qualities, is keen to learn technical skills, is able to get on with people, and is good at handling money and keeping accounting records.
- Leadership skills: If the business has employees, the entrepreneur must lead by example and will have to have a personality that encourages and motivates those workers.
- Self-confidence and an ability to bounce back: Many business start-ups fail, yet this would not discourage a true entrepreneur who would have such belief in themselves and their business idea that they would be able to bounce back from any setback.
- Risk-taking: Entrepreneurs must be willing to take risks in order to see results. Often the risk they take is by investing their own savings in the new business.

  KEY CONCEPT LINK Innovation is important for the success of any new enterprise. Offering exactly the same goods or services as existing businesses might not lead to great success.

Barriers to entrepreneurship

There are many barriers that every entrepreneur must overcome to turn their business ideas into reality. Every entrepreneur needs to address the following barriers to turn their business idea into reality. These barriers include:

Lack of a business opportunity

Identifying successful business opportunities is one of the most important stages in becoming an effective entrepreneur. The original idea for most new businesses comes from one of several sources, including:

- an entrepreneur's own skills or hobbies, such as dressmaking or car body-work repairing
- previous employment experience

- franchising conferences and exhibitions offering a wide range of new business start-up ideas
- small-budget market research: for example, the internet allows any user to browse business directories to see how many businesses are offering certain goods or services in the local area. Many new enterprises are set up in the following industries, often because of the entrepreneurs' own skills and the small sums of capital required:
- fishing – from a small boat owned by an entrepreneur
- market gardening – producing cash crops to sell at local markets
- jewellery making, dressmaking and craft work
- building trades
- hairdressing
- computer repairs
- cafés and restaurants
- childminding.

Obtaining sufficient capital (finance)

In an International Labour Organisation survey of new business start-ups, most entrepreneurs said that lack of finance was their main difficulty. So why is obtaining finance such a major barrier for entrepreneurs? This could be due to:

- insufficient savings – many entrepreneurs have limited personal savings
- no knowledge of the financial support and grants available
- no trading record to present to banks as evidence of past business success
- a poor business plan that fails to convince potential investors of the chances of a business's success.

Cost of good locations

When finance is limited, an expensive location should not be considered. It is important to keep the level of output at which revenue covers all costs as low as possible. This increases the business's chances of survival. Operating from home is the most common way for entrepreneurs to establish their business. This keeps costs low, but there are drawbacks:

- It may not be close to the area with the biggest market potential.
- It lacks status – a business with its own impressive premises tends to generate confidence.
- It may cause family tensions.

- It can be difficult to separate private life from working life. New businesses that offer a consumer service need to consider their location carefully. A website designer could operate from home very effectively, as communication with customers will be by electronic means, but a hairdresser may need to obtain premises in an area with the biggest number of potential customers.

Competition

A newly created business will often experience competition from established businesses with greater resources and market knowledge. The entrepreneur may therefore have to offer a more unusual product or better customer service to overcome the low-cost advantages that bigger businesses usually have.

Lack of a customer base

A new business must establish itself in the market and build up customer numbers quickly to survive. The long-term success of the business will depend on encouraging customers to return to purchase products repeatedly. Good customer service could be provided by:

- personal customer service
- knowledgeable pre- and after-sales service
- supplying one-off customer requests that large firms may be reluctant to provide.

Business risk and uncertainty

There are some differences between business risk and business uncertainty. All business decisions involve risk. For example, there is a chance that a new business selling clothing will fail. If, in the last 12 months, 10 clothing retailers have been established in a city and 3 fail by the end of the year, the risk of failure was 30%. A new entrepreneur could possibly reduce the risk of their new clothing business failing by studying why these three businesses did not survive. This would allow the entrepreneur to reduce business risk by avoiding the errors made by the failed businesses. Business planning (see below) is used to reduce risk.

Business uncertainty is different. Uncertainty cannot be foreseen, measured or calculated. Plans may be made by entrepreneurs for the future, but some events will always be unforeseen and impossible to predict. The 2020 COVID-19 epidemic caused such a fall in spending by consumers that many small and newly set-up businesses were forced to close. This is an excellent example of uncertainty that was impossible to forecast and very difficult for any business to prepare for.

Role of enterprise in a country's economic development

All governments use policies that aim to encourage more people to become entrepreneurs. What are the claimed benefits to an economy from successful business enterprise?

Employment creation: In setting up a new business, an entrepreneur is employing not only themselves (self-employment), but also, very often, employing other people too. These workers can include family members or friends. When a new business creates jobs, the national level of unemployment will fall. If the business survives and expands, additional jobs are created in suppliers' businesses.

Economic growth: Any increase in output of goods or services from a start-up business will increase the gross domestic product of the country. This is called economic growth. If enough small businesses are created, economic growth will lead to increased living standards for the population. Increased output and consumption will also result in higher tax revenues for the government.

Business survival and growth: Although a high proportion of start-ups fail, some survive, and a few expand to become very important businesses. These businesses will employ large numbers of workers, boost economic growth and take the place of businesses that may be in decline or closing due to changing consumer tastes or technology. In Trinidad and Tobago, the decline of the sugar industry has been balanced out by the growth of the tourist industry. Tourism has itself been boosted by small guesthouse owners becoming entrepreneurs.

Innovation and technological change: New businesses can be very innovative. This creativity adds dynamism to an economy. Creativity can stimulate other businesses and help to make the nation's business sector more competitive. Many new business start-ups are in the technology sector. The IT services they provide to other businesses can help industries in a country become more advanced in IT applications and therefore more competitive.

Exports: Most business start-ups offer products that meet the needs of local markets. Some will expand their operations to the export market in other countries. This will increase the value of a nation's exports and improve its international competitiveness.

Personal development: Starting and managing a successful business can aid in the development of useful skills and help an individual towards self-actualisation – a real sense of personal achievement. This creates an excellent example for others to follow and can lead to further successful new enterprises that will also boost the economy.

Increased social cohesion: Unemployment often leads to serious social problems and these can be reduced if there is a successful and expanding small business sector. By creating jobs and career opportunities and by setting a good example for others to follow, entrepreneurship can help to achieve social cohesion.

TIP Some questions may ask you to make references to businesses in your own country. While you are studying this course, take a close interest in the activities of new and well-established businesses in your country.

The role of intrapreneurship

Consider these questions:

Do enterprise, creativity and innovation end once a start-up business has become successful?

If they do, then the business will fail to adapt to new conditions and create new opportunities.

Is there any scope for the qualities and characteristics of successful entrepreneurs to be used within existing businesses?

Many successful businesses allow people to take risks and show initiative – just as entrepreneurs do – even when the business is established.

Large companies face many problems in rapidly changing economic times. Businesses must be innovative and need to keep their best managers. Rapid advances in technology allow new business start-ups to disrupt existing markets and business operations. The attractions of entrepreneurship can lead to many dynamic employees leaving a business that does not encourage them to be creative. Hence the development of intrapreneurship. This is the process of encouraging risk-taking and enterprise by employees within a business to help create and develop new opportunities.

'Intrapreneur' is the term given to people who have the same qualities as entrepreneurs and are encouraged to demonstrate the same skills as entrepreneurs within an existing business.

There are three key differences between an entrepreneur and an intrapreneur (see Table 1.1).

Entrepreneur

Intrapreneur

Main activity

Starting up a new business

Developing an innovative product or project within an existing business

Risk

Taken by the entrepreneur

Taken by the business

Rewards

To the entrepreneur

To the business

Table 1.1: Key differences between entrepreneurs and intrapreneurs

The benefits of intrapreneurship to existing businesses include:

- Injecting creativity and innovation into the business – developing new products to increase sales or creating exciting ways of selling existing products.
- Developing new ways of doing business – creativity in solving problems such as low efficiency can be more successful than continuing to use the old ways.
- Driving innovation and change within the business – generating excitement within the business about a new opportunity makes change more acceptable.
- Creating a competitive advantage – by developing more innovative products.
- Encouraging original thinkers and innovators to stay in the business – this is summed up by the expression: 'You don't have to leave our company to become an entrepreneur!'

1.3 Purpose and key elements of business plans

Without some evidence that entrepreneurs have thought about and planned for the future, it is unlikely that bankers, venture capitalists or potential shareholders will invest money in a new business. An effective business plan provides this evidence. The main elements of a typical business plan are:

==business plan:== a written document that describes a business, its objectives, its strategies, the market it is in and its financial forecasts.

- executive summary – an overview of the new business and its strategies
- description of the business opportunity – details of the entrepreneur's skills and experience; nature of the product; the target market at which the product is aimed
- marketing and sales strategy – details of why the entrepreneur thinks customers will buy the product and how the business will sell to them
- management team and personnel – details of the entrepreneur's skills and experience and the people they intend to recruit
- operations – premises to be used, production facilities, IT systems

- financial forecasts – the future projections of sales, profit and cash flow for at least one year ahead.

Benefits of business plans

Business plans are most important when setting up a new business. The main purpose of a business plan for a new business is to obtain finance for the start-up. Potential investors or creditors will not provide finance unless details about the business proposal have been written down clearly.

The business-planning process provides essential evidence to investors and lenders. It makes the finance application more likely to be successful. Business planning also:

- forces the owner to think seriously about the proposal, its strengths and any potential weaknesses
- gives the owner and managers a clear plan of action to guide their actions and decisions in the early months and years of the business. If an entrepreneur started a business with no clear sense of purpose or direction, no marketing strategy and no idea of which employees to recruit, then its chances of success would be much reduced.

Limitations of business plans

Even a detailed business plan does not guarantee a successful business. In fact, it could create a false sense of certainty in business owners. They might rely so much on the plan that they overlook the fact that it is based on forecasts and predictions.

The business plan must be detailed and supported by evidence such as market research. If it is not, then prospective creditors and investors can delay in making a finance decision until the plan is brought up to the required standard.

The plan might lead entrepreneurs to be inflexible. If the dynamic business world throws up new opportunities that are not in the plan, these could be rejected. This could mean that options for future profits and growth are rejected. The best business plans allow for some flexibility as external events change.

Image Image

2.1 Economic sectors

Business activity and ownership can be classified in a number of ways. One of these is by identifying which type of product or service is being produced.

Primary, secondary, tertiary and quaternary economic sectors

Business activity produces a vast range of different goods and services. It is possible to classify these into four broad types of business activity. These broad categories are based on the stages involved in turning natural resources, such as oil and timber, into the finished goods and services demanded by consumers. The stages take place in primary, secondary, tertiaryand quaternary sectors of industry.

==primary:== firms engaged in farming, fishing, oil extraction and all other industries that extract natural resources so that they can be used and processed.

==secondary:== firms that manufacture and process products from natural resources, including computers, brewing, baking, clothes-making and construction.

==tertiary:== firms providing services to consumers and other businesses, such as retailing, transport, insurance, banking, hotels and tourism.

==quaternary sectors:== businesses providing information services, such as computing, web design, ICT (information and communication technologies), management consultancy and R&D (research and development, particularly in scientific fields).

Figure 2.1: Primary production – dairy farm in New Zealand Figure 2.1: Primary production – dairy farm in New Zealand

Figure 2.2: Secondary production – clothing factory in China Figure 2.2: Secondary production – clothing factory in China

Figure 2.3: Tertiary sector – the breathtaking Burj Al Arab hotel in Dubai Figure 2.3: Tertiary sector – the breathtaking Burj Al Arab hotel in Dubai

Figure 2.4: Quaternary sector – research laboratory in India Figure 2.4: Quaternary sector – research laboratory in India

The balance of these sectors in the economies of different countries varies substantially. It depends on the level of industrialisation in each country. Table 2.1 shows the differences between three countries – and the change in importance of these sectors in Ghana since 2008.

Country

Primary

Secondary

Tertiary and quaternary

United Kingdom

1.2

18.1

80.7

China

26.1

27.6

46.3

Ghana

33.8 (52.5)

18.6 (14.2)

47.6 (33.3)

Table 2.1: Employment data in 2019 (2008) – percentage of total employment (quaternary data is included in the tertiary figures)

Changes in relative importance of economic sectors

The classification of business activity by economic sectors has two important features: changes over time and variations between different economies.

The importance of sectors changes over time

The importance of each sector in an economy changes over time. In Ghana (as shown in Table 2.1) the primary sector reduced and the secondary sector increased between 2008 and 2019. The growing importance of secondary sector manufacturing industries in developing countries is called industrialisation. The relative importance of secondary sector activity is increasing in many countries in Africa and Asia.

The relative importance of each sector is measured in terms of either employment levels or output levels as a proportion of the whole economy.

Consequences of industrialisation: benefits

- Total national output (gross domestic product) increases and this raises average standards of living.
- Increasing output of goods can result in lower imports and higher exports of such products.
- Expanding manufacturing businesses will result in more jobs being created.
- Expanding and profitable firms will pay more tax to the government.

- Value is added to the country's output of raw materials, rather than just exporting these as basic, unprocessed products.

Consequences of industrialisation: problems

- The chance of work in manufacturing can encourage a huge movement of people from the countryside to towns, which leads to housing and social problems.
- Imports of raw materials and components are often needed, which can increase the country's import costs.
- Much of the growth of manufacturing industry is due to the expansion of multinational companies. These can have a negative impact on the economy too. In developed economies, the situation is reversed. There is a decline in the importance of secondary sector activity and an increase in the tertiary sector. This process is termed deindustrialisation. In the UK, the proportion of total output accounted for by secondary industry has fallen from 38% to 20% in 25 years. Causes of this change include:
- Rising incomes associated with higher living standards have led consumers to spend much of their extra income on services rather than more goods. There has been substantial growth in tourism, hotels and restaurant services, financial services and other services. However, spending on physical goods has risen more slowly.
- Manufacturing businesses in developed countries face much more competition as a result of increasing global industrialisation. These rivals tend to be more efficient and use cheaper labour. Therefore, rising imports of goods are taking the market away from the domestic secondary sector firms.

Consequences of deindustrialisation

The consequences of the decline in the relative importance of the primary and secondary sectors and the increase in relative importance of the tertiary and quaternary sectors include:

- job losses in agriculture, mining and manufacturing industries
- movement of people towards towns and cities
- job opportunities in service industries – tertiary and quaternary sectors
- increased need for retraining programmes to allow workers to find employment in service industries.

The importance of sectors varies between economies

The importance of each sector varies significantly between different economies. Table 2.1 gives details of the differences that exist between three different countries' economies and the share of total employment accounted for by sectors of industry.

Public sector and private sector of the economy

Industry may also be classified in other ways, for example by public or private sector, or by type of legal structure. These two types of classification are interlinked, as some types of legal structure are found only in the private sector. What is the difference between the private sector and public sector of the economy?

==public:== organisations accountable to and controlled by central or local government (the state).

==private sector:== businesses owned and controlled by individuals or groups of individuals.

In nearly every country with a mixed economy, most business activity is in the private sector. The relative importance of the private sector compared to the public sector is not the same in all countries. Those economies that are closest to a free-market system have very small public sectors. Those countries with central planning command economies will have very few businesses in the private sector.

==mixed economy:== economic resources are owned and controlled by both private and public sectors.

==free-market:== economic resources are owned largely by the private sector with very little state intervention.

==command economies:== economic resources are owned, planned and controlled by the state.

The types and sizes of businesses in the private sector vary considerably. The legal structure of firms in the private sector is covered in Section 2.2.

Public-sector enterprises: public corporations

In most mixed-economy countries, important goods and services are provided by government-owned or state-run organisations as it is argued that they are too significant to be left to private businesses. These public-sector enterprises usually include health and education services, defence, and public law and order (police force). In some countries, important strategic industries, such as energy, water supply and public transport, are also owned and controlled by the state as public corporations.

==public corporations:== a business enterprise owned and controlled by the state – also known as a nationalised industry.

Another reason for the state or public sector, rather than the private sector, to provide products is the existence of public goods. These are goods and services that cannot be charged for, so it is impossible for a private-sector business to make a profit from producing them. A good example is street lighting. It is impossible to exclude people from obtaining the benefit of streetlights even if they have not contributed to paying for them. Why then should anyone contribute directly towards paying for them? Taxes have to be used to raise revenue to pay for a street-lighting system as the lights can only be provided by the public sector.

Public-sector organisations do not often have profit as a major objective. In many countries, the main priority of publicly owned TV channels is to produce public service programmes. State-owned airlines have safety as a priority. If public corporations are sold off to the private sector there will nearly always be a change of objectives towards the profit motive.

Table 2.2 contains a summary of the potential advantages and disadvantages of public corporations.

Advantages of public corporations

Disadvantages of public corporations

• They are managed with social objectives rather than solely with profit objectives.

• Loss-making services might still be kept operating if the social benefit is great enough.

• Finance is raised mainly from the government.

• There can be a tendency towards inefficiency due to lack of strict profit targets.

• Subsidies from government can also encourage inefficiencies.

• Government may interfere in business decisions for political reasons, for example by opening a new branch in a certain area to gain popularity.

Table 2.2: Advantages and disadvantages of public corporations

2.2 Business ownership

Businesses in the private sector may be owned by one person or by many thousands. There are various forms of business ownership, as shown in Figure 2.5.

Figure 2.5: The legal structure of private-sector businesses Figure 2.5: The legal structure of private-sector businesses

Sole trader

This is the most common form of business ownership. Although there is a single owner in this type of business organisation, it is common for sole traders to employ others. However, such firms are likely to remain very small. Because of this, although they are great in number, sole traders account for only a small proportion of the total business turnover of a country.

==sole traders:== a business in which one person provides the permanent finance and, in return, has full control of the business and is able to keep all of the profits.

All sole traders have unlimited liability. This means that the owner's personal possessions and property can be taken to pay off the debts of the business, should it fail. This can discourage some potential entrepreneurs from starting a business. Another significant problem is finance for expansion. Many sole traders remain small because the owner wishes to remain in control of their own business, but another reason is the limitations in raising additional capital. As soon as partners or shareholders are sought in order to raise finance, then the sole trader becomes another form of organisation altogether. In order to remain a sole trader, the owner must be dependent on their own savings, profits and loans for injections of capital.

==unlimited liability:== business owners have full legal responsibility for the debts of the business.

This type of business ownership is most commonly established in the construction, retailing, hairdressing, car-servicing and catering trades. It has several advantages and disadvantages (see Table 2.3).

Advantages of a sole trader

Disadvantages of a sole trader

• easy to set up – no legal formalities

• owner has complete control – not answerable to anybody else

• owner keeps all profits

• owner can choose times and patterns of working

• owner can establish close relationships with staff (if any are employed) and customers

• business can be based on the interests or skills of the owner – rather than working as an employee for a larger firm

• unlimited liability – all of the owner's assets are potentially at risk

• often intense competition from bigger firms, for example in food retailing

• owner is unable to specialise in areas of the business that are most interesting – is responsible for all aspects of management

• difficult to raise additional capital

• long hours are often necessary to make the business pay

• lack of continuity – as the business does not have a separate legal status, when the owner dies, the business also ends

Table 2.3: Advantages and disadvantages of the sole trader legal structure

Partnership

Partnershipsare formed in order to overcome some of the drawbacks of being a sole trader.

==Partnerships:== a business formed by two or more people to carry on a business together, with shared capital investment and, usually, shared responsibilities.

It is usual with all partnerships, although not a legal requirement, to draw up a formal Deed of Partnership between all partners. This provides agreement on issues such as voting rights, the distribution of profits, the management role of each partner and who has authority to sign contracts. However, a partnership agreement does not create a separate legal unit; a partnership is just a grouping of individuals.

When planning to go into partnership, it is important to choose business partners carefully – the errors and poor decisions of any one partner are considered to be the responsibility of all the partners. This also applies to business debts incurred by one partner – in most countries there is unlimited liability for all partners should the business venture fail. Unlimited liability can act as a disincentive for people to become partners in a business. This can limit the capital that partnerships can raise. See Table 2.4 for a summary of the advantages and disadvantages of partnerships.

Advantages of a partnership

Disadvantages of a partnership

• Partners may specialise in different areas of business management.

• They share decision-making.

• Additional capital is injected by each partner.

• Business losses are shared between the partners.

• There is greater privacy and fewer legal formalities than in corporate organisations (companies).

• All partners have unlimited liability (with some exceptions).

• Profits are shared.

• There is no continuity and the partnership will have to be reformed in the event of the death of one of the partners.

• All partners are bound by the decisions of any one of them.

- It is not possible to raise capital from selling shares.
- A sole trader, taking on partners, will lose decision-making independence.

Table 2.4: Advantages and disadvantages of partnership business structure

Partnerships are the most common form of business organisation in some professions, such as law and accountancy. Small building firms are often partnerships, too. Many other owners of businesses prefer the company forms of organisation and these are considered next.

Limited companies

There are three distinct and important differences between companies and the two forms of unincorporated business organisation that we have just studied. These are limited liability, legal personality and continuity.

==limited liability:== the only liability – or potential loss – a shareholder has, if the company fails, is the amount invested in the company, not the total wealth of the shareholder.

Limited liability for owners

The ownership of companies is divided into small units called shares. People can buy these and become shareholders: part-owners of the business. It is possible to buy just one share, but usually shares are owned in blocks, and it is possible for one person or organisation to have complete control by owning more than 50% of the shares. Individuals with large blocks of shares often become directors of the business.

==shares:== a certificate confirming part-ownership of a company and entitling the shareholder owner to dividends and certain shareholder rights.

==shareholders:== a person or institution owning shares in a limited company.

All shareholders benefit from the advantage of limited liability. Nobody can make any further claim against shareholders, should the company fail. This has two important effects:

- People are prepared to provide finance to enable companies to expand.
- The risk of the company failing to pay its debts is transferred from investors to creditors such as suppliers and banks. Creditors, as a result, are very interested in analysing the company's accounts for signs of potential future weakness.

Legal personality

A company is recognised in law as having a legal identity separate from that of its owners. This means, for example, that if the food sold by a company are found to be dangerous or contaminated, the company itself can be taken to court – not the owners, as would be the case with either a sole trader or a partnership. A company can be sued and can itself sue through the courts. This does not take all legal responsibilities away from the managers and owners. For example, directors can be legally responsible if they knowingly act irresponsibly. This includes continuing to trade when the company is illiquid, which means it does not have cash to pay bills.

Continuity

In a company, the death of an owner or director does not lead to its break-up or dissolution. All that happens is that ownership continues through inheritance of the shares, and there is no break in ownership at all.

Private limited companies

The protection that comes from forming a company is substantial. Small firms can gain this protection when the owner(s) create a private limited company. Table 2.5 contains a summary of the advantages and disadvantages of this form of business ownership.

Advantages

Disadvantages

• Shareholders have limited liability.

• The company has a separate legal personality.

• There is continuity in the event of the death of a shareholder.

• The original owner is still often able to retain control.

• The company is able to raise capital from the sale of shares to family, friends and employees.

• The company has greater status than an unincorporated business.

• There are legal formalities involved in establishing the business.

• Capital cannot be raised by the sale of shares to the general public.

• It is quite difficult for shareholders to sell shares.

• End-of-year accounts must be sent to the government office responsible for companies, and are available for public inspection (so there is less secrecy over financial affairs than for a sole trader or partnership).

Table 2.5: Advantages and disadvantages of private limited company structure

The word 'Limited' or 'Ltd' ('Pte' in some countries) tells us that the business is a private limited company. Usually the shares will be owned by the original sole trader, relatives, friends and employees. The former sole trader often still has a controlling interest. New issues of shares cannot be sold on the open market and existing shareholders may sell their shares only with the agreement of the other shareholders. Certain legal formalities must be followed in setting up such a business and these are explained in the section after public limited companies.

Public limited companies

These can be recognised by the use of 'plc' or 'inc.' after the company name. It is the most common form of legal organisation for very large businesses, for the good reason that they have access to very substantial funds for expansion.

> TIP To avoid one of the most common errors made by learners, remember that public limited companies are in the private sector of industry, but public corporations are not.

A public limited company (plc) has all the advantages of private company status, plus the right to advertise its shares for sale to the general public and have them quoted on the stock exchange. This means that:

- public limited companies can raise very large sums from public issues of shares
- existing shareholders may also quickly sell their shares if they wish to. This flexibility of share buying and selling encourages the public to purchase the shares when they are sold by initial public offering (IPO). The other main difference between private and public companies concerns the separation of ownership and control. The original owners of a business that converts to private company structure are usually still able to retain a majority of shares. They can continue to exercise management control. This is most unlikely with public limited companies because most shares will be issued to a large number of individuals and institutions as investors. These shareholders own the company, but at the annual general meeting they appoint a board of directors who control the management and decision-making of the business.

This clear distinction between ownership and control can lead to conflicts; for example, over business objectives and the direction the business takes. The shareholders might prefer measures that aim for short-term profits, whereas the directors may decide to aim for the long-term growth of the business, perhaps in order to increase their own power and status. Many private limited companies convert to plc status for the reasons given in Table 2.5.

It is also possible for the directors or original owners to convert a business back from a plc to private limited company status: Richard Branson and the Virgin group is one of the best-known examples. The reasons for doing this are largely to overcome the problems of separate ownership and control. In a private limited company, it is normal for the senior executives to be the majority shareholders. In addition, the owner of a private limited company can take a long-term planning view of the business. It is often said that the major investors in a plc are only interested in short-term gains. ‘Short-termism’ can be damaging to the long-term investment plans of a business.

See Table 2.6 for a summary of the advantages and disadvantages of public limited companies.

Advantages

Disadvantages

• Shareholders have limited liability.

• The company has a separate legal identity.

• There is continuity.

• It is easy for shareholders to buy and sell shares, encouraging investment.

• Substantial capital sources can be accessed due to the ability to issue a prospectus to the public and to offer shares for sale (called a flotation).

• Formation entails legal formalities.

• There can be high costs of paying for advice from business consultants when creating a plc.

• Share prices are subject to fluctuation, sometimes for reasons beyond a business's control (e.g. the state of the economy).

• There are legal requirements concerning disclosure of information to shareholders and the public (e.g. annual publication of detailed report and accounts).

• There is a risk of takeover due to the availability of the shares on the stock exchange.

• Directors may be influenced by the short-term objectives of the major investors.

Table 2.6: Advantages and disadvantages of public limited company structure

Legal formalities in setting up a company

All governments insist that certain legal stages are completed before a company may be established, to protect investors and creditors. The following documents are commonly required in many countries:

1. A Memorandum of Associationthis states the name of the company, the address of the head office through which it can be contacted, the maximum share capital for which the company seeks authorisation and the declared aims of the business. must be completed. This document is of great interest to shareholders. Knowing the maximum share capital means that the relative importance of a single share can be determined. Being aware of the company's aims means that shareholders can avoid businesses that may operate in markets and products – such as weapons – that they may not want to be associated with.

2. The other main document is called the Articles of Associationthis document covers the internal workings and control of the business, the names of directors and the procedures to be followed at meetings.. When these documents have been completed satisfactorily, the registrar of companies will issue a certificate of incorporation. Private limited companies may now begin trading.

Cooperatives

These are a very common form of business organisation in some countries, especially in agriculture and retailing. It is common to differentiate between producer or worker cooperatives, which are involved with making goods, and consumer or retail cooperatives, which sell goods and services. Certain features are common to all cooperatives:

==cooperatives:== a jointly owned business operated by members for their mutual benefit, to produce or distribute goods or services – as in consumers' cooperatives or farmers' cooperatives.

- All members can contribute to running the business and sharing the workload, responsibilities and decision-making. In larger cooperatives, some delegation to professional managers takes place.
- All members have one vote at important meetings.
- Profits are shared equally among members. In agricultural cooperatives, the members arrange for the purchase of seeds and materials in bulk so that they may benefit from economies of scale. The cooperative often buys the produce of the members and then sells it collectively to obtain a better price.

The advantages of such business units are:

- buying in bulk
- working together to solve problems and take decisions
- good motivation for all members to work hard as they will benefit from shared profits. The potential drawbacks can include:
- poor management skills, unless professional managers are employed
- capital shortages because the sale of shares to non-members is not allowed
- slow decision-making if all members are to be consulted on important issues.

Franchises

A franchise is not strictly a form of legal structure for a business, but it is a legal contract between a franchiser and a franchisee.

==franchise:== the legal right to use the name, logo and trading systems of an existing successful business.

==franchiser:== a person or business that sells the right to open stores and sell products or services, using the brand name and brand identity.

==franchisee:== a person or business that buys the right from the franchiser to operate the franchise.

This contract allows the franchisee to use the name, logo and marketing methods of the franchiser. The franchisee can then, separately, decide which form of legal structure to adopt.

Franchises are a rapidly expanding form of business operation. They have allowed certain multinational businesses, which are now household names, to expand much more rapidly than they could otherwise have done. McDonald's and Ben & Jerry's are just two examples.

Figure 2.6: Many McDonald's restaurants are franchised outlets – like this one in Malaysia Figure 2.6: Many McDonald's restaurants are franchised outlets – like this one in Malaysia

Why would a business entrepreneur want to use the name, style and products of another firm? Consider Activity 2.3, which includes all of the main features of a typical franchise contract. Table 2.7 outlines the advantages and disadvantages of franchises.

> KEY CONCEPT LINK Context affects the business owner's choice of which form of business ownership to adopt. The business may be trying to compete with famous and established brands, for example. Buying a franchise in this context means that the business can gain the benefit of using a well-known name and logo.

Advantages of franchises

Disadvantages of franchises

- There are fewer chances of a new business failing because it is using an established brand name and product.
- Advice and training are offered by the franchiser.
- The franchiser pays for national advertising.
- Supplies are obtained from established and quality-checked suppliers.
- The franchiser agrees not to open another branch in the local area.
- A share of the profits or revenue has to be paid to the franchiser each year.
- The initial franchise licence fee can be expensive.
- Local promotions may still have to be paid for by the franchisee.
- The franchisee cannot choose which supplies or suppliers to use.

• Strict rules over pricing and layout of the outlet reduce the franchisee's control over their own business.

Table 2.7: Advantages and disadvantages of franchises

Joint ventures

A joint ventureis when two or more businesses work closely together on a project. This is not the same as a merger, but can lead to a merger if businesses' interests coincide and if the joint venture is successful. The reasons for joint ventures are:

==joint venture:== two or more businesses agree to work closely together on a particular project and create a separate business division to do so.

- The costs and risks of a new business venture are shared, which is a major consideration when the cost of developing new products is rising rapidly.
- Different companies might have different strengths and experiences, and therefore fit well together.
- They might have major markets in different countries and they could exploit these with the new product more effectively than if they both decided to 'go it alone'. Such agreements are not without their risks:
- Styles of management and culture might be so different that the two teams do not blend well together.
- Errors and mistakes might lead to one company blaming the other for mistakes.
- The business failure of one of the partners would put the whole project at risk.

Social enterprise

Social enterprises are businesses that aim to make profit in socially responsible ways. Much of any profit is used to benefit society. However, social entrepreneurs do not operate businesses as charities. They can and often do keep some of any profit they have made.

==Social enterprises:== a business with mainly social objectives that re-invests most of its profits into benefiting society rather than maximising returns to owners.

Social enterprises do have objectives that are often different from those of an entrepreneur who is only profit motivated. However, they compete with other businesses in the same market or industry. They use business principles to achieve social objectives.

Most social enterprises have these common features:

- They directly produce goods or provide services.
- They have social aims and use ethical ways of achieving them.
- They need to make a profit to survive as they cannot rely on donations as charities do.

Changing the form of business ownership

Most businesses do not change their form of business ownership over time, but many do. The most likely advantages of changing from one form of ownership to another (for example, sole trader to private limited company) can be summarised as:

- access to more finance
- gaining legal identity
- protecting owners' capital through limited liability. The most likely disadvantages of changing the form of business ownership (for example, from sole trader to private limited company) can be summarised as:
- legal costs and formalities
- some loss of control and ownership by the original owner
- profits are shared.

Image Image

3.1 Measurements of business size

Why is it useful to measure business size? A government might wish to give assistance to small firms, so it will need to identify them. Investors in a business may wish to compare the size and the rate of growth of the business with close competitors. Customers may prefer to deal only with large businesses, assuming they give greater security of supply. Some workers prefer a small business workplace.

There are two problems with attempting to measure business size:

1. There are several different ways of measuring business size. They often give different comparative results. A business might appear large by one measure but quite small by another.
2. There is no internationally agreed definition of a small, medium or large business. However, the number of employees is often used to make this distinction.

Different measures of business size

Various measures are used to determine the size of businesses.

Number of employees

This is the simplest measure. It is easy to understand. It is clear that a business employing many employees is likely to be large. However, there are problems. Some businesses only need to employ a few people even though they have invested a lot of capital in the business and achieve high annual sales. For example, a highly automated computer chip manufacturing business with expensive capital equipment will employ relatively few workers. One soft drinks firm might use traditional methods of production, employing 100 people to make 300 000 litres of drink a week. Its rival in the same town might be fully automated and produce 1 million litres a week with just 10 workers.

Revenue (or sales turnover)

Revenue is often used as a measure of size, especially when comparing businesses in the same industry. It is less effective when comparing businesses in different industries because some might be engaged in high-value production, such as precious jewels, whilst others might be in low-value production, such as cleaning services. Revenue is needed to calculate market share.

==Revenue:== the total value of sales made during the trading period = selling price × quantity sold.

Capital employed

Generally, the larger the business enterprise, the greater the value of capital needed for long-term investment, or the greater the amount of capital employed. Again, comparisons between firms in different industries may give a rather misleading picture. Two firms employing the same number of workers may have very different capital equipment needs, such as a hairdresser and an optician. The optician will need expensive diagnostic and eyesight-measuring machines.

==capital employed:== the total value of all long-term finance invested in the business.

Market capitalisation

Market capitalisation can be used only for businesses that have shares quoted on the stock exchange (public limited companies). It is calculated by this formula:

==Market capitalisation:== the total value of a company's issued shares.

As share prices tend to change every day, this form of comparison is not a very stable one. For example, a sharp but temporary drop in the share price of a company could make it appear much smaller than before, even though it still employs the same number of workers.

Market share

Market share is a relative measure. If a firm has a high market share, it must be among the leaders in the industry and comparatively large. However, if the size of the total market is small, a high market share will not indicate a very large firm. Market share is calculated, for a given time period, using the following formula:

==Market share:== sales of the business as a proportion of total market sales.

Other measures that can be used

These will depend very much on the industry. Examples include:

- the number of guest beds or guest rooms could be used to compare hotel businesses
- the number of shops could be used for retailers
- total floor sales space could also be used to compare retail businesses
- the number of units sold could be used to compare businesses in the same industry.

  TIP Remember not to refer to profit as a measure of business size. Profit can be used to assess business performance but not business size.

Which form of measurement is best?

There is no best measure. The one that should be used depends on what needs to be established about the businesses being compared. This could depend on whether we are interested in absolute size or comparative size within an industry. If an absolute measure of business size is required, then it is advisable to assess business size on at least two of the above criteria and to make comparisons on the basis of these.

> TIP You may be asked to comment on data showing the sizes of different businesses. Remember that if another measure was used, the conclusions about relative size might be very different.

3.2 Significance of small businesses

The importance of small businesses to the economy in which they operate should not be overlooked. In addition, small businesses can play a very significant role within their own industry, even though the total output they produce might be relatively small.

What is a small business?

Even though we have not established a universally agreed definition of small firms, it will be easy to identify them within your own country's economy. Small businesses employ few people and will have a relatively low annual revenue. You might also be able to find an official definition for small businesses within your own country from the trade and industry department.

It is now also common to make a further distinction for very small businesses, known as micro-enterprises. The European Union (EU) definitions are shown in Table 3.1.

Business category	Employees	Revenue	Capital employed
Medium	51–250	over €10m to €50m	over €10m to €34m
Small	11–50	over €2m to €10m	over €2m to €10m
Micro	10 or fewer	up to €2m	up to €2m

Table 3.1: EU classifications of business size

Small firms (including micro-enterprises) are very important to all economies and to the industry in which they operate. Small businesses have many economic benefits and their role in the structure of some industries is also very important:

- They create employment . Each firm may not employ many workers, but collectively the small-business sector in most countries employs a high proportion of the working population.

- They are often run by dynamic entrepreneurs with new ideas for consumer goods and services. This helps to create variety and consumer choice in the market and can also lead to change in the whole industry.
- They create competition for larger businesses. Without this competition, larger firms could exploit consumers with high prices and poor service. For example, in recent years increasing competition in the air travel industry has reduced the prices of air flight tickets.
- They can be important suppliers to larger businesses. They often supply specialist goods and services to important industries. For example, the global car industry is dominated by major manufacturers such as Toyota, BMW and Ford. All these large businesses depend upon small specialist suppliers for products such as onboard computers, high-quality audio equipment and headlights. By being able to adapt quickly to the changing needs of customers, small businesses can increase the competitiveness of the larger organisations.
- All great businesses were small at one time. The Body Shop began in one small rented store in 1976. Hewlett-Packard started assembling electrical equipment in David Packard's garage. The large businesses of the future are the small enterprises of today. If more small firms are encouraged to become established and expand, the economy will benefit from large-scale organisations in the future.
- They might have lower average costs than larger ones. Wage rates may be less than the salaries paid in large organisations. Also, small businesses tend to have lower administration and management costs than large organisations. These cost benefits could be passed on to the consumer.

Figure 3.2: Hewlett-Packard started operating from this garage Figure 3.2: Hewlett-Packard started operating from this garage

These factors demonstrate the benefits to a country's economy of a thriving small business sector. Nearly all governments encourage and assist business start-ups and existing small businesses.

Advantages and disadvantages of being a small business

Some business owners choose to keep their business small. However, others may not have any choice if the market they operate in is itself very small. There are advantages and disadvantages to operating as a small business, as shown in Table 3.3.

> KEY CONCEPT LINK Do you think small or large businesses are likely to be more innovative? Most social media innovations have been produced by small-scale entrepreneurs setting up businesses which then become hugely successful, for example Twitter and Facebook.

Advantages of small businesses

Disadvantages of small businesses

• can be managed and controlled by the owner(s) – little risk of losing control

• often able to adapt quickly to meet changing customer needs – especially if the owner deals directly with customers

• offer personal service to customers to help build customer loyalty

• easy to know each worker – many people prefer to work for a small business

• if family-owned, the business culture is often informal, employees are well-motivated and family members perform multiple roles

• can usually be started up and operated with low capital investment

• may have limited access to sources of finance

• the owner has to carry a large burden of responsibility and is usually unable to afford to employ specialist managers

• if the owner or important workers are absent/ill, other employees may not have the necessary skills to operate the business

• may not be diversified, so there is a greater risk of external change having a negative impact

• few opportunities for economies of scale – average costs could be high

Table 3.3: Potential advantages and disadvantages of small businesses

> TIP Many business observers focus only on the benefits of small businesses. If you are asked to evaluate the importance of small businesses, remember that large businesses supply most of the world's consumer goods. Most large businesses do this by increasing efficiency and improving levels of quality.

Strengths and weaknesses of family businesses

Family-owned businesses are those that are actively owned and managed by at least two members of the same family. In many cases, the family that founded the business retains complete ownership of it. Family-owned businesses are very important in nearly all economies, especially newly industrialising ones. It is estimated that 80% of all businesses in South Africa are family-owned and -operated.

Many family businesses are small; for example, 65% of all small businesses in Malaysia are family-owned and -managed. However, not all family businesses are small. In Asia, family businesses make up 50% of all public limited companies (67% in India) and the founding families still retain a controlling interest (over 50% of the shares).

Family businesses have several significant strengths and weaknesses, as shown in Table 3.4.

Strengths of family businesses

Weaknesses of family businesses

Commitment: The family owners often show dedication in seeing the business grow, prosper and be passed on to future generations. As a result, many family members identify with the company and have the incentive to work harder and re-invest part of their profits into the business to allow it to grow in the long term.

Reliability and pride: Because the family name and reputation are associated with the products, family businesses strive to increase the quality of their output and to maintain a good relationship with their stakeholders.

Knowledge continuity: Families in business make it a priority to pass their accumulated knowledge, experience and skills to the next generation. Many family members become involved in the family business from a very young age. This increases their level of commitment and could provide them with the necessary tools to run their family business.

Succession/continuity problem: Many family businesses fail to be sustainable in the long term. On average, only around 15% continue into the third generation of descendants of the founder(s). This high rate of failure can often be explained by the lack of skills and ability of later generations or the splitting of management responsibilities between several family members to give them all a role in it.

Informality: Because most families run their businesses themselves, there is usually little interest in setting clear and formal business practices and procedures. As the family and its business grow larger, this situation can lead to inefficiencies and internal conflicts.

Tradition: There is quite often a reluctance to change systems and procedures, with family members preferring to continue to operate the business as it was run historically. Lack of innovation could be a consequence.

Conflict: Problems within the family may reflect on the management of the business and make effective decisions less likely.

Table 3.4: Strengths and weaknesses of family businesses

Importance of small businesses in the economy

The economies of most countries are heavily reliant on small businesses. For example:

- Small businesses help generate economic growth and they can be particularly important in some regions of a country that have no large companies.

- Globally, small businesses amount to up to 90% of all employers, so many jobs are dependent on these enterprises. In the USA, 60 million people work for small businesses. In Pakistan, over 80% of jobs in manufacturing are created by small businesses.
- It is estimated that 80% of all new jobs in developing countries are created by small businesses.
- Small businesses are often innovative and can develop new products and services which create competition for existing companies.

Role of small businesses in some industries

Some industries are almost completely dominated by small businesses. Personal care, hairdressing, house-decorating and gardening are examples of industries in which small businesses produce over 95% of the total output in most countries. In contrast, in the nuclear power generation industry, small businesses produce zero output of electricity. However, small supplying businesses might still have important roles to play. They could offer:

- Specialist services such as research, technical support, repair and maintenance facilities. Even some large businesses may not have the specialised employees and equipment needed to provide these services for themselves.
- To undertake functions that the larger business wants to buy in rather than undertake itself, such as recruitment and training of employees and transport of supplies and employees. This allows the larger businesses to focus on their main or core activities and may reduce their overall costs.

3.3 Business growth

The owners of many businesses do not want the firm to remain small, although some do, for reasons of remaining in control, avoiding taking too many risks and preventing workloads from becoming too heavy. Why do some business owners and directors of companies seek growth for their business? There are a number of possible reasons:

- Increased profits – expanding the business and achieving higher sales is one way of becoming more profitable.
- Increased market share – this will give a business a higher market profile and greater bargaining power with both suppliers and retailers.
- Increased economies of scale (see Section 26.2).
- Increased power and status of the owners and directors. The opportunities to gain publicity or influence government policy will increase if the business controlled by the owners or directors is large and well known.

- Reduced risk of being a takeover target – a larger business may become too large a target for a potential predatory company.

Organic (internal) growth

Business growth can be achieved in a number of ways. These different forms of growth can lead to various effects on stakeholder groups such as customers, workers and competitors. The different forms of growth can be grouped into organic (internal) growth and external growth, which involves mergers with and takeovers of other businesses.

==organic:== expansion of a business by means of opening new branches, shops or factories (also known as internal growth).

==external growth:== business expansion achieved by integrating with another business by either merger or takeover.

==mergers:== an agreement by owners and managers of two businesses to bring them together in a new combined business. This is often referred to as a friendly merger.

==takeovers:== when a company buys more than 50% of the shares of another company and becomes its controlling owner. It can be called an acquisition.

An example of organic growth would be a retail business opening more shops in new locations. This growth can be quite slow with, perhaps, only a few branches or shops opening each year. However, this can avoid the problems of excessively fast growth, which tends to lead to inadequate capital (overtrading) and management problems associated with bringing together two businesses with different attitudes and cultures.

External growth and its impact

External growth is often referred to as integration, as it involves bringing together two or more businesses. This form of growth can lead to rapid expansion, which might be vital in a competitive and expanding market. However, it often leads to management problems. These are caused by the need for different management systems to deal with bigger organisations. There can also be conflict between the two teams of managers (Who will get the top jobs?) and conflicts of culture and business ethics. The different forms of external growth – horizontal integration, forward vertical integration, backward vertical integration and conglomerate integration – are shown in Figure 3.3. The advantages, disadvantages and impact on stakeholders of each are shown in Tables 3.5–3.8.

==horizontal integration:== integration with a business in the same industry and at the same stage of production.

==forward vertical integration:== vertical integration with a customer business.

==backward vertical integration:== vertical integration with a supplier business.

==conglomerate integration:== integration with a business in a different industry.

Figure 3.3: Types of integration Figure 3.3: Types of integration

Advantages

Disadvantages

Impact on stakeholders

• It eliminates one competitor and increases market share and power.

• There are potential economies of scale.

• There is scope for rationalising production, concentrating all output on one site as opposed to two.

• There may be increased power over suppliers to obtain lower prices.

• Rationalisation may bring bad publicity and redundancies.

• There may be customer opposition to less competition and less choice.

• It may lead to a monopoly investigation if the combined business exceeds certain market share limits.

• Consumers now have less choice and may have to pay higher prices.

• Workers may lose job security as a result of rationalisation:

• Suppliers may have to offer lower prices to the bigger integrated business.

• Shareholder impact depends on whether profit rises or not.

• Local communities may have job losses.

Table 3.5: Advantages, disadvantages and impact of horizontal integration

Advantages

Disadvantages

Impact on stakeholders

• The business is now able to control the promotion and pricing of its own products.

• It gives a secure outlet for the products of the business and may now exclude competitors' products from retail outlets.

• Consumers may suspect an attempt to act uncompetitively and react negatively.

• The business may lack experience in this sector of the industry – a successful manufacturer does not necessarily make a good retailer.

• Workers may have greater job security because the business has secure outlets.

• There may be more varied career opportunities.

• Consumers may resent the lack of competition in the retail outlet because of the withdrawal of competitor products:

• Shareholder impact depends on whether profit rises or not.

Table 3.6: Advantages, disadvantages and impact of forward vertical integration

Advantages

Disadvantages

Impact on stakeholders

• It gives control over quality, price and delivery times of supplies.

• It encourages joint research and development into improved quality of components.

• The business may now control supplies of materials to competitors.

• The business may lack experience of managing a supplying company – a successful steel producer will not necessarily make a good manager of a coal mine.

• The supplying business may become complacent due to having a guaranteed customer.

• Workers may have more career opportunities.

• Consumers may obtain improved quality and more innovative products.

• Control over supplies to competitors may limit competition and choice for consumers.

• Profit might rise to benefit shareholders.

Table 3.7: Advantages, disadvantages and impact of backward vertical integration

Advantages

Disadvantages

Impact on stakeholders

• It diversifies the business away from its original industry and markets.

• This should spread risk and may take the business into a faster-growing market.

• There may be lack of management experience in the acquired business sector.

• There could be a lack of clear focus and direction now that the business is spread across more than one industry.

• Workers may have more career opportunities.

• There may be more job security because risks are spread across more than one industry.

• Profits could rise to benefit shareholders.

Table 3.8: Advantages, disadvantages and impact of conglomerate integration

Why a merger or takeover might fail to achieve objectives

When two businesses integrate, the argument is that the newly combined larger business will be more effective, more efficient and more profitable than the two separate companies. The objectives of mergers and takeovers are to increase efficiency and profitability. Why might these objectives be achieved?

- The integrated businesses will be able to share research facilities and pool ideas that achieve better results than the two separate businesses.
- The economies of operating a larger scale of business, such as buying supplies in large quantities, should cut average costs and increase efficiency.
- The larger combined business can save on marketing costs and distribution costs by using the same sales outlets and sales teams.
- Rationalisation of property and other assets will reduce duplication and costs. The record of many mergers and takeovers is mixed. In practice, many mergers and takeovers fail to gain true synergy. Shareholders can be left wondering about the original purpose of the integration. Many examples of business integration have not increased shareholder value and have not increased profitability. The most common reasons for a merger or takeover to fail to achieve its objectives are:

==synergy:== literally means that 'the whole is greater than the sum of parts' – it is often assumed that the new business will be more successful than the original separate businesses.

- The integrated firm is too big to manage and control effectively. This is a diseconomy of scale.
- A different business and management culture. For example, the approach each company takes to environmental issues may be so different that the two sets of managers and workers may find it very difficult to work effectively and cooperatively together.
- There may be little benefit from combined research departments or marketing/distribution facilities if the original businesses produced different products.

- The rate of growth is too rapid for the directors to manage effectively. Some problems of the very sudden growth resulting from mergers/takeovers are examined in Table 3.9.

Problems of growth through mergers/takeovers

Possible strategies to overcome problems

Financial

• Takeovers can be very costly, stretching the financial resources of the business.

• Additional fixed capital and working capital will be required quickly.

• A merger/takeover could lead to negative cash flow and an increase in long-term borrowing and interest payments.

• Use internal sources of finance when possible, for example retained earnings.

• Raise finance from share issues.

• Offer shares, not cash, to pay for a takeover.

Managerial

• Existing management may be unable to cope with problems of controlling an operation which may have doubled in size overnight.

• There may be a lack of coordination between the divisions of an expanding business – a real problem for integrating businesses.

• The culture clash between the two management teams may be very great.

• New management systems and structures are required: a policy of delegation and employee empowerment should reduce the pressure on senior managers.

• A decentralisation policy could provide motivated managers with a clear local focus.

• A new management culture needs to be put in place rapidly.

Table 3.9: Some problems of rapid growth through mergers/takeovers and possible strategies to overcome them

> TIP If a question refers to a merger or takeover, you should start by identifying what type it is. Do not forget that mergers and takeovers often cause businesses as many problems as they solve.

Joint ventures and strategic alliances

Joint ventures and strategic alliances are further forms of external growth. Joint ventures were analysed earlier (see Section 2.2). A strategic alliance is a form of external growth that does not involve complete integration or changes in ownership. Instead, it keeps the parties to the agreement independent.

==strategic alliances:== agreement between two organisations to commit resources to achieving a specific objective while remaining independent.

Strategic alliances can be made between a wide variety of businesses/organisations. For example, a business might form an alliance with:

- A university, providing finance to provide new specialist training courses that will increase the supply of suitably trained employees for the business.
- A supplier, to design and produce components and materials that will be used in a new range of products. This may help to reduce the total development time for getting the new products to market, thereby gaining competitive advantage.
- A competitor, to reduce the risks of entering a market that neither firm currently operates in. Care must be taken that, in these cases, the actions are not seen as being anti-competitive and therefore illegal. The best strategic alliances benefit both businesses or organisations. Once the objective of the alliance has been reached, it is often ended. The most successful strategic alliances bring together businesses with different skills and strengths so that the combination of these achieves the planned objectives.

Image Image

4.1 The importance of business objectives

A business is unlikely to survive if managers do not think about the future and do not set targets for the future. By setting clear business objectives, managers will:

==business objectives:== a stated measurable target that a business plans to achieve.

- create a sense of direction and purpose for all employees, which will increase their motivation
- provide specific targets for future business strategies to aim for, as new business strategies will lack focus without an objective to work towards
- give a means of assessing success or failure when actual business performance is judged against the original objectives.

Objectives of private-sector businesses

Businesses in the private sector can set various objectives, as explained below.

Profit maximisation

Profits are essential for rewarding investors in a business and for financing further growth. Profits are also important to persuade business owners – or entrepreneurs – to take risks. But what does profit maximisation really mean? In simple terms, it means producing at that level of output where the greatest positive difference between total revenue and total costs is achieved.

However, there are limitations with this business objective:

- The focus on high short-term profits may encourage competitors to enter the market.
- Many businesses seek to maximise sales to gain higher market share, rather than to maximise profits.
- The owners of smaller businesses may be more concerned with ensuring that leisure time, independence and work–life balance are protected rather than just earning more money.
- Most business analysts assess the performance of a business through return on capital employed rather than through total profit figures.
- Profit maximisation may be the preferred objective of the owners and shareholders, but other stakeholders will prioritise other objectives. Managers' concerns over workers' job security or environmental protection may force profitable business decisions to be modified, yielding lower profit levels.
- In practice, it is very difficult to assess whether the point of profit maximisation has been reached. Constant pricing changes to increase profit may lead to negative consumer reactions.

Profit satisficing

This means aiming to achieve enough profit to keep the owners satisfied. This objective is in contrast to profit maximisation where the aim is to earn as much profit as possible. Profit satisficing is a common aim for owners of small businesses, who wish to live comfortably but do not want to work longer hours to earn more profit. Once a satisfactory level of profit has been achieved, some owners will consider that other aims take priority, such as more leisure time.

Growth

Business growth has many potential benefits for the managers and owners. Larger firms will be less likely to be taken over and should be able to benefit from economies of scale. Managers will be motivated by business growth if it means they could gain higher salaries and fringe benefits. A business that does not attempt to grow could become uncompetitive.

Business objectives based on growth do have limitations:

- Expansion that is too rapid can lead to cash flow problems.
- Sales growth might be achieved at the expense of lower profit margins.
- Larger businesses can experience diseconomies of scale.
- Using profits to finance growth can lead to lower short-term returns to shareholders.
- Growth into new business areas and activities – away from the firm's core activities – can result in a loss of focus and direction for the whole organisation.

Increasing market share

An important indicator of success is the proportion of total market sales a business has. An increase in market share indicates that the business's marketing strategies are proving more successful than those of its competitors. The benefits of being the brand leader with the highest market share include:

- Retailers will be keen to stock and promote the best-selling brand.
- Products can be supplied to retailers at a low discount rate, since the shops will be more keen to stock them. This will give the producer a higher profit margin.
- Effective promotional campaigns are often based on 'You can buy our product with confidence as it is the brand leader.'

Survival

This is likely to be the key objective of most new business start-ups. The high failure rate of new businesses means that to survive for the first two years of trading is an important aim for entrepreneurs. Once the business has become firmly established, then other longer-term objectives can be established.

Corporate social responsibility (CSR)

Should businesses show corporate social responsibility by having objectives about social, environmental and ethical issues? There is a growing belief that businesses must adopt a wider perspective than just profit when setting their objectives. One reason for this is the adverse publicity given to business activity that is seen to be damaging to stakeholder groups and the wider world. Influential pressure groups are forcing businesses to reconsider their approach to decision-making. Also, legal changes at local, national and international level are forcing businesses to stop activities that harm the environment or damage the social and ethical interests of external stakeholders.

==corporate social responsibility:== when businesses consider the interests of society by taking responsibility for the impact of their decisions and activities on customers, employees, communities and the environment.

==pressure groups:== organisations created by people with a common interest or aim, who put pressure on businesses and governments to change policies so that an objective is reached.

There are other reasons for this trend towards corporate social responsibility. Increasingly, consumers and other stakeholders are reacting positively to businesses that act in green or socially responsible ways. Examples include:

- firms that promote organic, vegetarian and vegan foods
- retailers that advertise the proportion of their products made from recycled materials
- businesses that refuse to stock goods that have been tested on animals or foods based on genetically modified ingredients. In these cases, is the business action taken so that sales and reputation are not affected or because such action is increasingly profitable? Are businesses being socially responsible just because it is the popular thing to do? Or, because they have a genuine concern for society and the environment? It might be that businesses are being responsible and environmentally aware because they believe in the objective that Peter Drucker, a famous writer on business management, calls 'public responsibility'. In other words, because business managers want to behave in these ways. (See Chapter 5 for more information.)

Maximising short-term revenue

This objective could benefit managers and workers when salaries and bonuses are dependent on sales revenue levels. However, if increased sales are achieved by reducing prices, the actual profits of the business might fall.

Increasing shareholder value

This means pursuing strategies to increase returns to shareholders. By increasing profit, the business will be able to pay out higher dividends, which should lead to higher share prices. This shareholder value objective puts the interests of shareholders above those of other stakeholders.

Objectives of social enterprises

Social enterprises have three main aims. These are:

1. economic (financial) – to make a profit to re-invest back into the business and provide some financial return to the owners
2. social – to provide jobs or support for local, often disadvantaged, communities
3. environmental – to protect the environment and to manage the business in an environmentally sustainable way. These aims are often referred to

as the triple bottom line. This means that profit is not the sole objective of these enterprises.

==triple bottom line:== the three objectives of social enterprises: economic, social and environmental.

Many business analysts now believe that other forms of business, not just social enterprises which genuinely aim to be socially responsible, also have a triple bottom line objective.

You can probably link the significance of CSR with the triple bottom line principle. Any business, not just a social enterprise, that is really committed to achieving CSR objectives will also be aiming for 'triple bottom line' targets. If a business only considers profit as its main objective, then it will not be setting social or environmental objectives and will not have a triple bottom line target.

Objectives of public-sector businesses

Public-sector businesses such as nationalised industries or public corporations can have a number of objectives. The importance given to these will vary from country to country, depending on the political motives of the government. Typical objectives include:

- to provide an efficient, reliable service to the public, such as water supply or postal service
- to encourage economic and social development, especially in deprived areas
- to create employment or prevent major job losses if the industry is making a financial loss
- to meet financial targets set by the government, but not necessarily make a profit
- to achieve high environmental standards. It is often argued that public-sector businesses are less efficient than many private-sector businesses. This is because they do not have the profit motive as their main objective. However, if they achieve other social or environmental objectives, this might help the government achieve its overall political objectives.

The most effective objectives are SMART

If a business stated that its objective was to be 'as successful as possible over the next few years', how useful would that be? The answer is: not very useful at all. What does 'successful' mean? How will success be measured? What does a 'few years' mean? General objectives like this one are almost meaningless in business.

The most effective business objectives meet the following SMART criteria:

==SMART:== aims that are specific, measurable, achievable, realistic and time-limited.

S – Specific: Objectives should focus on what the business does and should apply directly to that business. A hotel business might set the objective of a 15% return on capital in each of its hotels. This objective is specific to this business.

M – Measurable: Objectives that have a quantitative value are likely to prove to be more effective targets for directors and staff to work towards. An example would be to increase sales in the south-east region by 15% this year.

A – Achievable: Setting objectives that are almost impossible in the time frame given will be pointless. They will demotivate the staff who have the task of trying to reach these targets. So, objectives should be achievable.

R – Realistic and relevant: Objectives should be realistic when compared with the resources of the company and should be expressed in terms that are relevant to the people who have to carry out the objectives. So, informing hotel cleaners about increasing market share is less relevant than giving them a target to reduce the amount of cleaning materials they use by 20%.

T – Time-limited: A time limit should be set when an objective is established. Without a time limit, it will be impossible to assess whether the objective has actually been met. An example would be to increase profits by 5% over the next three years.

Summary: factors that determine business objectives

Various factors determine business objectives, as summarised in Figure 4.3. (For an exploration of the influence of ethics, see Section 4.2.)

Figure 4.3: Influences on business objectives Figure 4.3: Influences on business objectives

Business culture

Culture is a way of doing things that is shared by all those within an organisation. The culture of a business and its senior managers impacts greatly on the decisions made. If senior managers aggressively pursue only the profit objective, their decisions will be different to those of the managers of a business with a people-centred or society-centred culture.

The size and legal form of the business

Owners of small businesses may solely be concerned with a satisfactory level of profit (called satisficing). Larger businesses, perhaps controlled by directors rather than owners – such as most public limited companies – might be more concerned with rapid business growth in order to increase the directors' status and power.

Private sector or public sector

Profit and shareholder value are common business objectives in the private sector. In the public sector, quality of service measures are often used, such as the maximum number of days a patient needs to wait for an operation. Even revenue-earning businesses in the public sector, for example the postal service, may have other objectives such as maintaining services in non-profitable locations.

The number of years the business has been operating

Newly formed businesses are likely to be driven by the desire to survive at all costs, as the failure rate of new firms in the first year of operation is very high. Later, once well established, the business may pursue other objectives such as growth and profit.

The influence of ethics on business objectives is assessed in Section 4.2.

The objectives of these two business organisations will be very different:

Figure 4.4: A private-sector oil refinery in Mexico Figure 4.4: A private-sector oil refinery in Mexico

Figure 4.5: A public-sector hospital in Brazil Figure 4.5: A public-sector hospital in Brazil

Relationship between mission statement, aims, objectives, strategy and tactics

Figure 4.6 shows the links between the different stages in setting aims, a mission statement and objectives. These then help managers develop appropriate business strategies and tactics.

Figure 4.6: Hierarchy of objectives Figure 4.6: Hierarchy of objectives

Business aims

The core central purpose of a business's activity is expressed in its business aims. These are not expressed in SMART terms but are broad indications of what a business hopes to achieve in future. These aims must be converted into specific and measurable objectives.

==business aims:== a long-term goal that a business hopes to achieve.

Mission statements

Mission statements are an attempt to condense the central purpose of a business's existence into one statement. They are not concerned with specific, quantifiable goals, but attempt to sum up the business aim in a motivating and appealing way.

==Mission statements:== a brief statement of the business's core aims, phrased in a way to motivate employees and to stimulate interest from outside groups.

Here are some examples of mission statements:

A college: 'To provide an academic curriculum in a caring and supportive environment.'

Samsung: 'We will devote our human resources and technology to create superior products and services, thereby contributing to a better global society.'

Huawei: 'To invest resources in the making of a digitally connected world.'

Microsoft: 'To empower every person and every organisation on the planet to achieve more.'

Google: 'To organise the world's information and make it universally accessible and useful.'

Merck: 'To discover, develop and provide innovative products and services that save and improve lives around the world.'

Businesses communicate their mission statements in a number of ways. They often feature in the published accounts and in other communications to shareholders. They will appear in the business plans – the detailed report on the company's aims and strategies for the future. Internal company newsletters and magazines may draw their title from part of the mission statement. Advertising campaigns are frequently based around the themes of the mission statements.

Evaluation of mission statements

Virtually any organisation of any size will, in recent years, have established a mission statement. Do they perform a useful function or are they just a management gimmick? Some of the benefits of mission statements could be that they:

- inform groups outside the business what the central aim and vision are
- motivate employees, as they are associated with the positive qualities the statement refers to
- often include moral statements or values to be worked towards, which might help to guide and direct individual employees' behaviour at work
- help to establish what the business is about, for the benefit of other groups. On the other hand, mission statements might have limitations by being:

- too vague and general, so that they end up saying little that is specific about the business and cannot be used as actual targets
- just a public relations exercise to make stakeholder groups feel good about the organisation
- virtually impossible to really analyse or disagree with
- too general and lacking in specific detail, so two completely different businesses could have very similar mission statements. In summary, mission statements are insufficient for forming strategies. They do not tell managers what decisions to take or how to manage the business. They do provide a vision and an overall sense of purpose and they can prove very worthwhile in public relations terms.

Objectives, strategies and tactics

The aims and mission statement of a business share the same problems: they lack specific detail for operational decisions and they are rarely expressed in quantitative terms. They need to be turned into SMART objectives. These can then be broken down into strategic departmental targets. Business objectives must, of course, be based upon the central aims or mission of the business. They are expressed in terms that provide a much clearer guide for business strategiesand tactics.

==business strategies:== a long-term plan of action for a business, designed to achieve a particular objective.

==:==

==tactics:== a short-term action as part of an overall strategy.

Aims and objectives provide the focus for business strategies – the long-term plans of action of a business. Without a clear objective, managers will be unable to make important strategic decisions for the business as a whole or for individual departments. For example, should a marketing manager decide to sell products in new markets or attempt to sell more in existing markets? Without a clear business objective translated into a marketing objective, any strategic decisions will lack focus and direction.

Once a strategy has been decided, then small-scale tactical decisions must be taken. For example, once the strategic decision to market a product in a foreign country has been taken, tactical decisions about the methods of promotion and the level of pricing must be made.

The links between objectives, strategies and tactics are shown in Figure 4.7.

Figure 4.7: Links between objectives, strategies and tactics Figure 4.7: Links between objectives, strategies and tactics

KEY CONCEPT LINK The setting of clear and realistic objectives is one of the primary roles of senior management. Before decision-making on key strategies can be undertaken, SMART objectives are needed.

4.2 Objectives and business decisions

Setting objectives is the starting point of business decision- making. Without having a clear sense of direction, it is impossible to take effective business decisions. Business managers cannot decide on future plans of action or strategies if they are uncertain of which direction they want to take the business in.

The role of objectives in the stages of business decision-making

This essential link between decision-making, strategies and objectives is shown in Figure 4.8. All the following stages are based upon setting clear objectives:

1. Set objectives to provide focus for strategic decisions.
2. Assess and clarify the problem that requires strategic action.
3. Gather data about the problem and identify possible strategic solutions.
4. Analyse the likely impacts of all decision options on the chance of achieving business objectives.
5. Make the strategic decision.
6. Plan and implement the decision.
7. Review its success against the original business objectives. Has the business, through its decisions, achieved its objectives?

Figure 4.8: The decision-making framework Figure 4.8: The decision-making framework

Clearly, without setting relevant objectives at the start of this process, effective decision-making for the future of the business becomes impossible.

How objectives might change over time

There are many examples of businesses changing their business objectives over time. These are some of the reasons for this:

- A newly formed business may have satisfied the survival objective by operating for several years, and now the owners wish to pursue objectives of growth or increased profit.

- The competitive and economic environment may change. The entry into the market of a powerful rival or the start of an economic recession may force a business to switch from growth to survival as its main aim.
- A short-term objective of growth in sales or market share might be adapted to a longer-term objective of maximising profits from the higher level of sales.

Translation of objectives into targets and budgets

An important role of senior management is to convert the overall objectives of the business into targets for individual departments, groups and individuals. Specific and measurable short-term targets must be set for each business section, based on the overall objective of the business. These targets will be for limited time periods, such as the next three months. These targets must be reached if the overall objective is to be achieved.

==targets:== a short-term goal that must be reached before an overall objective can be achieved.

Usually, these targets form part of a department's budget or financial plan. For example, a business might aim to increase sales in foreign markets. The promotion department operating in each foreign country could be allocated $3m to spend on increasing sales, with the target of reaching total sales increases of 15% within four months.

==budget:== a detailed financial plan for the future.

Communicating objectives

There is no point in setting objectives and then telling no one about them. Companies communicate with shareholders and other external stakeholders through the annual published report. This contains details of the objectives the senior managers have established for the business. Mission statements are often widely publicised as well (although these do not contain specific details about business objectives).

Business objectives must also be explained to employees. If employees are unaware of the business objectives, how can they contribute to achieving them? Communicating business objectives, and translating them into individual targets, are essential for the effective motivation of employees.

If employees are communicated with and therefore involved in the setting of individual targets, then these benefits should result:

- Employees and managers have a greater understanding of both individual and company-wide goals.
- Employees understand the overall plan and how their individual goals fit into the company's business objectives.

- Employees share responsibility for targets and objectives by interlinking their goals with those of others in the company.
- Managers stay in touch with employees' progress more easily, as regular monitoring of employees' work allows for praise or training to keep performance and deadlines on track. If managers fail to communicate with employees on objectives or changes in objectives, fear and uncertainty might spread amongst the workforce. This could lead to resistance to change and potential industrial action.

Ethical influences on business objectives and activities

The growing acceptance of corporate social responsibility has led to businesses adopting an ethical code to influence the way in which decisions are taken.

==ethical code:== a document detailing a company's rules and guidelines on staff behaviour that must be followed by all employees.

Most business decisions have an ethical or moral dimension. For example:

- Should a toy company advertise its products to young children so that they pester their parents into buying them?
- Is it acceptable to take bribes to place an order with another company?
- Should a bank invest in a company that manufactures weapons or tests chemicals on animals?
- Is it acceptable to feed genetically modified food to cattle?
- Do we accept lower profits in the short term by purchasing less polluting production equipment?
- Should chief executives receive substantial pay rises and bonuses when other workers in the business are being made redundant?
- Is it acceptable to close a factory to save costs and increase profits even though many jobs will be lost and workers may find it hard to get other jobs?
- If legal controls and inspections are weak, is it acceptable to pay very low wages for long hours of work in order to reduce business costs?
- If it is not illegal, should a business employ child labour to reduce costs?
- Should a business produce potentially dangerous goods as long as 'no one finds us out'? These are all examples of ethical dilemmas. The way in which employees behave and take decisions in these cases should be covered and explained by a company's ethical code of conduct.

Some managers will argue that any business decision that reduces costs and increases profits is acceptable as long as it is legal, and some might argue that even illegal actions could be justified. However, there is now considerable evidence that more and more companies are considering the ethical dimension of their actions – not just the impact they might have on profits. Other managers will operate their business along strict ethical rules and will argue that, even if certain actions are not illegal, they are not right. Morally, such activities cannot be justified even if they might cut costs or increase sales.

> TIP Remember to think about the short-term and the longterm business issues involved in all ethical decisions.

Evaluating ethical decisions

Following a strict ethical code in decision-making can be expensive in the short term:

- Using ethical and Fairtrade suppliers can add to business costs.
- Not taking bribes to secure business contracts can mean failing to secure significant sales.
- Limiting the advertising of toys to just adults, so that children do not pester them to buy, may result in lost sales.
- Accepting that it is wrong to fix prices with competitors might lead to lower prices and profits.
- Paying fair wages, even in very low-wage economies, raises wage costs and may reduce a firm's competitiveness against businesses that exploit workers. In the long term, there could be substantial benefits from acting ethically:
- Avoiding potentially expensive court cases can reduce the cost of fines.
- Acting unethically can lead to bad publicity, lost consumer loyalty and long-term reductions in sales. Ethical policies can lead to good publicity and increased sales.
- Ethical businesses attract ethical customers and, as world pressure grows for corporate social responsibility, this group of consumers is increasing.
- Ethical businesses are more likely to be awarded government contracts.
- Well-qualified employees may be attracted to work for the companies with the most ethical and socially responsible policies.

Image Image

5.1 Business stakeholders

The main stakeholders of a business are:

==stakeholders:== individuals or groups who can be affected by, and have an interest in, any action taken by an organisation.

- owners (shareholders in a limited company)
- customers
- suppliers
- employees, including managers and their families
- local communities
- government and government agencies
- special interest groups, such as pressure groups that want to change a business's policy towards pollution or the testing of chemicals on animals
- lenders. Most of these groups are external stakeholders. Owners, managers and other employees are referred to as internal stakeholders.

==external stakeholders:== individuals or groups who are separate from the business but are affected by or interested in its operations.

==internal stakeholders:== individuals or groups who work within the business, or own it, and are affected by the operations of the business.

> TIP Do not confuse the two terms 'stakeholder' and 'shareholder'. 'Stakeholder' is a much broader term that covers many groups including, of course, shareholders.

Stakeholders' roles, rights and responsibilities

Businesses have responsibility towards stakeholders. Stakeholders also have important roles and responsibilities towards businesses. See Table 5.1 for more detail.

Roles

Rights

Responsibilities (not necessarily legally binding)

Customers

• to purchase goods and services

• to provide revenue from sales, which allows the business to function and expand

• to receive goods and services that meet local laws regarding health and safety, design and performance

• to be offered replacements, repairs or compensation in the event of failure of the product or service to at least the minimum levels laid down by law

• to be honest – to pay for goods bought or services received when requested

- not to steal
- not to make false claims about poor service, underperforming goods or failed items

Suppliers

- to supply goods and services to allow the business to offer its products to its own customers
- to be paid on time as stated in the service agreement between the business and suppliers
- to be treated fairly and not to be exploited by the customer business
- to supply goods and services ordered by the business in the time and condition laid down by the purchase contract or supplier's service agreements

Employees

- to provide manual and other labour services to the business, in accordance with the employment contract, to allow goods and services to be provided to customers
- to be offered employment contracts that meet legal standards, e.g. minimum wage rate
- to be treated and paid in the ways described in the employment contract
- in most countries, to be allowed to join a trade unionan organisation of working people with the objective of improving the pay and working conditions of its members and providing them with support and legal services. if desired
- to be honest
- to meet the conditions and requirements of the employment contract
- to cooperate with management in all reasonable requests
- to observe the ethical code of conduct

Local community

- to provide the labour services required by the business
- to be consulted about major changes that affect it, e.g. expansion plans or changing methods of production
- to cooperate with the business, where reasonable to do so, on expansion and other plans

Local government

- to provide local services and infrastructure to the business to allow it to operate, produce and sell within legal limits
- not to have the community's lives badly affected by the business's activities

• to meet reasonable requests from the business for local services such as public transport for employees and waste disposal

Government

• to pass laws that restrain many aspects of business activity

• to provide law and order and economic stability to allow business activity to take place

• to expect the business to meet all legal constraints, such as producing only legal goods and to pay taxes on time

• to treat businesses equally under the law

• to prevent unfair competition that could damage chances of business survival

• to establish good trading links with other countries to allow international trade

Lenders

• to provide finance to the business in different forms

• to be repaid on the agreed date

• to be paid finance charges, e.g. interest on loans

• to provide the agreed amount of finance on the agreed date for the agreed time period

Managers

• to control, command and direct resources

• to have contract of employment; to have sufficient authority to fulfil roles

• to report to stakeholders; to act legally and ethically

Owners/shareholders

• to provide finance

• to receive a share of profits; to receive accurate reports on business performance

• to set targets for managers; give managers adequate time and resources to meet targets

Table 5.1: Stakeholders' roles, rights and responsibilities

5.2 Importance and influence of stakeholders on business activities

Business activity always has an impact on at least one stakeholder group. On the other hand, some stakeholder groups are so powerful and influential that they can influence business activities and business decisions.

Impact of business decisions on stakeholders and their reactions

The traditional view of business is often called the shareholder concept. The shareholders are the owners of the company and the company has a legally binding duty to put their needs first – to take actions and to make decisions that will increase shareholder value. It is important to remember that directors and managers ultimately owe their positions to shareholders, so it is important to keep them satisfied.

In recent times, this limited view of business responsibility has been extended to include the interests of other stakeholders too. The stakeholder concept is that there are many other parties involved and interested in business activity than just the owners. The interests of groups such as local communities, the public, government and environmental pressure groups should also be considered by business decision-makers. If this does not happen, negative reactions from stakeholder groups can be damaging. Table 5.2 refers to some business decisions, the likely impact on major stakeholders and their reactions.

==stakeholder concept:== the view that businesses and their managers have responsibilities to a wide range of groups, not just shareholders (also known as stakeholder theory).

Business decision

Employees

Local community

Customers

Build a new factory to expand business

Impact:

• more job opportunities

• new working methods in this factory might require new skills

Reaction:

• more potential employees seeking a job

• trade unions might demand higher pay for more skilled work

Impact:

• more jobs for local residents and increased spending in other local businesses

• disruption caused by increased traffic and pollution and loss of site for amenity use

Reaction:

• seeks to refuse planning permission

- bans large trucks
- organises petition or boycott

Impact:

- greater efficiency might result in lower prices
- will business focus be on quantity not quality?

Reaction:

- buy more products if prices are lower for the same quality

Horizontal integration – takeover

Impact:

- combined business is more secure and more career promotion opportunities
- rationalisation may occur to avoid waste and cut costs – jobs might be lost

Reaction:

- possible industrial action if jobs are under threat

Impact:

- if business expansion is on the existing site, local jobs and incomes might increase
- rationalisation of duplicated premises might lead to closures and job losses

Reaction:

- encourages government to ban the takeover if rationalisation is threatened

Impact:

- economies of scale could lead to lower prices
- reduced competition and choices could have the opposite effect and might result in higher prices

Reaction:

- consumer boycott if prices are raised due to less competition

Purchase of IT-controlled automated machines

Impact:

- training and promotion opportunities might be offered
- fewer untrained workers required; those unable to learn new skills may be made redundant

Reaction:

- industrial action by workers to be made redundant

Impact:

- local suppliers of IT services could benefit from increased orders
- only specialist skilled workers needed and fewer unskilled jobs

Reaction:

- demand retraining programmes for unskilled unemployed

Impact:

- more efficient and flexible production methods resulting in improved quality and more product variety
- IT reliability problems could cause supply delays

Reaction:

- increased demand if product quality is high

Table 5.2: Impact of three business decisions on stakeholders and their possible reactions

Business accountability to stakeholders and how stakeholder aims impact business decisions

The increasing importance of corporate social responsibility in business decision-making shows that businesses are becoming more accountable (or responsible) to their stakeholders. Businesses can respond to this increased accountability by showing more understanding of stakeholder aims in their decision-making.

Responsibilities to customers

In a world of increasing free trade and international competition, it is essential to satisfy customers' demands in order to stay in business in the long term. Decisions about quality, design, durability and customer service should consider the customers' aims for well-made, attractive goods that perform as intended, all at reasonable prices. Businesses also have responsibilities to customers not to break the law concerning consumer protection and accurate advertising. Avoiding taking advantage of vulnerable customers, such as the elderly, and not using high-pressure selling tactics are other policies of responsible businesses.

The benefits of accepting these responsibilities include consumer loyalty; repeat purchases; good publicity when customers give word of mouth recommendations to others; and good customer feedback, which helps to improve further goods and services.

Responsibilities to suppliers

The quality of a product is only as good as the supplies that the business purchases. If these are of poor quality or frequently late, then the same problems will exist with the finished products and these will not satisfy customer requirements. Good, reliable suppliers must be found and given clear guidance on what is required. In return, the purchasing department should take decisions that satisfy suppliers' aims and requirements, such as prompt payment, the placing of regular orders and the offer of long-term contracts.

The benefits of accepting these responsibilities include supplier loyalty, the likelihood of securing reasonable credit terms and a preparedness to meet deadlines and special order requests.

Responsibilities to employees

All countries have some laws that outline business responsibilities to workers. These laws are stricter in some countries than others. Apart from not breaking these laws, do businesses have other responsibilities to employees? Many people think they do. Business decisions that reflect the aims of employees include providing training opportunities and job security, paying rates above minimum wage, offering good working conditions and involving employees in some of the decision-making.

The benefits of accepting these responsibilities include employee loyalty and low labour turnover; ease of recruiting good workers; employee suggestions for improving efficiency and customer service; improved motivation; and more effective communication.

Responsibilities to local community

Businesses that fail to meet responsibilities to the local community may experience serious problems with opposition to plans or changes to the use of premises. The stakeholder concept assumes that businesses will meet responsibilities to the local community. Examples of business decisions that focus on the aims of the local community include offering secure employment so that there is less local fear of job losses, using local suppliers where possible to generate more income, reducing the transport impact of the business and keeping other adverse environmental effects to a minimum.

The benefits of accepting these responsibilities include local councils being more likely to give planning permission to expand the business and giving contracts only to businesses with a record of community involvement. Also, local communities will be more likely to accept some of the negative effects caused by business operations if they provide financial support for community groups and projects, such as children's playgrounds.

Responsibilities to government

Clearly, all businesses should meet their legal responsibilities as defined by government legislation. In addition, businesses should decide to pay taxes on time, complete government statistical and other forms accurately and, where possible, seek export markets. The foreign currency earned by exports allows a country to pay for important imports of food, materials, new technology and so on.

The benefits of accepting these responsibilities include:

- developing good relations with government, so planning permission for future expansion projects is more likely to be granted
- more likely to receive valuable government contracts
- requests for subsidies to expand businesses more likely to win government approval
- licences to set up new operations more likely to be awarded to businesses that meet their responsibilities to the government and the wider society.

  TIP When considering the conflict of stakeholder aims, remember that it is difficult for a business to meet all responsibilities to all stakeholder groups at any one time. Compromise might be necessary, such as meeting as many stakeholder aims as possible or meeting the needs of the most important group in each situation.

Conflicts arising from different stakeholder aims

According to the traditional shareholder concept, attempts to meet obligations to other stakeholders will conflict with the business's legal duty to its shareholders. Any non-essential costs will reduce profits – so the argument goes. Taking the stakeholder approach, the objectives of different groups may be satisfied in ways that also result in benefits to shareholders in the long term.

However, conflicts might still arise between the objectives of these different stakeholder groups. How do businesses deal with these conflicts of stakeholder aims? A compromise is often the answer. Perhaps a factory will close in stages, rather than immediately, to allow workers time to find other jobs, even though business costs will fall more slowly. Plans to build a new chemical plant may have to be adapted to move the main site away from a housing estate to protect the local community, even though the new site might be more expensive. The introduction of 24-hour flights at an airport, to benefit the airlines and passengers, may only be accepted if local residents are offered sound insulation in their homes, paid for by the airport and airlines.

Clearly, senior management must establish its priorities in these situations. Which are the most important stakeholders in each case? What will be the extra cost of meeting the needs of each stakeholder group? Will bad publicity resulting from the failure to meet the interests of one group lead to lost revenue? Perhaps lost revenue will be greater than the cost savings of not satisfying this group. Taking such difficult decisions, which are based on weighing up the conflicting interests of these groups, is one of the reasons why managers and directors are often paid more than other employees.

Impact on stakeholders of changing business objectives

The dynamic business environment often means that directors or senior managers might be forced to change corporate objectives. When this happens, the impact on stakeholders can be significant. Two examples illustrate this:

- Volkswagen's objective to be world leader in diesel engines for cars and vans had to be changed when the 'Dieselgate' scandal broke. This involved Volkswagen deliberately cheating emissions control regulations.The company is now focused on being the world's leading manufacturer of electric cars, but this has required massive investment and the closure of some diesel engine factories.

- 'Social and environmental change' is one of The Body Shop's major objectives but, due to difficult trading conditions, it was recently forced to focus on cost-cutting by closing some shops to ensure survival and achieve profitability. Making employees redundant goes against The Body Shop's original objectives. Different stakeholder groups will be affected in different ways by these changes in objectives. Employees' jobs will be lost and customers will have less choice, for example. However, owners' returns might be safeguarded in the future by the decisions taken above. Lenders might be reassured that action is being taken to stop losses or improve reputation, which should mean that they are repaid the loans they provided.

  KEY CONCEPT LINK When there is a change in the objective set by a business, it must change strategy too – and this can impact on stakeholder groups.

Image Image

Introduction

All businesses operate within an external environment which influences their activities and decisions. This external environment comprises: laws, political and social factors, economic conditions, level of technology, competitors and suppliers, international trade links and environmental pressures. Businesses cannot take effective decisions without understanding these external forces and how they might impact on business operations. This chapter considers all external influences, except economic factors, which are studied in Chapter 7.

6.1 Political and legal influences

These influences include privatisation, nationalisation and legal controls over business activity.

==privatisation:== the act of selling state-owned and -controlled business organisations to investors in the private sector.

==nationalisation:== the transfer of privately owned businesses to state (government) ownership and control.

Advantages and disadvantages of privatisation

Privatisation transfers ownership of state-owned industries into the private sector by creating public limited companies. Shares in these newly formed public limited companies are sold through the stock exchange. The list of privatised companies in Europe is very extensive and includes British Airways, Deutsche Telekom and Skoda.

The debate over privatisation is a complex one. It has also become very political. Supporters of government-controlled economies stress the benefits of nationalisation. Supporters of free market economies stress the benefits of privatisation. Table 6.1 contains a summary of the claimed advantages and disadvantages of privatising state-owned businesses.

Arguments for privatisation

Arguments against privatisation

- Private-sector businesses lead to greater efficiency than when a business is supported and subsidised by the state.

- Decision-making in state bodies can be slow and bureaucratic.

- Privatisation gives responsibility for success to managers and employees. This is motivating. There is a greater sense of empowerment than in state-owned businesses.

- Market forces operate: failing businesses will be forced to change or die; successful ones can expand. Profits of most privatised businesses have increased following their sell-off.

- Important business decisions are taken for financial reasons not political reasons, for example keeping electricity prices artificially low.

- Sale of nationalised industries can raise finance for government, which can be spent on other state projects.

- Private businesses will have access to the private capital markets and this will lead to increased investment in these industries.

- The state should take decisions about essential industries. These decisions can be based on the needs of society and not just the interests of shareholders. This may involve keeping open business activities that private companies would consider unprofitable.

• Privately operated businesses that compete with each other are unlikely to achieve a coherent and coordinated policy for the benefit of the whole country, for example on the railway system, electricity grid and bus services.

• Through state ownership an industry can be made accountable to the country. This is by means of a responsible minister and direct accountability to parliament.

• Many strategic industries could be operated as private monopolies if privatised and they could exploit consumers with high prices.

• Breaking up nationalised industries, perhaps into several competing units, reduces the opportunities for cost saving through economies of scale.

Table 6.1: Arguments for and against privatisation

Advantages and disadvantages of nationalisation

The arguments for and against the state buying privately owned businesses to nationalise them (i.e. nationalisation) are the opposite of the points for and against privatisation. They are summarised in Table 6.2.

Arguments for nationalisation

Arguments against nationalisation

• The government will have control of major industries.

• Integrated industrial policy (e.g. for water supply) should now be possible.

• It prevents private companies operating as monopolies and exploiting consumers.

• Economies of scale can be achieved by merging all private businesses in an industry into one nationalised corporation.

• There is less profit motive, so less incentive to operate the industry efficiently, and the government may provide subsidies to loss-making nationalised industries.

• Government may intervene too much in business decision-making for political reasons.

• The cost to the government of buying private companies could be very high.

• It removes the ability of the industry to raise finance from private sources (e.g. through the stock exchange).

Table 6.2: Arguments for and against nationalisation

Legal constraints on business activity

In most countries, governments have introduced laws that control business decisions and activities. These fall into the following main categories:

- employment practices, conditions of work and wage levels
- marketing behaviour, consumer rights and controls over some products
- competition
- location of businesses (see Chapter 26).

The law and employment practices

These laws control the relationship between employers and employees. There are substantial differences in legal controls over employment between countries.

The two main objectives of these laws are to:

- prevent exploitation of workers by powerful employers by insisting on appropriate levels of health and safety and minimum wage rates
- control excessive use of trade union collective action. Legal constraints usually cover the following areas of employment practices:
- recruitment, employment contracts and termination of employment
- health and safety at work
- minimum wagesemployers are not allowed to pay less than the set minimum wage per hour (in some countries it is a minimum payment per week or per month)..

Recruitment, employment contracts and termination of employment

In many countries, legally protecting the rights of workers takes the following forms:

- a written contract of employment so that the employee is fully aware of the pay, working conditions and disciplinary procedures to be followed
- minimum ages at which young people can be employed
- maximum length of the working week
- holiday and pension entitlements
- no discrimination against people during recruitment and selection – or while at work – on the grounds of race, colour, gender or religion
- protection against unfair dismissal. In the European Union (EU), it is illegal to discriminate on the basis of an employee's age. The EU has some of the most protective legislation in the world for employees, which includes

not only paid maternity leave after the birth of a baby but paternity leave (for fathers) too.

Some country comparisons are as follows:

- maximum weekly working hours can be long – 52 hours in Central African Republic, but only 37 hours in Denmark
- no minimum wage law in Sweden, Norway and Denmark
- minimum working ages vary; for example, just ten years old in Sri Lanka
- health and safety at work requirements can be less stringent – Bangladesh and the Bahamas have not agreed to adopt International Labour Organization standards on work health and safety. These differences have been a major factor driving the location decisions of some European and multinational organisations.

Health and safety at work

These requirements aim to protect workers from discomfort and physical injury at work. Providing a healthy and safe environment in which to work is now a legal requirement in most countries. The strictness of these laws and the efficiency of inspection systems vary considerably. Health and safety laws usually require businesses to:

- equip factories and offices with safety equipment and train staff to use it
- provide adequate washing and toilet facilities
- provide protection from dangerous machinery and materials
- give adequate breaks and maintain certain workplace temperatures. In the EU there is a comprehensive and legally enforceable inspection system. This has the power to inspect any work premises at any time and to start legal proceedings against firms that fail to meet minimum standards.

Minimum wages

Minimum wage rates are legally binding on businesses. The rates vary considerably around the world. In 2020, the highest rate paid was in Luxembourg ($13.80 per hour). The lowest rate, based on a 160-hour working month, was Egypt ($1.10 per hour). The two main aims of the minimum wage are to:

- prevent exploitation of poorly organised workers by powerful employers
- reduce income inequalities between the high paid and low paid in the economy. Apart from these two benefits, other effects of the minimum wage are:
- increased standard of living and purchasing power of low-paid workers

- a work incentive, as working is more worthwhile than being unemployed. Criticisms of most minimum wage systems include:
- They can be avoided by employers insisting on casual employees with no employment contracts and no job security. These actions are illegal, but difficult to prevent.
- Raising labour costs can make businesses uncompetitive and they might make workers redundant.
- Other workers being paid just above the minimum wage will ask for a wage raise, and inflation might increase as business costs increase further.

  TIP You do not need to know about specific laws for A Level Business, but it is a good idea to know what the main employment laws are in your country and what they expect employers to do.

Impact on business of changes in employment and health and safety laws

There are both positive and negative effects to changes to these laws. On the one hand, they are constraints that add to business costs, including:

- supervisory costs for checking on recruitment, selection and promotion procedures
- higher wage costs if a minimum wage is introduced or increased
- higher costs from an increase in paid holidays, pension contributions and paid leave for sickness, maternity and paternity
- employment of more employees to respond to controls over length of the working week
- protective clothing and equipment to meet stricter health and safety laws. Clearly, multinationals that operate in countries with very few legal constraints will enjoy lower production costs.

However, there are some benefits to be gained by businesses that meet or even exceed minimum standards laid down by law. Some businesses offer conditions of employment, pay levels and working conditions that far exceed legal minimum levels. The benefits include:

- Workers will feel more secure, more highly valued and more motivated with a clear and fair employment contract.
- A safe working environment reduces the risk of accidents and time off work for ill health or injury.
- Meeting minimum standards avoids expensive court cases and heavy fines.

- Businesses that make a policy of providing employment conditions and a healthy environment beyond legal requirements are likely to attract the best employees.
- Good publicity will be gained if the business culture is considered to treat workers as partners in the business, equal in status and importance to managers and shareholders.

The law, marketing behaviour and consumer rights

There are various reasons why governments around the world take legal action to protect consumers of goods and services from unfair or unscrupulous business activity and marketing behaviour:

- Individual consumers are relatively weak and powerless against businesses with large marketing and promotion budgets. Advertising can also be very influential but misleading.
- Products are becoming more scientific and technological. It is difficult for consumers to understand how they operate and to assess the accuracy of the claims being made for them.
- Selling techniques are very pressurised and are increasingly difficult for some consumers to resist. These include the offer of apparently cheap loans, some of which can commit consumers to paying off debts for many years at high interest rates.
- The globalised marketplace has increased the import of goods. Consumers need protection from products that have different quality and safety standards to those in the domestic country.
- Increasingly competitive markets lead to some businesses trying to take advantage of consumers by reducing quality, service and guarantee periods in order to offer a lower price.

Consumer protection laws

The following are the main UK consumer protection laws. Many countries have similar legislation.

- Sale of Goods Acts. There are three main conditions of these acts:
- Trade Descriptions Act. The most important condition is that there should be no misleading descriptions of, or claims made for, the goods being sold (e.g. a plastic chair cover cannot be claimed to be leather).
- Consumer Protection Act. The two main conditions are: Other laws govern weights and measures, consumer credit regulations and the safety and preparation of food products. In addition, some products cannot be produced or sold at all. These include dangerous products such as guns, illegal substances, tribal knives and harmful pesticides. The import and sale of

these products is usually strictly controlled and heavy fines are imposed on individuals or businesses that break these laws.

TIP You do not need to give specific details of consumer protection laws, but you may be asked how a business is affected by such laws in your country.

Impact on business of consumer protection laws

Complying with these laws increases business costs for:

- redesigning products to meet consumer health and safety laws
- redesigning advertisements to give only clear and accurate information
- improving quality-control standards and the accuracy of weights and measures. Laws to protect consumers may require a change of strategy and culture in the business. Putting consumer interests at the forefront of company policy may demand a change of attitude among very senior managers.

Possible benefits of consumer protection include:

- reduced risk of consumer injury from using a product and resulting bad publicity
- reduced risk of court action
- improved customer loyalty for products that meet minimum performance standards
- a reputation for dealing with complaints fairly and quickly and for advertising with fairness and honesty. A business could gain a good reputation for offering consumers even higher standards of consumer protection than required by law. If consumers are offered an improved deal in terms of honest advertisements, accurate promotional offers, quality products and good after-sales service, then the sales and marketing benefits, and eventually profit increases, could be real and long-lasting.

The law and business competition

It is usually argued that free and fair competition between businesses has the following benefits for consumers:

- There is a wider choice of goods and services than when just one business dominates a market.
- Businesses have to keep prices as low as possible to be competitive.
- Businesses compete by improving the quality, design and performance of the product.

- Competitive markets within one country also have external benefits. Rival businesses become more competitive against foreign firms and this helps to strengthen the domestic economy. Governments attempt to encourage and promote competition between businesses by passing laws that:
- investigate and control monopolya market in which there is only one supplier with no close competitors. activities and make it possible to prevent mergers and takeovers that create monopolies
- limit or outlaw uncompetitive practices between businesses, such as collusionbusinesses agree to work together and restrict competition by fixing prices and sharing contracts between themselves..

6.2 Social and demographic influences

Significant changes in society, including demographic changes, can influence business decisions, such as which products to supply.

Corporate social responsibility

When a business accepts its legal and moral obligations to all stakeholders, not just investors, it is said to be showing corporate social responsibility (CSR). The ways in which the decisions of a business impact on society and the environment are very important indicators of whether CSR is a key priority for that business. This section considers CSR and social issues (see Section 6.6 for CSR and the environment).

CSR and accounting practices

Is it socially responsible to report misleading profit figures that convince shareholders that a company is a good potential investment? Is it socially responsible to inflate the value of a business so that lenders are more willing to give loans? These practices, and other forms of making accounts appear more favourable, are called 'accounting window dressing' (see Section 36.2).

The widely held view is that any deliberate attempt to distort the profitability or value of a company to give a misleading picture is socially irresponsible and should be against the law.

CSR and the payment of illegal incentives

Is it socially responsible to award 'incentive payments' (bribes) to directors or purchasing managers so that a contract is awarded to a particular company? Is it socially responsible to award 'incentive payments' to government officials to obtain subsidies or to avoid legal action for breaking environmental laws? Most countries have effective laws to prevent these and other forms of 'incentive payments'. They lead to a distorted marketplace, where it is not necessarily the best product that receives a contract or the worst wrongdoer who pays fines.

CSR and social auditing

There is growing demand for businesses to report annually on how socially responsible they have been. Just as annual accounts report on profits or losses, an annual social report indicates the social impact of a business over the same period. It would show, for example, if profits were made at the expense of stakeholder interests, or if the business made real efforts to meet its social responsibilities. Annual social reports are called social audits (see Table 6.3). It is not currently a legal requirement for businesses to produce such audits, but many do so voluntarily.

==social audits:== a report on the impact a business has on society.

Social audits usually include:

- a health and safety record (e.g. the number of accidents and fatalities)
- pollution levels
- contributions to local community events and charities
- the proportion of supplies from ethical sources (e.g. Fairtrade suppliers)
- employee benefit schemes
- feedback from customers and suppliers on the ethical nature of the business's activities
- annual targets for social responsibility measures.

Benefits of social audits

Limitations of social audits

• They identify what social responsibilities the business is meeting – and what still needs to be achieved.

• Managers can set targets for improvement in social performance by comparing these audits with the best-performing firms in the industry.

• They improve a company's public image, which acts as a useful marketing tool to increase sales.

• If the social audit is not independently checked, it may not be taken seriously by stakeholders.

• Detailed social audits require time and money.

• Some consumers are just interested in cheap goods, not whether the businesses they buy from are socially responsible or not.

Table 6.3: The main benefits and limitations of social audits

Why businesses need to consider community needs

A business that aims to be socially responsible will take decisions that consider the needs of the community as well as its shareholders. The benefits of a business attempting to meet the needs of the community are:

- improving the public image of the business, making it more attractive to investors and socially aware consumers
- increasing the chance that the community will accept business decisions such as expansion or relocation
- increasing the chance that the business will receive government grants and subsidies
- reducing the risk of negative action being taken against the business by pressure groups.

Pressure groups

More and more businesses are accepting the need to incorporate environmental and ethical considerations into their strategic decision-making. One of the main reasons concerns the growing power and influence of pressure groups at both national and international levels.

Perhaps the best-known international examples are:

- Greenpeace – campaigns for greater environmental protection by businesses adopting green strategies and governments passing tighter anti-pollution laws.
- Fairtrade Foundation – aims to achieve a better deal for agricultural producers in low-income countries.
- Amnesty International – rigorously supports human rights, especially in countries where these are at risk as a result of government action.
- Extinction Rebellion – encourages demonstrations to force governments to take action against climate change. Pressure groups want changes to be made in three important areas:
- businesses to change policies so that, for example, less damage is caused to the environment
- consumers to change their purchasing habits, so that businesses which adopt appropriate policies see an increase in sales, but those that continue to pollute or use unsuitable work practices see sales fall
- governments to change their policies and to pass laws supporting the aims of the group. Pressure groups try to achieve these goals in a number of ways:

- Publicity through media coverage: Effective public relations are vital to successful pressure-group campaigns. Frequent press releases giving details of undesirable company activity and coverage of direct-action events, such as meetings, demonstrations and consumer boycotts, help to keep the campaign in the public eye. The more bad publicity the group can create for the company concerned, then the greater the chance of changing company policy.
- Influencing consumer behaviour: If the pressure group is so successful that consumers stop buying a company's products for long enough, then the commercial case for changing policy becomes much stronger. The successful consumer boycott of Shell petrol stations following a decision to dump an old oil platform in the sea led to a change of strategy. Shell is now aiming to become 'the leading multinational for environmental and social responsibility'. Public sympathy for a pressure-group campaign can increase its effectiveness significantly.
- Lobbying of government: This means putting the arguments of the pressure group to government members and ministers because they have the power to change the law. If the popularity of the government is damaged by a pressure-group campaign that demands government action, then the legal changes asked for stand a greater chance of being introduced.

Figure 6.3: Extinction Rebellion supporter protesting outside the Brazilian Embassy in Mumbai against the burning of the Amazon rainforest Figure 6.3: Extinction Rebellion supporter protesting outside the Brazilian Embassy in Mumbai against the burning of the Amazon rainforest

Figure 6.4: Greenpeace organised a blockade of EDF headquarters campaigning against nuclear power Figure 6.4: Greenpeace organised a blockade of EDF headquarters campaigning against nuclear power

Demographic changes

The structure of society is constantly evolving. Many of these changes occur due to demographic change. Changes in the size and structure of the population can occur at:

==demographic:== relating to the structure of the population.

- Local level: examples include an increase in the local population due to a large settlement of foreign refugees or the building of large new housing estates.
- National level: examples include an increase or a decline in the national birth rate and an ageing national population.
- Global level: examples include the projected growth in the world's population from almost 8 billion in 2020 to 11 billion by 2100. The world

population has doubled since 1970. Recent global social and demographic changes include:

- an ageing population in many high-income countries
- the changing role of women, who increasingly seek employment and fill posts of responsibility in industry
- better provision of education facilities and increasing literacy, leading to more skilled and adaptable workforces
- early retirement in many high-income countries, leading to more leisure time for a growing number of relatively wealthy pensioners
- rising divorce rates, creating increasing numbers of single-person households
- job insecurity, often caused by globalisationthe increasing freedom of movement of goods, capital and people around the world., forcing more employees to accept temporary and part-time employment, although some workers prefer this option. This list is not complete, and you could add to it from knowledge of the changes occurring in your own society.

Impact on business of social and demographic change

This section considers two of the most significant changes affecting many societies in recent years.

An ageing population

This means that the average age of the population is rising. It is often associated with:

- a larger proportion of the population over the age of retirement
- a smaller proportion of the population below 25 years of age
- a larger number of dependants on social benefits, putting a higher tax burden on the working population. These changes often result from lower birth rates, more women in work and longer life expectancy. The impact on business of these changes is most apparent in two ways:
- Changing patterns of demand. Older consumers demand different types of products from those bought by younger consumers. A construction company might, for example, switch from building large apartments for families to smaller units with special facilities for the elderly. Market research will be important to forecast changes in demand for products as a consequence of an ageing population.
- Age structure of the workforce. There may be reduced numbers of young employees available. It may be necessary for workforce planning to include provision for employing older workers or for keeping existing workers

longer than usual. Younger employees may be more adaptable and easier to train in new technologies. Older workers are often said to show more loyalty to a business and will have years of experience that could improve customer service.

Patterns of employment

Changing patterns of employment are one of the social constraints on the activities of business. For many businesses, labour is still a crucial factor of production and probably the greatest single expense. This is particularly true in the personal service industries, such as childcare or homes for the elderly.

The main features of changing employment patterns in many countries are:

- Labour is being replaced by capital equipment such as automated machines, particularly in the secondary sector of the economy. Output and efficiency can rise due to increasing productivity, yet total employment often falls.
- Labour is transferring from old established industries, such as steel, to new hi-tech industries, such as computer-games design.
- The number of women in employment and in a wider range of occupations is increasing.
- Part-time employment is increasing.
- Learner employment on a part-time basis is increasing. Some industries are substantially staffed by learners and part-timers. McDonald's, most of the other fast-food chains and many supermarkets employ many such workers.
- Temporary and flexible employment contracts are increasing. These can be imposed by employers on workers to reduce the fixed costs of full-time jobs and to allow for flexibility when faced with seasonal demand or uncertainties caused by increasing globalisation.
- Flexible work patterns are more common. Working from home or flexi-hours arrangements can benefit both employer and employee.
- An ageing population increases the dependency ratio. In Germany, the decision to raise the retirement age to 67 for receiving the state pension increases the working population and reduces the dependency ratio.
- Women are tending to stay in full-time employment for longer – families are smaller, more women do not have children and many women only have children later in life.
- More women take maternity leave and then return to work.
- Many countries are increasingly multicultural, and this has an effect on the pattern of women at work.

- In the UK, the proportion of women seeking full-time employment has risen to 75%.

Image Image

Evaluating the impact on business of social and demographic changes

As with all other external influences on business activities and decisions, the most successful companies will be those that quickly adapt to social and demographic changes and attempt to turn them to their own competitive advantage (see Table 6.4).

Possible opportunities of social and demographic change

Possible threats of social and demographic change

• Demand is increasing for products aimed at ethnic groups or age groups.

• Rising population increases the demand for housing and household products.

• Increasing numbers of high-income, middle-class people increase consumer spending on luxury products.

• Part-time employment patterns allow for greater flexibility of operations.

• Reduced demand for products aimed at age groups or social groups that are becoming relatively less important.

• Shortage of labour supply if there is an ageing population.

• Increased taxation to pay for more people dependent on social benefits.

• Need to restructure work patterns to suit more part-time workers.

• Part-time workforce may be more difficult to build into a loyal team.

Table 6.4: The possible opportunities and threats of social and demographic change

> TIP Changing social conditions and employment patterns can create just as many opportunities for businesses as potential risks or threats. This could be one way for you to evaluate the impact of these changes on business activity.

6.3 Technological influences on business activities

In its simplest form, technology means the use of tools, machines and science in an industrial context. Businesses have been using low-technology tools and machines, such as drills and lathes, for hundreds of years. This section focuses on the rapid changes in technology and information technology (IT) in the last 30 years. These recent developments have transformed the way most businesses operate, including:

==information technology (IT):== the use of electronic technology to gather, store, process and communicate information.

- the products consumers demand
- the ways products are made
- the ways businesses communicate
- the ways businesses collect, store and use information. Technological change is affecting all businesses and all departments within business. The specific applications of technology in and its impact on human resources, marketing and operations are fully explained in Chapters 10, 17 and 23. This chapter focuses on the general impact of technology on businesses and how new technology can be introduced most effectively.

  TIP You should not assume that a business must always use the latest technology. There are substantial costs to new technology and some businesses thrive without it. For example, handmade designer furniture will sell because each piece is unique and computer-controlled robots might be completely impractical.

Impact on business of technological change

Opportunities from new technology include:

- New products: as in developing new consumer electronics products.
- New processes: automation and robotics are being widely adopted.
- Reduced costs: resulting from much higher levels of productivity.
- Better communications: for example, from increasing use of social media.
- More information: IT systems are providing much more data for business decision-making.

  KEY CONCEPT LINK Innovation through new technology is one of the most important ways for businesses to add value. Technological change is having a big impact on how businesses produce goods and services.

New technology also presents some potential threats to business:

- Costs: Capital costs can be substantial. Labour training costs are also necessary and recur regularly with further technological development. Redundancy costs will be incurred if existing employees are being replaced by technology.
- Workforce relations: These can be damaged if the technological change is not explained and presented to workers in a positive and fully justified way. If many jobs are lost during the process of change, remaining workers may suffer from reduced job security and this could damage their motivation

levels. Trade unions can oppose technological change if it risks too many of their members' jobs.

- Reliability: Breakdowns in automated production or inventory-handling systems can lead to the whole process being halted. There may be teething problems with new systems and the expected gains in efficiency may take longer to be realised than forecast.
- Data protection: The right to hold data on staff and customers is controlled by national laws and the business must keep up-to-date with these legal constraints on its use of IT.
- Management: Some managers do not welcome new technology. Recognising the need for change and managing the process of change require good management skills.
- Competition: Rival companies might be even more innovative and adopt technology more rapidly, leaving a business less competitive than before it invested in technology.

Providing data for business decision-making

Management information systems use IT to provide managers with huge amounts of data about business operations. This has the following benefits:

- Managers can obtain data quickly and frequently from all departments and regional divisions of the business, which aids overall control.
- Computers can be used to analyse and process the data rapidly. This allows managers to interpret data and take decisions based on it quickly.
- Management information systems accelerate the communication of decisions to those in the organisation who need to know. Information gives managers the opportunity to review and control the operations of the business. Management information systems give central managers substantial power. Although this could be used to improve business performance, there are possible drawbacks too:
- The ease of transferring data electronically can lead to information overload. It becomes more difficult to identify the most important information and the areas of the business most in need of action.
- The power that information brings to central managers could reduce the authority and empowerment given to work teams and middle managers. Central control can become oppressive, reducing job enrichmentaims to use the full capabilities of workers by giving them the opportunity to do more challenging and fulfilling work. and motivation levels. The best managers use information provided by IT systems to improve and speed up decision-making. They should not use it to control all aspects of the organisation.

Introducing technology effectively

There are important stages a business should go through when introducing or updating technology to reduce internal opposition to change:

- Analyse the potential use of the new technology and the ways it can make the business more effective.
- Involve managers and other employees in assessing the potential benefits and pitfalls of introducing the new technology. Better ideas may come from workers who will use the system than from managers responsible for purchasing it.
- Evaluate the different systems available, comparing cost, and expected efficiency and productivity gains. Consider the budget available.
- Plan for the introduction of the new system, including extensive training for all users and demonstrations to all staff.
- Monitor the introduction and effectiveness of the system. Is it giving the expected benefits and, if not, what can be done to improve performance?

  TIP You should be prepared to evaluate a firm's use of new technology and how it introduced the system. New technology is not the best solution to all problems and introducing it badly can create more problems than it solves.

6.4 Influence of competitors and suppliers

The greater the number of competitors and their total market share, the less market power individual businesses have. Decisions on pricing have to be taken in line with competitors' prices, unless effective product differentiation is achieved. Even if there are few competitors, if it is easy for new businesses to join an industry, the market power of any one business will be low.

The smaller the number of suppliers, the less likely a business customer is able to influence prices and credit terms. If there are many suppliers competing with each other, a customer business has an excellent chance of forcing prices of supplies down and demanding longer credit terms.

These, and other factors that determine competitive rivalry, are considered in more detail in Section 8.3 (Porter's five forces).

6.5 International influences

All countries engage in international trade with other countries. The opportunities presented by international trade mean that an increasing proportion of businesses either use imported materials or export their own products – or, very commonly, both.

Importance of international trade and its impact

The growth of world trade in recent years has been very rapid. In addition, the huge expansion in trade between certain countries, such as China with the USA and the EU, has had a great impact on their economic development. By trading together, countries can also build improved business, political and social links.

Trading internationally, however, can also have drawbacks, which need to be considered carefully by governments. Selective assistance may need to be given to those firms and groups most adversely affected. The potential risks from international trade include:

- There may be loss of output and jobs from domestic firms that cannot compete effectively with imported goods.
- There may be a decline, due to imports, in domestic industries that produce essential goods, for example steel or foodstuffs. This could put the country at risk if there was to be a conflict between countries or another factor leading to a loss of imports.
- The switch from making goods that cannot compete with imports, to those in which the country has a comparative advantage, may take a long time. This will cause job losses and factory closures before other production increases.
- Newly established businesses may find it impossible to survive against competition from existing importers. This will prevent 'infant industries' from growing domestically.
- Some importers may 'dump' goods at below cost price in order to eliminate competition from domestic firms.
- If the value of imports exceeds the value of exports (products sold abroad) for several years, then this could lead to a loss of foreign exchange.

Impact of international trade agreements

Over recent years, there has been a series of international trade agreements which have led to significant reductions in protectionism. The most common forms of trade barriers are tariffs, quotas and voluntary export limits.

==protectionism:== the use of barriers to free trade to protect a country's domestic industries.

==tariffs:== a tax imposed on an imported product.

==quotas:== a physical limit placed on the quantity of imports of certain products.

==voluntary export limits:== agreed limits to the quantity of certain goods sold by one country to another (possibly to discourage the setting of tariffs/quotas).

The recent moves towards free international trade with less protectionism have been driven by:

==free international trade:== trade with no restrictions or barriers that might prevent or limit trade between countries.

- The World Trade Organization (WTO): This is made up of countries committed to freeing world trade from restrictions through negotiated agreements.
- Free-trade blocs: These groups of countries agree to trade with each other without restrictions but impose trade barriers on other countries in order to gain competitive advantage against their imports. Examples include: ASEAN (Association of Southeast Asian Nations) and the European Union (EU). The important benefits of international trade agreements that reduce protectionism lead to an increase in international trade. The benefits of increased international trade are:
- By being able to purchase products from other nations, consumers have a much wider choice of goods and services. Many of these products would not be available at all without international trade, because the production facilities do not exist in their own country (e.g. bananas in Europe or deep-sea fish in Botswana).
- The same principle applies to raw materials (e.g. the UK steel industry depends entirely on imports of iron ore).
- Imports of raw materials can allow a developing economy to increase its rate of industrialisation.
- Importing products creates competition for domestic industries. This should encourage them to keep costs and prices down and make well-designed, high-quality goods.
- Countries can specialise in products they make best and import products they make less efficiently compared to other countries. This is called comparative advantage.
- Specialisation can lead to economies of scale and further cost and price benefits.
- Some imported products are cheaper than similar products made within a country.
- The living standards of all consumers in all countries trading together should increase.

The role of technology in international trade

Improved communications via the internet – between business, suppliers and customers – have been a major factor driving the growth in international trade.

The future expansion of trade will be stimulated further by the following technologies:

- Blockchain – these technologies are speeding up the finance arrangements needed for international trade and reducing the cost of trade finance.
- Artificial intelligence and machine learning – these can be used to establish the most cost-effective trade shipping routes, manage ship and truck traffic at ports efficiently, and translate e-commerce search queries from one language into other languages.
- New digital platforms – these are bringing together service providers – educators, web developers, accountants and others – with potential global customers. When these services had to be delivered face-to-face, the scope for selling to other countries was minimal. Now these digital platforms are revolutionising the international trade in services.
- Mobile payments – Apple Pay, M-Pesa and other technologies for making mobile payments are enabling more people to buy products online. This is particularly true in developing countries where traditional banking systems have been weak. Mobile payments are allowing even low-income groups to be global consumers. Not all technological developments will lead to increased trade. For example, if 3D printing develops its full potential, it could actually lead to reduced international trade. As 3D printing requires very little labour, it might become cheaper to produce goods within countries rather than to import them from suppliers paying low wages.

Multinational businesses and relationships with government

A multinational business is more than just an importer or exporter. It has its headquarters in one country but owns operations in more than one country, which produce goods and services. The biggest multinationals have annual revenues exceeding the size of many countries' entire economies.

The size of multinationals, and the influence they have, can lead to many problems for governments. Many multinationals have their head offices in Western European countries or in the USA, yet have many of their operating bases in less-developed countries with much smaller economies. If the companies need to save costs by reducing the size of their workforces, often the last countries to lose jobs are the ones where the head offices are based. Countries where multinationals operate have to carefully compare the potential benefits versus disadvantages of these operations.

> TIP When defining a multinational business, it is not enough to state that such businesses 'sell products in more than one country'. Revise the Key term in Section 1.1.

Why become a multinational?

There are several reasons why businesses become multinationals:

- It brings them closer to their main markets, with the benefits of lower transport costs and better market information about consumer tastes.
- The benefits include lower costs of production as a result of lower wages, lower rental costs and relatively weak government restrictions.
- They avoid import restrictions by producing in the local country.
- They gain access to natural resources which might not be available in their base country.

Potential problems for multinationals

Setting up operating plants in foreign countries is not without risks:

- Communication links with headquarters may be poor.
- Language, legal and culture differences could make communications difficult.
- Coordination with other plants in the multinational group will become more difficult.
- The skill levels of the local employees may be low, requiring substantial investment in training programmes.

Evaluation of the impact of multinationals on host countries

The potential benefits are clear:

- The investment brings in foreign currency and, if output from the plant is exported, further foreign exchange is earned.
- Employment opportunities are created and training programmes improve the quality and efficiency of local people's skills.
- Local firms benefit from supplying services and components, generating additional jobs and incomes.
- Local firms are forced to improve quality and productivity to international standards, either to compete with the multinational, or to supply to it.
- Tax revenues are boosted from profits made by the multinational.
- Management expertise in the community will improve when, and if, foreign supervisors and managers are replaced by locals, once they are suitably qualified.

- The total output of the economy is increased, increasing gross domestic product. However, the expansion of multinationals into a country can lead to drawbacks:
- The local workforce might be exploited. There are no strict labour and health and safety laws in some countries. Multinationals can employ cheap labour for long hours with few of the benefits that workers elsewhere would demand. Recent publicity has forced Gap and Nike to check more carefully that child workers are not employed in factories that produce their clothes in Thailand.
- Manufacturing plants might produce more pollution than allowed in other countries. This could result from inadequate laws or fear in the host country that the multinational might cease operations if environmentally acceptable practices are insisted on.
- Local competing firms may be squeezed out of business due to inferior equipment and much smaller resources than the multinational.
- Western-based businesses, such as McDonald's and Coca-Cola, have been accused of imposing Western culture on other societies by the power of advertising and promotion. This could lead to a reduction in cultural identity.
- Profits may be sent back to the country where the head office is based, rather than kept for re-investment in the host nation.
- Depletion of limited natural resources has been blamed on multinationals. They may have no incentive to conserve these resources because they can relocate quickly if the resources run out.

  TIP In case study questions on multinational business activity, you may have the opportunity to use examples from your own country as well as from the case study to support your answers. Keep a file of news reports about multinational business activities in your own country.

6.6 Environmental influences on business activity

The environment in which we all live can be greatly affected by business activity. Air and noise pollution from manufacturing processes, road congestion caused by heavy trucks, business expansion into country areas, emissions of gases that lead to global warming, and the use of scarce non-renewable natural resources are important environmental issues. People all over the world are increasingly concerned about them.

How environmental issues influence business behaviour

Some analysts argue that there is a strong business case for corporate social responsibility (CSR) when business activities and decisions impact on the environment. There is good evidence that growing numbers of consumers will support businesses that adopt green policies and boycott companies that damage the environment.

- Businesses can benefit from making decisions that reduce negative environmental effects, including: reducing pollution by using low-energy equipment; using recycled materials instead of scarce natural products; disposing of waste responsibly.
- These decisions give businesses marketing and promotional advantages. They reduce the chances of breaking laws designed to protect the environment, avoiding bad publicity and heavy fines. They also attract more applications from better-qualified potential employees who are keen to work for an environmentally responsible business.
- There could be long-term financial benefits. For example, generating electricity from solar panels requires heavy capital expenditure but is low cost once the equipment has been paid for, especially compared with rising prices for oil and gas.
- The potential costs of cleaning up the environment or compensating locals will be avoided. These might include the cost of clearing polluted waste from rivers or land, or compensation for lost livelihoods and the cost of healthcare for those affected by pollution. The arguments for businesses not taking environmentally friendly decisions include:
- Environmentally friendly decisions can be very costly. Replacing oil boilers with solar panels can cost millions of dollars, as can low-polluting equipment. These costs might push product prices up. Keeping prices low may increase sales. Consumers will benefit from low-priced goods and may overlook the environmental consequences.
- Higher costs may reduce profits. This limits how much can be invested in the future.
- In many countries, legal protection of the environment is weak and inspection systems are inadequate. If there is little risk of legal action or heavy fines, some businesses will choose cheaper, less environmentally friendly options.
- In developing countries, economic growth may be more important than protecting the environment. It might seem that increasing output using low-cost methods is better than using the greenest production methods.

Figure 6.6: The long-term benefit of these solar panels fitted to a VW factory might outweigh the cost Figure 6.6: The long-term benefit of these solar panels

fitted to a VW factory might outweigh the cost

Businesses must ensure that any environmental claims they make are genuine. Making misleading or untrue claims is called greenwashing, which often results in bad publicity. Some critics suggest that CSR environmental activities are just attempts to get governments to impose fewer legal controls and restrictions on powerful multinational firms. A business might invest in CSR projects to distract attention away from environmental damage caused by its other activities. However, if found out, this is likely to backfire badly on the business.

==greenwashing:== giving a false impression or providing misleading information about how a company's products are environmentally sound and sustainable.

Environmental audits

An audit simply means an independent check. It is most commonly associated with company accounts, which have to be verified by an external auditor as a true and fair record. In recent years, some businesses have been using the auditing approach to evaluate their environmental performance. This is despite the fact that environmental factors are often difficult to measure in monetary terms and, legally, they do not currently have to be included in published accounts.

However, stakeholders are increasingly demanding that these audits should become a legal requirement. Environmental audits would then allow a meaningful comparison to be made between the environmental impacts of different businesses. At present, these audits are voluntary. The businesses that undertake them and publish the results nearly always have a very good environmental record – that is why they are published. Businesses with a poor reputation or poor environmental record are unlikely to produce an audit unless they become compulsory.

==Environmental audits:== assesses the impact of the activities and decisions of a business on the environment.

How stakeholders may use environmental audits

- Businesses use environmental audits to report on their pollution and waste levels, energy and transport use, and recycling rates. The audit compares these factors with previous years and pre-set targets, and possibly with other similar businesses.
- Managers may set sustainability targets for the coming year, then report their performance against these targets in the next annual audit.
- Consumer groups may use these audits to influence consumers' purchasing behaviour. Favourable consumer reaction to an environmental audit could lead to increased sales. Positive media coverage will give free publicity.

- Investors, particularly ethical investors, will use these audits to help decide whether to invest in or lend to the company.
- Employees often have pride in a business that has an excellent environmental record and publicises this through an audit. Working towards a common aim of reducing harm to the environment could help to bring employees and managers together as a team. Better-qualified applicants will want to join a company with a good reputation and a fine team spirit.

Evaluation of environmental audits

- Until environmental audits are compulsory and there is agreement on what they should include and how the contents will be verified, some observers will not take them seriously.
- Companies have been accused of using them as a publicity stunt or a smokescreen to hide their true intentions and potentially damaging practices.
- They can be very time-consuming and expensive to produce and publish, and this may limit their value to small businesses or those with very limited finance.

Sustainability and business decisions

Taking environmentally friendly business decisions is one way in which companies can demonstrate their commitment to sustainability.

==sustainability:== activities that meet the needs of the present without compromising the ability of future generations to meet their needs.

The ability of our global community to continue to enjoy current standards of living will be assisted by sustainable business decisions. Helping to protect the environment means that business activity becomes more sustainable. If, for example, forests are replanted, fish resources are not over-exploited and rivers not blocked with business waste, then future generations will be able to enjoy at least the same quality of life as we do.

Pressure-group activity, government environmental laws and green consumerism are forcing most businesses to take more sustainable business decisions. Details of some of these are given in Chapter 23.

==green consumerism:== the trend for consumers to only buy products that are produced sustainably without environmental damage.

Image Image

Introduction

One of the most significant external influences on business activity and decisions is the state of a country's economy and government economic policies. Governments intervene in business activity in a number of ways. They can constrain business activity by using laws as explained in Section 6.1.

7.1 Government support for business activity

Governments can also intervene to support or subsidise business start-ups, small firms and other existing businesses.

Government assistance for entrepreneurs

Most governments provide special assistance for entrepreneurs and other owners of small businesses. These measures include:

- Offering loan guarantee schemes – government-funded schemes that guarantee the repayment of a certain percentage of a bank loan should the new enterprise or small business fail.
- Providing information, advice and training schemes for entrepreneurs through government industry departments and local colleges.
- Financing the building of small workshops, which are let to entrepreneurs and small businesses at low rents. This assistance is commonly made available in economically deprived areas, such as cities with high unemployment.
- Reducing the paperwork and legal formalities needed to set up a new business.
- Cutting the rate of profits tax (corporation tax) for new and small businesses. This allows them to retain more profits in the business for expansion.

Government assistance for all businesses

It is also common for governments to intervene in industry in ways that will support both small and large businesses. These measures could include:

- subsidies to help keep prices down
- subsidies to stop a loss-making business failing and protect employment (see Table 7.1)
- grants to relocate to particular areas with high unemployment
- financial support for consumers to buy products (e.g. houses) that will increase national output.

Advantages of subsidies

Disadvantages of subsidies

- They avoid rising unemployment due to business failure.

- Avoiding business failure also keeps suppliers in business.

- If a business fails, consumers may switch to buying imported products, making the balance of payments worse.

- Government has to raise taxes or cut other spending programmes in order to provide subsidies.

- Subsidies act as a disincentive to businesses to become more efficient.

- Consumers buy subsidised products at lower prices, so spend less on unsubsidised products, distorting the market.

Table 7.1: Advantages and disadvantages of government subsidies to existing businesses

7.2 How governments deal with market failure

Free markets should operate efficiently to match demand and supply at equilibrium prices. In this way, some economists argue, resources are allocated in the most effective way possible. One major criticism of this approach is that free markets do not take all costs into consideration when setting prices. For example, the costs to the environment of some production methods will not be included in free market prices. This will lead to an inefficient allocation of resources. Failure to allocate resources effectively is referred to as market failure.

==market failure:== when markets fail to achieve the most efficient allocation of resources, resulting in under- or overproduction of certain goods or services.

Examples of market failure

The examples below illustrate the concept of market failure. Their relevance to business and government decision-making is also considered.

Example 1: Externalcosts

Pollution resulting from manufacturing is a good example of an external cost. When a business makes a product, it must pay for the costs of the land, capital, labour and materials. These are called private costs. There are other consequences of production, however – air pollution, carbon emissions, noise pollution and the dumping of waste products are all side effects of most manufacturing processes. For example, who pays for the costs of cleaning up after the production of chemicals or plastics? Unless the business is forced to pay, the costs will be borne by the rest of society. The government will have to raise taxes to clean the buildings affected by smoke, to pay for medical provision for those affected by air pollution, and to clear up and dispose of industrial wastes.

==external cost:== the costs of an economic activity that are not paid for by the producer or consumer, but by the rest of society.

In these cases, the market fails to include the external cost of production in the price of the product. If the price charged to consumers included all the costs of production (external as well as private), then fewer products would be demanded and produced. As the price charged does not include the external costs, too much of the product will be demanded and too much produced. This is an example of market failure.

Example 2: Labour training Will businesses pay for the training of employees when there is a real danger that, once qualified, they could be poached by other businesses that have not paid for the training? The answer is often no – too many businesses do not provide sufficient training. This means that the country has a shortage of skilled and professional workers, which will reduce economic growth. In this case there is under-provision of training, another form of market failure.

Example 3: Monopolyproducers

When a market is dominated by one supplier, a monopoly is said to exist. The business will be interested in making as much profit as possible. The easiest way of achieving this is to restrict output and raise prices. As the monopolist can prevent competitors from entering the market, this strategy leads to under-provision of products compared with demand. This is, therefore, a form of market failure.

Correcting or controlling market failure

Table 7.2 considers the stakeholders most affected by the examples above and possible government intervention.

Examples of market failure

Stakeholder groups most affected

Possible stakeholder reaction and government intervention

External costs – pollution from manufacturing process

• Consumers may be forced to buy environmentally damaging goods if there are no alternatives.

• Government and local authorities will be forced to take the issue seriously by voters and pressure groups.

• Workers will be worried about the health effects of pollution and job security if the business is closed down.

• The business may take action to reduce external costs if bad publicity leads to lasting damage to its reputation and sales.

• Government can impose fines on polluting businesses or impose strict limits on pollution levels.

Labour training – inadequate provision of skills training

• Consumers may receive bad customer service if employees are poorly trained.

• Government will worry about international competitiveness of the industry if there are insufficient skilled workers.

• Shareholders may see future profits fall as output will be below potential.

• Industrial organisations, such as the Engineering Employers Federation, could get members to pay for industry-wide training, which would benefit all businesses in the industry.

• Government could pay for more training courses at colleges funded from general taxation.

Monopoly producers – restriction of output of goods to keep prices high

• Consumers are affected by lack of choice, restricted supplies and high prices. Monopolies may not invest to develop new goods as there is limited competition.

• Government is concerned as prices are high and important industries lack competitiveness.

• Consumers could use the internet for consumer goods, allowing them to choose from a wider range of suppliers. This will break down some monopoly situations.

• Governments use competition laws.

Table 7.2: Government intervention to correct market failure

7.3 Macroeconomic objectives of governments

All governments set targets for the whole economy and these are referred to as macroeconomic objectives.

==macroeconomic objectives:== the goals a government is aiming to achieve for the whole economy.

These macroeconomic objectives include:

- economic growthan increase in a country's productive potential, measured by an increase in its real GDP. – the annual percentage increase in a country's total level of output – known as gross domestic product (GDP)the total value of goods and services produced in a country in one year. – usually measured by changes in real GDPgross domestic product data adjusted for the effects of inflation.

- low price inflation an increase in the average price level of goods and services resulting in a fall in the value of money.– the rate at which consumer prices, on average, increase each year
- low rate of unemployment when members of the working population are willing and able to work but are unable to find a job.of the workforce
- a long-term balance of payments between the value of importsgoods and services purchased from other countries. and the value of exportsgoods and services sold to consumers and businesses in other countries.
- exchange rate the price of one currency in terms of another.stability – to prevent uncontrolled swings in the external value of the currency. Several of these objectives may conflict with each other. In trying to achieve one of these targets, the government could make it less likely that one or more of the others is achieved. For example, if it is believed that the rate of inflation is too high, then policies might be introduced to reduce spending. This will lead to lower demand and result in increased unemployment.

  TIP You are advised to start keeping your own file of newspaper or website articles on economic events and data, and how businesses are responding to economic decisions made by the government.

7.4 How economic objectives and performance impact business activity

Economic growth, low inflation, low unemployment and a country's economic performance are important influences on business activity.

Economic growth

Economic growth means that a country is becoming richer. It is measured by increases in GDP.

GDP is measured in monetary terms, and inflation will raise the value of GDP. Such an increase is not true economic growth. Economic growth in the economy occurs when the real level of GDP rises as a result of increases in the physical output of goods and services in an economy.

Every economy aims to achieve consistent economic growth, some with more success than others. For example, annual real GDP growth varied in the USA from –2.3% to 3% between 2009 and 2018. Over the same period, GDP rose by an average of 8% in China. Negative economic growth or a recession is when GDP falls – this occurred in Zimbabwe in 2008 (–17%) and in Venezuela in 2018 (–25%).

==recession:== a decline in real GDP of two or more quarters (at least six months).

Benefits of economic growth

Economic growth can lead to the following benefits:

- Real GDP growth raises average living standards if the population increases at a slower rate.
- Higher output levels usually result from increased employment, which increases consumer incomes and reduces the rate of unemployment.
- More resources can be devoted to desirable public-sector projects, such as health and education, without reducing resources in other sectors.
- Absolute poverty can be reduced, or even eliminated, if the benefits of growth spread to the whole population.
- Businesses should experience rising demand for their products, although this will depend on income elasticity of demand.
- Higher GDP makes more resources available for government through greater income from taxes and reduced spending on social benefits.

Country	Percentage change in real GDP, 2018
Libya	17.8
Bangladesh	7.7
India	7.0
China	6.5
Kenya	5.9
Nicaragua	–4.0
Dominica	–11.9
Venezuela	–25.0

Table 7.3: Some of the biggest changes in real GDP, 2018

> TIP When you are evaluating economic growth as a government objective, remember that rapid economic growth is not always beneficial to everyone. For example, rapid industrial growth can make pollution worse and damage health. Some workers may lose their jobs as a result of the technological changes that contribute to economic growth.

Causes of economic growth

The main factors that lead to economic growth are:

- Technological changes and expansion of industrial capacity: Governments stimulate this form of non-inflationary economic growth by encouraging business investmentexpenditure by businesses on capital equipment, new technology and research and development. and innovation in new industries and products.
- Increases in economic resources, such as a higher working population or discovery of new oil and gas reserves: A country's economy can increase its total output when more economic resources are available.
- Increases in productivity: Higher labour productivityaverage output per employee in a given time period. can be achieved with a more highly skilled workforce and a greater willingness by workers to accept and work with new technology.

The business cycle

Economic growth is rarely achieved at a steady, constant rate every year. Instead, economies tend to grow at very different rates over time. This leads to the business cycle (see Figure 7.4).

==business cycle:== the regular swings in output, measured by real GDP, that occur in most economies, varying from boom conditions to recession.

Figure 7.4: The business cycle Figure 7.4: The business cycle

The four stages of the business cycle are:

1. Boom: This is a period of very rapid economic growth with rising incomes and profits. Inflation increases due to very high demand for goods and services. Shortages of key skilled workers lead to substantial wage increases. High inflation makes an economy's goods uncompetitive. Business confidence eventually falls as profits are hit by higher costs. Interest rates are usually increased to reduce inflation. A downturn often results from this.
2. Downturn or recession: Falling demand and higher interest rates start to take effect. Real GDP growth slows and may even start to fall. This is technically called a recession. Incomes and consumer demand fall, and

profits are reduced. Some businesses make record losses and others fail completely.

3. Slump: A very serious and prolonged recession can lead to a slump, where real GDP falls substantially and product and asset prices fall. This is much more likely to occur if the government fails to take corrective economic action.

4. Recovery and growth: All downturns eventually lead to a recovery when real GDP starts to increase again. This is because corrective government action starts to take effect. Also, one effect of lower product prices is to increase the competitiveness of the country's exports and demand for them starts to increase. The impact of these stages on business is summarised in Table 7.4.

Is a recession always bad?

An economic recession has serious consequences for most businesses and the whole economy. As output is falling, fewer workers are needed. Unemployment increases and incomes fall. Demand for products declines further. Government tax revenue also falls as less income tax and sales revenue tax are received. Businesses producing luxury high-priced products experience reduced demand, creating spare capacity.

However, there are also opportunities that some businesses could take advantage of:

- Capital assets, such as factories, may be relatively cheap and businesses could invest in expectation of an economic recovery.
- Demand for inferior goods (negative income elasticity of demand) could actually increase.
- The risk of retrenchment and job losses may encourage improved relations between employers and employees, leading to increased efficiency.
- Decisions to close factories and offices could reduce business costs significantly. They will then be more able to take advantage of economic growth when this starts again.

  TIP As a business learner, you should think about how the stages of the business cycle affect different businesses in different ways, and how businesses respond to these stages with different strategies.

Type of business

During economic growth

During recession

Producers of luxury goods and services (e.g. cars)

• increase the range of goods and services

• raise prices to increase profit margins

• promote exclusivity and style

• increase output

• may not reduce prices for fear of damaging long-term image

• offer credit terms to improve affordability

• offer promotions

• widen product range with lower-priced models

Producers of basic goods and services (e.g. tinned food)

• add extra value to the product (e.g. better ingredients/improved packaging)

• make brand image more exclusive

• do nothing as sales not much affected anyway

• lower prices

• offer promotions

• do nothing as sales not much affected anyway

Producers of inferior goods and services (e.g. low-priced clothing)

• attempt to move the product upmarket

• add extra value to the product (e.g. higher quality)

• extend the product range to include more exclusive or better-designed products

• promote good value and low prices

• offer consumers special promotions

• increase range of distribution outlets

Table 7.4: Examples of how the business cycle can impact on business decisions

Inflation and deflation

The spending power of one dollar is the goods that can be bought with that dollar. The spending power of money can change over time. If one dollar buys fewer goods this year than it did last year, then the value of money has fallen. This must have been caused by inflation.

If one dollar buys more goods this year than it did last year, then the value of money has increased. This must have been caused by deflation.

==deflation:== a fall in the average price level of goods and services.

Figure 7.6: Estimated annual inflation rates (2020, estimate) Figure 7.6: Estimated annual inflation rates (2020, estimate)

Country	Annual rate of inflation, 2019 (%)
Venezuela	58 561
Zimbabwe	481
South Sudan	157
Argentina	51
Liberia	31

Table 7.5: Highest national rates of inflation, 2019

Causes of inflation

Prices rise either because businesses are forced to increase them, when their costs are rising, or because businesses raise prices to take advantage of high consumer demand and make extra profits. These two causes can be considered as:

- cost–push causes of inflation
- demand–pull causes of inflation.

Cost–push causes of inflation In certain situations, businesses are faced with higher costs of production. These could result from:

- A lower exchange rate pushing up prices of imported materials (e.g. the average exchange rate value of the pound sterling fell by 25% between 2016 and 2020).
- World demand for materials pushing up prices (e.g. the price of oil rose by over 50% between 2016 and 2019).
- Higher wage demands from workers, possibly ‘in response to inflation in the previous year. In order to maintain their real living standards, workers will expect wage rises in line with previous or expected inflation. In 2018, Dacia car workers in Romania demanded, and received, a wage increase of 20% to raise their living standards ahead of inflation. When businesses

face higher costs of production, they attempt to maintain profit margins, and one way of doing this is to raise selling prices. This becomes cost–push inflation.

Demand–pull causes of inflation When consumer demand is rising, usually during an economic boom, producers and retailers realise that existing products can be sold at higher prices. If they do not raise prices, inventories could run out, leaving unsatisfied demand. Supply shortages, leading to excess demand, are the major reason for the hyperinflation in Venezuela (referred to above). By raising prices, businesses earn higher profit margins.

The impact of low inflation on business decisions

Inflation can have the following benefits for business if the rate is quite low:

- Cost increases can be passed on to consumers more easily if there is general price inflation.
- The real value of debts owed by companies will fall. Businesses that are heavily dependent on loan finance see a fall in the real value of their liabilities.
- The value of fixed assets owned by businesses, such as land and buildings, could rise. This increases the value of a business and makes it seem more financially secure.
- Since inventories are bought in advance and then sold later, there is an increased profit margin from the effect of inflation.

The impact of high inflation on business decisions

However, higher rates of inflation – such as over 6% a year – can have very serious drawbacks for business:

- Employees will demand big wage increases to maintain the real value of their incomes.
- Consumers may become more price sensitive and look for bargains, rather than buying big brand names.
- Rapid inflation will often lead to higher rates of interest. These higher rates could make it very difficult for highly indebted companies to find the cash to make interest payments.
- Cash flow problems may occur for all businesses as they struggle to finance the higher costs of materials and other supplies.
- If inflation is higher in one country than in other countries, then businesses in that country will lose competitiveness in overseas markets.

- Businesses that sell goods on credit will be reluctant to offer extended credit periods. Repayments by creditors will be with money that has lost real value.
- Consumers may stockpile some items and cut back on non-essential items of spending. High inflation also adds to uncertainty about the future:
- Will prices continue to rise?
- Will the rate of inflation go up again?
- Will the government be forced to take policy actions which could reduce business profits? These uncertainties make forecasting for the future very difficult. This is particularly true with sales forecasts and investment appraisal, which require estimates about future cash flows.

Business decisions during a period of rapid inflation might include:

- cutting back on investment spending
- cutting profit margins and limiting price rises to stay as competitive as possible
- reducing borrowing to make interest payments more manageable
- reducing the time period for customers (trade receivables) to pay
- reducing labour costs.

  TIP When answering a question, you should not forget that the impact of inflation on any one business depends very greatly on the rate of inflation and on forecasts for the future rate of price rises.

Is deflation beneficial?

It might be thought that, if rapid inflation has so many negative effects, then a period of falling prices could be beneficial? Here are some reasons why most businesses would not actually benefit from deflation:

- Consumers delay making important purchases, hoping that prices will fall further. This causes a reduction in demand, leading to a possible recession.
- Businesses with long-term debts make interest payments and loan repayments with money that has risen in value since the original loan was taken out. Borrowing to invest is discouraged.
- As prices fall, the future profitability of new investment projects appears doubtful.
- Inventories of materials and finished goods fall in value. Businesses hold as few inventories as possible. Although this reduces their working capital needs, it also reduces orders for supplies from other businesses. So, there are potential business losers from both rapid inflation and deflation. The

optimum position for most economies is to tolerate low rates of inflation, but to make sure that the rate does not rise above a predetermined target. In the UK and EU, this target is for the consumer price index (CPI) to rise by 2.0% per year.

Unemployment

Table 7.6 shows the percentage of the working population registered as unemployed in certain countries. The rate of unemployment varies substantially between countries. Those with the highest rates of unemployment are experiencing a huge waste of labour resources.

==working population:== all those in the population of working age who are willing and able to work.

Country	2019 (% of working population unemployed)
Lesotho	27.25
Swaziland	22.48
Mozambique	25.04
Qatar	0.10
Cambodia	0.20
Belarus	0.30

Table 7.6: Highest and lowest unemployment rates, 2019

Causes of unemployment

There are three main causes or types of unemployment: cyclical unemployment, structural unemployment and frictional unemployment.

==cyclical unemployment:== unemployment caused by low demand for goods and services during a period of slow economic growth or a recession.

==structural unemployment:== unemployment caused by the decline in important industries, leading to significant job losses in one sector of industry.

==frictional unemployment:== unemployment caused by workers losing or leaving jobs and taking a substantial period of time to find alternative employment.

Cyclical unemployment

This is caused by falling demand for products during the recession stage of the business cycle. Businesses need fewer workers as they are producing fewer goods and services. Workers who are made unemployed will have lower incomes. When there are fewer overtime opportunities, those workers still employed will also have reduced incomes. They all spend less. This can deepen the recession.

Structural unemployment

Structural unemployment can exist even when the economy is growing rapidly. This type of unemployment results in certain types of workers being unable to find work, even though jobs could exist in expanding industries. This happens because of structural changes in the economy, which radically changes the demand for labour. The most likely causes are:

- Consumer tastes and expenditure patterns change.
- Workers in some industries are replaced by technology. New technology employers are looking for adaptable and multi-skilled workers. Many unskilled workers who previously performed manual jobs find it difficult to adapt to these new requirements.
- Heavy manufacturing industries – such as steelmaking and shipbuilding – in most Western economies have declined. The workers losing their jobs find it difficult to transfer their skills to other industries and occupations.

Frictional unemployment

Most workers who lose their jobs are able to move quickly into new ones, but others may take longer to find suitable employment. While they are looking for other work, they are said to be frictionally unemployed. This is a feature of the changing labour demands in different businesses and industries, which are occurring all the time. If labour turnover rates increase in the economy as a whole, then the level of frictional unemployment will also increase.

The costs of unemployment

Unemployment is a waste of human resources. The costs are significant:

- The output of the economy is lower than it could be, which reduces living standards.
- The cost of supporting unemployed workers and their families is substantial and is paid for out of general taxation.

- High unemployment may lead to social problems, such as crime, which is a cost to society.
- Unemployment reduces demand for goods and services by reducing the incomes of those looking for work.
- There will be reduced incomes and lower living standards.
- The longer the period of unemployment, the more difficult it is to find work, as skills become increasingly out of date.

Impact of unemployment on business activity

- Reduced income levels will reduce demand for most products.
- It is easier to recruit new employees as more people apply for each vacancy.
- Workers may accept lower pay increases as they are afraid of losing their jobs.
- Government grants and subsidies might be available to encourage job creation.

7.5 Government policies to achieve macroeconomic objectives

Governments can use four main policies to try to achieve macroeconomic objectives: monetary, fiscal, supply-side and exchange rate policies. They have different impacts on businesses and business decisions.

Monetary policy

Monetary policy is mainly concerned with changes in interest rates. These are determined by the base interest rate set each month by the central bank. In most countries the central banks (e.g. the European Central Bank and the Central Bank of India) are given clear inflation targets by the government and they use interest rates to achieve these targets.

==Monetary policy:== decisions about the level of interest rates and the supply of money in the economy.

When inflation is forecast to rise above the targets set by government, the central bank will raise its base interest rate and all other banks will follow. This situation nearly always occurs when the economy is experiencing inflation in the growth phase of the business cycle.

If inflation is low and is forecast to remain below government targets, then the central bank could reduce interest rates. A reduction in interest rates will be more likely if economic growth is also low and there is a danger that unemployment might rise. Although the central bank is concerned about other macroeconomic objectives, its primary aim is the control of inflation.

Impact on business and business decisions

Higher interest rates will have an impact on businesses in three main ways:

- They increase interest costs and reduce profits for businesses that have very high debts.
- They reduce borrowing by consumers, which reduces demand for goods bought on credit (e.g. houses, cars, washing machines).
- They often lead to an appreciation of the country's exchange rate.

  TIP You should be able to evaluate the possible impact of interest rate changes on any one business. Even small changes in interest rates could be significant for businesses with high debt levels or for those businesses selling goods on credit.

Fiscal policy

Governments are responsible for fiscal policy, which involves decisions about government spending and tax rates. In many countries, government spending accounts for at least 40% of GDP. The major expenditure programmes include social security, the health service, education, defence, and law and order.

==fiscal policy:== decisions about government expenditure, tax rates and government borrowing.

The government raises tax revenue to pay for these schemes. The main tax revenues come from income tax, value added (or sales) tax, corporation tax and excise duties. Each year, in the annual budget, the finance minister announces the spending, tax and borrowing plans of the government for the coming year. The difference between these two totals is called either the budget deficit or the budget surplus.

==budget deficit:== the value of government spending exceeds revenue from taxation.

==budget surplus:== the value of taxation revenue exceeds the value of government spending.

Impact on business and business decisions

Many changes in fiscal policy are relatively unimportant and only affect individual product markets, such as an increase in duties on petrol or a reduction in spending on defence equipment. These changes may have an impact on certain businesses but will not affect the macroeconomy greatly. However, when the finance minister announces an overall change in total tax revenues or total government expenditure plans, there will be macroeconomic effects that impact on all businesses. Under what circumstances is the government likely to make these changes? We will consider two situations.

Situation 1: The economy is in recession and unemployment isrising

This results from aggregate demand for domestic goods falling below the potential output of industry. The government is likely to want to increase aggregate demand to boost economic growth and reduce unemployment. This could be done in one of two ways (or both could be undertaken together). The government could increase expenditure plans, such as constructing more hospitals or schools. It could also decide to reduce taxes to leave consumers and firms with higher disposable incomes – that is, more income after tax. This should encourage increased spending by consumers and businesses. Using fiscal policy in this way is described as expansionary and will lead to a budget deficit. This policy is summarised in Figure 7.9.

Figure 7.9: Expansionary fiscal policy Figure 7.9: Expansionary fiscal policy

Situation 2: The economy is booming and in danger ofoverheating

This situation could lead to two other macroeconomic targets not being met. A booming economy is likely to lead to both higher inflation and a large balance of payments (current account) deficit. It results from excess aggregate demand in the economy. The finance minister could respond by reducing government expenditure levels, which will have a direct impact on demand in the economy. Unfortunately, all governments tend to find it easier to cut back on investment spending (e.g. road construction or hospital equipment) rather than on current expenditure (e.g. social security benefits or numbers of teachers). The finance minister could also increase taxes, which would take spending power out of the economy by leaving consumers and/or businesses with less disposable income. Both of these policies would be termed contractionary or deflationary policies and are summarised in Figure 7.10.

Figure 7.10: Contractionary fiscal policy Figure 7.10: Contractionary fiscal policy

Fiscal and monetary policy: a summary

Table 7.7 summarises the measures that the government and the central bank can take to control a booming economy that has a high inflation rate. These measures and their effects will be reversed if the economy starts moving into recession.

Government policy

Measures to reduce inflation and slow down economic growth

Likely impact on business

Fiscal policy:government spending, taxes and borrowing

Raise direct taxes – income tax and profits tax

Consumers' disposable incomes fall, so demand for products falls. The impact on businesses depends on income elasticities of demand for their products.

If corporation tax rates are increased, businesses' retained earnings decline. This reduces finance for investment.

Raise indirect taxes on spending, e.g. value-added tax (VAT)

If VAT rises, retail prices of the taxed products increase. The impact on demand depends on price elasticities.

Reduce government spending

Businesses selling products directly to the government experience a reduction in demand. Defence suppliers and construction companies could be hit, for example.

Monetary policy: interest rates and the supply of money

Increase interest rates

• Highly indebted businesses have to increase interest payments, which worsens their cash flows.

• Businesses are less likely to borrow to finance further investment – the cost of loans may exceed the expected returns.

• Consumers are affected in two ways:

• They are less likely to buy goods on credit as interest charges are higher. This reduces demand for high-price consumer goods, such as cars.

• Demand for houses falls as mortgage interest costs rise. The interest on existing consumer debts, such as mortgages, takes a higher proportion of incomes. This reduces consumers' discretionary incomes. Consumer demand falls, depending on income elasticity.

• Higher interest rates may encourage overseas capital to flow into the country. An appreciation of the exchange rate is likely. This will impact on the competitiveness of businesses.

Table 7.7: Impact on business of fiscal and monetary policies to reduce an inflationary economic boom

Supply-side policies

Government policies that aim to increase industrial competitiveness are often referred to as supply-side policies. Their aim is to improve the supply efficiency of the economy. If successful, these policies make a country's industries more competitive in global markets.

==supply-side policies:== government measures that aim to improve the competitiveness of markets and the economy.

The following policies could have this effect:

Reducing rates of income tax

If workers and managers are forced to pay high rates of tax on any increase in income, the motivation to work hard and to gain promotion is lost. High rates of income tax discourage entrepreneurs from setting up new businesses. They will consider that the rewards after tax do not justify the risks involved. Reducing rates of income tax is a supply-side policy. Low tax rates can encourage enterprise and increase incentives to work.

Reducing the rate of corporation tax (profit tax)

This is a tax on the profits of limited companies. High rates of profit tax leave less internal finance for re-investment in businesses. This discourages new investments in projects. A fall in business investment reduces business competitiveness. Many governments have steadily reduced the rates of corporation tax in recent years, especially for smaller companies. In the Republic of Ireland and Poland, this tax has been reduced to just 10%. Low rates of profit tax increase retained earnings and encourage investment.

Increasing labour market flexibility and labour productivity

Labour is a key economic resource. Most governments use policies that increase the skills and efficiency of the country's workforce and provide workers with a strong work incentive. Policies that governments use to achieve these aims include:

- subsidies for worker training and increasing state provision at colleges for skills training
- increased funding of higher education to allow more workers to enter employment with degrees and other high-level qualifications
- low rates of income tax to encourage workers to set up their own businesses and to encourage work incentives
- encouraging the immigration of skilled workers who can fill job vacancies and help to increase total industrial output
- restricting welfare benefits to those in genuine need; healthy and potentially productive workers are not encouraged to stay at home and live off the state.

Spending on infrastructure projects

Government spending on dams and irrigation projects increases agricultural productivity. New roads and railways improve the efficiency of transport systems and allow exporters to get products to port more quickly. Faster and more reliable internet provision encourages e-commerce and web entrepreneurs.

Making it easier to start businesses

Reducing the form filling and time needed to set up new businesses encourages new enterprises. These create new jobs and increase competition for existing businesses, forcing them to become more efficient. According to the World Bank's 'Ease of Doing Business' index, an entrepreneur in New Zealand can set up a business more easily and rapidly than in any other country. Somalia is bottom of this index – it can take 70 days to register a new business in this country and the process costs twice the average annual income.

Exchange rate policy

Exchange rates between currencies are like other prices – they are determined by the supply of and demand for a country's currency. Table 7.8 gives a summary of the factors that make up the demand for and supply of a currency on the foreign exchange market.

Demand for the currency

Supply of the currency

- foreign buyers of domestic goods and services

- domestic businesses buying foreign imports

- foreign tourists spending money in the country

- domestic population travelling abroad

- foreign investors buying the currency to take advantage of, for example, higher domestic interest rates

- domestic investors wanting to obtain foreign currency to, for example, buy a foreign business

Table 7.8: Factors that determine the demand for and supply of currency

If the supply of a currency is greater than demand, the price of the currency falls. This is called an exchange rate depreciation. If $1 falls in value from €2 to €1.5, the dollar has depreciated in value against the euro. If the demand for a currency is greater than its supply, the price of it rises. This is called an exchange rate appreciation. If $1 rises from €1.5 to €2, the value of the dollar has appreciated against the euro.

==exchange rate depreciation:== a fall in the external value of a currency as measured by its exchange rate against other currencies.

==exchange rate appreciation:== a rise in the external value of a currency as measured by its exchange rate against other currencies.

Figure 7.11: Pound sterling to euro exchange rate, 2015–2020 Figure 7.11: Pound sterling to euro exchange rate, 2015–2020

Exchange rate appreciation: business winners and losers

The domestic businesses that gain from exchange rate appreciation of the currency are:

- Importers of foreign raw materials and components – the domestic currency cost of these imports will fall. This increases the competitiveness of these businesses. Assume that the US dollar appreciates from $1: €2 to $1: €3, as per the example below:
- Importers of foreign manufactured goods – the domestic currency cost of these imports will fall. In 2018, it was claimed that European importers of US-produced cars were profiteering at the expense of consumers. This was because, although the import price of cars was falling due to the appreciation of the euro against the US dollar, the importers were not selling them more cheaply to European consumers. They were taking advantage of the appreciation to make much higher profits. Lower import prices help to reduce the rate of inflation for the whole economy and all businesses are likely to gain from this.

The domestic firms that lose from exchange rate appreciation are:

- Exporters of goods and services to foreign markets. This includes not just manufactured goods, such as cars, but also services sold to customers in other countries. For example, holiday resorts experience a fall in demand from overseas tourists because of the higher holiday costs in foreign currency terms.
- Businesses that sell goods and services to the domestic market and have foreign competitors. As appreciation makes imports cheaper, it makes domestic producers less competitive in their own market. Consumers switch to imported goods and foreign holidays because of the cost advantages they have over home-produced products. However, local businesses importing raw materials from other countries should be able to lower prices to combat this.

Exchange rate depreciation: business winners and losers

The fall in the value of a currency in terms of other currencies has the reverse effects on domestic businesses compared to exchange rate appreciation. These effects can be investigated by working through Activity 7.4 below.

The domestic businesses that gain from exchange rate depreciation are:

- Exporters, who can now reduce their prices in overseas markets. This should increase the value of their exports and lead to an expansion of their business.
- Businesses that sell in the domestic market will experience less price competition from importers. Prices of imported goods and services are likely to rise on the domestic market. The domestic businesses that are likely to lose from exchange rate depreciation are:
- Manufacturers, who depend heavily on imported supplies of materials, components or energy sources. These costs will rise and will reduce competitiveness.
- Retailers, who purchase foreign supplies, especially if there are domestic substitutes. The prices of these imports will rise, and the retailers may be forced to find domestic suppliers of similar-quality goods.

  TIP Exchange rates are a very important Business topic. You should be able to analyse, with appropriate calculations if necessary, how rises or falls in an exchange rate might impact on importers and exporters.

Exchange rate policy summary

Most governments want to keep the exchange rate of their country's currency stable over time. This reduces the risky and destabilising effects of large depreciations and large appreciations. There are some exceptions to this. Governments may allow or actively encourage:

- depreciation, in order to increase the competitiveness of domestic industries
- depreciation, in order to cancel out the loss of competitiveness caused by high inflation – although this will actually add to inflationary pressures
- appreciation, in order to increase living standards, as it increases consumer spending power when purchasing imports and helps to reduce inflation. Another policy option for some governments is to join a common currency scheme such as the euro. This is the common currency used by most members of the European Union, which make up the eurozone. A common currency completely eliminates currency fluctuations between member countries because they all use the same currency. (See Table 7.9.)

==common currency:== a currency that is used by more than one country.

==eurozone:== countries in the European Union that all use the euro currency.

Claimed benefits of a common currency

Claimed limitations of a common currency

• It eliminates currency fluctuations between member countries. Between countries using a common currency, there will be:

• no fluctuating prices of imported materials and components

• no fluctuations in export prices, which lead to unstable levels of demand

• no uncertainty over profits earned from trading with, or from investing in, other member countries.

• It reduces the costs for businesses trading with other member countries:

• other currencies do not need to be converted into the domestic currency, so there are no commission payments to banks

• the same product price is listed for all member countries.

• It encourages inward investment from businesses in non-member countries that want to gain access to the common currency market.

• In the eurozone, interest rates for all member countries are set by the European Central Bank. The central bank for each country loses its power to control interest rates.

• A common currency may eventually lead to common tax policies throughout the currency zone, which reduces the independence of each government to control its own tax rates.

• Each government cannot allow a depreciation of its own country's currency to increase competitiveness.

Table 7.9: The claimed benefits and limitations of a common currency

International competitiveness: non-price factors

Exchange rate depreciation is not the only factor that affects the competitiveness of products on world markets. Non-price factors are also important:

- Product design and innovation: An innovative product, such as the latest Apple iPhone, will attract customers, even though it may be sold at premium prices.
- Quality of construction and reliability: For several years, Japanese cars have been declared the most reliable on the US market. Although they are not the cheapest cars to buy, reliability appeals to consumers.
- Effective promotion and extensive distribution: These two factors go some way towards explaining the universal success of McDonald's restaurants.
- After-sales service: This includes extended guarantee periods.
- Investment in trained employees and modern technology: This improves flexibility of production to meet frequent changes in consumer tastes.

Higher labour productivity can overcome drawbacks caused by higher costs of other resources.

KEY CONCEPT LINK External economic events are one of the most important causes of change that result in businesses taking strategic decisions to try to ensure that their objectives are still achieved.

Image Image

Introduction

One of the most significant responsibilities of senior business managers is to develop new strategies for the future success of the organisation.

8.1 Business strategy: meaning and purpose

In simple terms a strategy is 'how we get from where we are now to where we want to be in the future'. A successful business will have SMART objectives. Its business strategy will be a clear plan and set of policies that should help it focus on achieving these aims.

Business strategy asks the big questions, such as, 'Which markets and products do we want to be in?' It also makes the big decisions, such as, 'Can we expand from manufacturing operations into retailing?' All businesses need strategies to provide integration, direction and focus.

Establishing business strategy

Business strategies are influenced by four main factors (see Figure 8.2).

Figure 8.2: Influences on strategy formation Figure 8.2: Influences on strategy formation

Resources available

All business resources are finite. Limited resources force a business to choose which strategies to proceed with, and which to drop or scale back. For example, the strategy of launching a new product nationwide may have to be scaled back because of lack of resources.

Strengths of the business

If a business has proven capabilities in certain areas, it is often advisable to apply these strengths when developing future strategies. A long-term plan that takes a business away from a proven area of operation may require business skills and experience that it does not have. In addition, the expansion of the business may be best achieved if some underperforming areas (or non-core businesses) are sold off. The business will then focus on its current successes to achieve growth. After it purchased Quaker Oats, Pepsi sold off the breakfast cereal division, but kept the soft drink division, which sells the highly successful Gatorade drink in the USA. This allowed Pepsi to further develop its strengths in soft drinks.

Competitive environment

Competitors' actions are a major constraint on business strategy. Innovations by competitors may be difficult to copy or better. An example is Nintendo's Wii gaming system, which was a break from the incremental development of computer games by Nintendo's rivals. All businesses operate in a competitive environment to a greater or lesser degree. Price reductions by supermarkets selling petrol in the UK forced a change of strategy by the main petrol retailers. Esso quickly adopted a strategy called Pricewatch, which promised prices as low as local supermarkets. Would this plan have been introduced without competitive pressures?

Objectives

The objectives of the business also influence strategy. Increasing returns to shareholders in the short term might not be achieved by investing in extensive research and development with a payback period many years into the future. Maximising returns to shareholders might not be the central objective of the business if it aims for the triple bottom line approach to corporate objectives. If a business has a clear social responsibility objective, it will pursue different strategies from those of a business that is focusing solely on shareholder returns.

8.2 Strategic management: meaning and purpose

Once SMART objectives have been set, the process of strategic management has three key stages (see Table 8.1).

==strategic management:== analysis of the current business situation, setting long-term objectives, deciding on business strategies to achieve them and then implementing these strategies.

Stages of strategic management

Main purpose

1 Strategic analysis: assessing the current position of the company in relation to its market, competitors and the external environment.

Decisions that do not start from knowledge of where the business is now may be inappropriate and ineffective.

2 Strategic choice: taking important long-term decisions that will push the business towards the objectives set.

A new direction for a business will require key decisions to be taken about products and markets.

3 Strategic implementation: allocating sufficient resources to put decisions into effect, and evaluating success.

New business strategies always require additional resources. These must be provided at the right time and in sufficient quantities to allow the new strategies to be effective.

Table 8.1: The stages of strategic management

Strategic analysis is about looking in detail at a business's current position, what is happening to it now and what might happen to it in the future. Then managers can make sure that their long-term plans or strategy for the business fit in with this external analysis.

==Strategic analysis:== analysis of the current business situation, setting long-term objectives, deciding on business strategies to achieve them and then implementing these strategies.

Strategic analysis tries to find answers to three key questions:

1. Where is the business now?
2. How might the business be affected by what is happening, or likely to happen?
3. How could the business respond to these likely changes?

Strategic choice

After potential strategies have been identified through strategic analysis, strategic choice is the next stage. Strategic choice analyses the benefits and limitations of different strategic options and decides between them. Successful strategic choices have to be challenging enough to gain competitive advantage. They must also be achievable and affordable within the resources available. There are techniques available to assist managers in making strategic choices, but judgement, experience and skill are also very important.

==strategic choice:== the process that leads to a decision to choose a particular strategy from various alternatives and the techniques used to help make the choice.

Strategic implementation

Without successful strategic implementation, there can be no effective change within an organisation. Implementing a major strategic change is a very important cross-functional management task. It involves ensuring that all the following factors are in place:

==strategic implementation:== the process of planning, allocating and controlling resources to support the chosen strategy.

- an appropriate organisational structure to deal with the change
- adequate resources to make the change happen
- well-motivated staff who want the change to happen successfully
- leadership style and organisational culture that allow change to be implemented with wide-ranging support
- control and review systems to monitor the firm's progress towards the desired final objectives.

Strategy and tactics

Strategic management is the highest level of managerial activity. It is undertaken by, or at least closely supervised by, the chief executive officer and approved by the board of directors.

Tactics, on the other hand, are concerned with making smaller-scale decisions aimed at reaching more limited and measurable goals, which themselves are part of the longer-term strategic aim. It is important to be clear about the distinction between tactics and strategies (see Table 8.2 and Activity 8.1).

The need for strategic management

If a business did not undertake strategic management, it would fail to:

- plan for the future
- respond logically to the changing business environment
- make effective long-term decisions based on clear objectives.

Strategic decisions (e.g. to develop new markets abroad)

Tactical decisions (e.g. to sell a product in different-sized packaging)

Strategic decisions are long term.

Tactical decisions are short to medium term.

The decision is difficult to reverse once made as departments will have committed resources to it.

The decision is reversible, but there may still be costs involved.

It is taken by directors and/or senior managers.

It is taken by less senior managers and subordinates with delegated authority.

It is cross-functional and will involve all major departments of the business.

The impact of tactical decisions is often only on one department.

Table 8.2: Differences between strategic decisions and tactical decisions

Figure 8.3: Strategic management Figure 8.3: Strategic management

> KEY CONCEPT LINK Decision-making involving a new strategy for a business needs to consider the likely impact of potential changes in the business environment.

8.3 Approaches to developing business strategy

The following techniques and approaches are used by senior managers to identify, develop and choose between new business strategies.

Blue ocean strategy

The basis of this approach to developing business strategy is to stop competing and start creating. This means not focusing strategies on existing markets with several or many competitors. Instead, it means finding and developing uncontested markets. This involves being creative and original with strategies that other businesses have not yet adopted. These uncontested market spaces are newly created markets or market segments that have no close competitors. They are referred to as blue oceans. Highly contested markets are referred to as red oceans.

The management theorists who created this approach, W. Chan Kim and Renée Mauborgne, suggest that the best blue ocean strategies combine high product differentiation and low cost. Competition, in these situations, becomes irrelevant.

==blue ocean strategies:== one that exploits uncontested market space through product differentiation and low cost.

The key to exceptional business success, the theorists suggest, is to redefine the terms of competition and move into the blue ocean, where you have the water to yourself. The goal of these strategies is not to beat the competition, but to make the competition irrelevant.

To help identify a blue ocean, Kim and Mauborgne recommend that businesses consider what they call the Four Actions Framework. The framework asks four important questions:

- Raise: What factors, such as quality or customer service, could be raised above the industry's standard?
- Reduce: What factors, such as costly competitive advertising, were a result of competing against other businesses, and which of these can be reduced?

- Eliminate: Which factors that the business has used to compete against rivals could be eliminated altogether?
- Create : Which factors should be created that the industry has never offered before? This exercise forces companies to examine every element of how they currently compete. They can then search for blue oceans within their industries and make the strategic shift to clear blue waters. (See Table 8.4.)

Red ocean strategyone that competes with rivals in existing markets.: focus on existing customers

Blue ocean strategy:focus on potential customers

Compete in existing markets

Create uncontested markets to enter

'Out-compete' the competition

Make the competition irrelevant

Exploit existing demand

Create and exploit new demand

High value to customer = high costs to business

High value to customer but low cost to business

Product differentiation or low cost

Product differentiation and low cost

Table 8.4: Differences between red ocean and blue ocean strategies

Scenario planning

In an uncertain and fast-changing world, no one really knows what the future holds for any business. Making fixed plans for the future leads to the risk of inflexibility. Making no plans for the future leads to being unprepared for any future development or trend. In scenario planning, a group of senior managers begin by identifying a limited number of possible outcomes or situations, called scenarios. They then discuss what strategy the business could adopt if each scenario actually occurred. (See Table 8.5.)

==scenario planning:== identifying possible future situations and how the business might respond to them.

The scenarios used for each business are likely to be different. The identification of these future events will depend on the key risk factors that affect each particular business. For example, these could be social, economic, technological or competition factors.

Scenario planning is regularly used not just by businesses. Many of the big international not-for-profit organisations, including Amnesty International, Oxfam, Greenpeace and the Red Cross, use it to improve strategic thinking.

Benefits of scenario planning

Limitations of scenario planning

It forces managers to consider the main risks and uncertainties that affect their business.

Managers try to consider too many uncertainties and become confused by the range of possible scenarios.

Managers have to develop a range of strategies to deal with different scenarios.

In contrast, some managers might only focus on one possible future scenario and be unprepared for others.

It makes managers adopt a flexible approach as different scenarios will require different strategies.

It will be less effective if only short-term risks are considered. Looking far into the future can lead to more creative strategies.

Table 8.5: Benefits and limitations of scenario planning

SWOT analysis

A SWOT analysis provides information that can be helpful in matching the firm's resources and strengths to the competitive environment in which it operates.

==SWOT analysis:== a form of strategic analysis that identifies and analyses the main internal strengths and weaknesses, and external opportunities and threats, that will influence the future direction and success of a business.

SWOT is a very widely used strategic analysis technique, which helps to identify future strategies (see Table 8.6 for an example). It comprises:

- Strengths: These are the internal factors about a business that are its current real advantages. They could be used as a basis for developing a competitive advantage. They might include: experienced management, product patents, loyal workforce and a good product range. These factors are identified by undertaking an internal audit of the firm. This is often undertaken by specialist management consultants who analyse the effectiveness of the business, its departments and its products.
- Weaknesses: These are the internal business factors about a business that are viewed as disadvantages. In some cases, these can be the opposite of strengths. For example, spare manufacturing capacity might be a strength in times of a rapid economic upturn. However, if capacity continues to be

unused, then it could add substantially to the average costs of production. Weaknesses might include: a poorly trained workforce, limited production capacity and ageing equipment. This information would also have been obtained from an internal audit.

- Opportunities: These are the potential areas for expansion of the business and future profits. These factors are identified by an external audit of the market the business operates in and its major competitors. Examples include: new technologies, export markets expanding faster than domestic markets, and lower interest rates increasing consumer demand.
- Threats: These are also external factors gained from an external audit. This audit analyses the business and economic environment, market conditions and the strength of competitors. Examples of threats include: new competitors entering the market, globalisation driving down prices, changes in the law regarding the sale of certain products, and changes in government economic policy.

Strengths

Weaknesses

Internal

• specialist marketing expertise

• a new, innovative product or service

• location of the business

• quality products and processes

• any other aspect of the business that adds value to the product or service

• lack of marketing expertise

• undifferentiated products or services

• location of the business

• poor-quality goods or services

• damaged reputation and weak brand image

Opportunities

Threats

External

• a developing market such as the internet

• mergers, joint ventures or strategic alliances

• moving into new market segments that offer improved profits

• a new international market

- a market vacated by an ineffective competitor
- a new competitor in the home market
- price wars with competitors
- a competitor with a new, innovative product or service
- competitors with superior access to channels of distribution
- taxation of the product or service

Table 8.6: An example of a Swot analysis for a business

SWOT and strategic objectives

SWOT helps managers assess the most likely successful future strategies and the constraints on them. A business may stand a good chance of developing a competitive advantage by identifying a good match between its strengths and potential opportunities. In many cases, a business may need to overcome a weakness in order to take advantage of a potential opportunity.

SWOT is a common starting point for developing new corporate strategies, but it is rarely sufficient. Further analysis and planning are usually needed before strategic choices can be made.

Evaluation of SWOT

Subjectivity is often a limitation of a SWOT analysis. Different managers would not necessarily agree on their assessment of the company they work for. It is not a quantitative form of assessment so the cost of correcting a weakness cannot be compared with the potential profit from pursuing an opportunity. SWOT should be used as a management guide for future strategies, not as a specific guide for future action. Part of the value of the process of SWOT analysis is the greater understanding that senior managers gain about their business from the focus that the SWOT analysis provides.

> TIP Some questions may ask you to undertake a SWOT analysis, while others will ask you to evaluate the technique for a particular business. Read the question carefully to grasp its key requirements.

PEST analysis

This is another form of strategic analysis. It focuses on analysing the macro environment in which a business operates. The macro environment means the wide-ranging and major factors that could influence the future strategies of a business. PEST analysis is an acronym for:

==PEST analysis:== the strategic analysis of a firm's macro environment, including political, economic, social and technological factors.

P = political (and legal) factors; E = economic factors; S = social factors; T = technological factors.

PEST analysis plays an important role in assessing the likely chances of a business strategy being successful. The four key areas covered by it are clearly external to the business and beyond its control. They are considered as being either opportunities or threats. PEST is complementary to SWOT, not an alternative.

Evaluation of PEST

Any significant new business strategy should be preceded by a detailed analysis of the wider environment in which the strategy has to operate and be successful. The use of PEST analysis formalises this process. The results of the analysis should be an important part of developing strategies for the future. Once completed, PEST analysis does not just stop. It may need to be constantly updated and reviewed, especially in a rapidly changing wider environment. For multinational businesses, or for a business considering foreign expansion for the first time, it will be important to undertake PEST analysis for each country in which it operates (see Table 8.7).

Political and legal

Economic

Social

Technological

- stability of the government
- likely legal changes impacting on this industry
- environmental regulations
- employment law
- competition regulations
- consumer protection laws
- government attitude to free market and legal controls over business
- rate of economic growth
- exchange rate stability
- country's membership of free-trade areas
- membership of a common currency such as the euro
- tax rates and likely changes
- interest rates and likely changes

- inflation rates and stage of the business cycle
- demographic changes: ageing or youthful population?
- dominant religion and impact this could have on marketing strategies
- education standards and impact on labour skills
- roles of men and women in society
- social and environmental issues could be of increasing concern to the population
- labour and social mobility and migration levels
- one or many languages spoken
- new technology allowing products to be made more cheaply
- government support for research spending
- impact of internet access and speed on marketing and other strategies
- cost of renewable energies compared to fossil fuels
- speed of technological obsolescence
- importance of product innovations to consumers
- process innovations and impact on competitiveness

Table 8.7: PEST factors analysed by a business planning to export to another country

Porter's five forces analysis

Michael Porter provided a framework that models an industry as being influenced by five forces. When managers are developing a new strategy, attempting to establish a competitive advantage over rivals, they can use this model to understand the industry in which the business operates. The model has similarities with other tools for an external environmental audit, such as PEST analysis.

==five forces:== a technique for analysing competitive forces within an industry.

Five forces analysis focuses on business units, rather than on single products or product ranges. For example, Dell would use Porter's five forces model to analyse the market for business computers at its strategic business unit (SBU) level.

Figure 8.5 shows these five forces, with the key force of competitive rivalry at the centre.

1 Barriers to entry

This means the ease with which other firms can join the industry and compete with existing businesses. This threat of entry is greatest when:

- economies of scale are low in the industry
- the technology needed to enter the industry is relatively cheap

Figure 8.5: Diagram of Porter's five forces model Figure 8.5: Diagram of Porter's five forces model

- distribution channels are easy to access (e.g. retail shops are not owned by existing manufacturers in the industry)
- there are no legal or patent restrictions on entry
- the importance of product differentiation is low, so extensive advertising may not be required to get established.

2 The power of buyers

This refers to the power that customers have over the producing industry. For example, if there are four major supermarket groups that dominate this sector of retailing, their buyer power over food and other producers will be great. Buyer power will also be increased when:

- there are many undifferentiated small supplying firms (e.g. many small farmers supplying milk or chickens to supermarkets)
- the cost of switching suppliers is low
- buyers can realistically and easily buy from other suppliers.

3 The power of suppliers

Suppliers will be relatively powerful compared with buyers when:

- the cost of switching is high (e.g. from Microsoft computers to Macs)
- the brand being sold is very powerful and well-known (e.g. Cadbury's chocolate or Nike shoes)
- suppliers could realistically threaten to open their own forward-integration operations (e.g. coffee suppliers open their own cafés)
- customers have little bargaining power as they are small firms and fragmented (e.g. dispersed around the country, as with independent petrol stations).

4 The threat of substitutes

In Porter's model, the idea of substitute products does not mean alternatives in the same industry, such as Toyota for Honda cars. It refers to substitute products in other industries. For instance, the demand for aluminium for cans is partly affected by the price of glass for bottling and the price of plastic for containers. These are substitutes for aluminium, but they are not rivals in the same industry. Threats of substitution will exist when:

- New technology makes other options available, such as satellite TV instead of traditional antenna reception.
- Price competition forces customers to consider alternatives. For example, lower bus fares might make some travellers switch from rail transport.
- Any significant new product leads to a switch in consumer spending. For example, increasing spending on mobile (cell) phones by young people reduces the available cash they have to spend on clothes.

5 Competitive rivalry

This is the key part of this analysis. It sums up the most important factors that determine the level of competition or rivalry in an industry. It is based on the other four forces. This is why it is often illustrated in the centre of the five forces diagram. Competitive rivalry is most likely to be high where:

- it is cheap and easy for new firms to enter an industry
- there is a threat from substitute products
- suppliers have much power
- buyers have much power. There will also be great rivalry between competing firms in an industry when:
- there are a large number of firms with similar market share
- high fixed costs force firms to try to obtain economies of scale
- there is slow market growth that forces firms to take a share from rivals if they wish to increase sales.

Porter's five forces as a framework for business strategy

How does this analysis of the competitive situation in an industry help a business take important strategic decisions?

- It helps businesses decide whether to enter an industry or not. It provides insight into the potential profitability of markets. Is it better to enter a highly competitive market or not?
- By analysing the existing markets, decisions may be taken regarding:

- With the knowledge gained of the competitive forces, businesses can develop strategies that might improve their own competitive position. (See Activity 8.5.)

Evaluation of the five forces model

The benefit of Porter's model is that it enables managers to think about the current competitive structure of their industry in a logical way. It is usually regarded as a good starting point for the development of business strategy.

However, it is sometimes criticised because:

- It is static analysis that examines an industry at just one moment in time. Many industries are changing very rapidly due to globalisation and technological changes.
- The model can become very complex when trying to use it to analyse many modern industries with joint ventures, multiple product groups and different market segments within the same industry. They will each have their own competitive forces.

Core competencies

The concept of core competencies was first analysed in the work of Gary Hamel and C. K. Prahalad. They argued that if a business develops core competencies, then it may gain competitive advantage over rival businesses.

==core competencies:== an important business capability that gives a firm competitive advantage.

To be of commercial and profitable benefit to a business, a core competence should:

- provide clear benefits to consumers
- be difficult for other businesses to copy (e.g. if it is a patented design)
- be applicable to a range of different products and markets. According to Prahalad and Hamel, core competencies lead to the development of core products. Core products are not necessarily sold to final consumers. Instead they are used to produce a large number of end-user products. For example, Black & Decker, it is claimed, has a core competence in the design and manufacture of small electric motors. These core products are used in a huge variety of different applications from power tools, such as drills, to lawnmowers and food processors.

==core products:== product based on a business's core competencies, but not necessarily for the final consumer or end user.

Developing core competencies

A business might be particularly good at a certain activity and it might have competence in this activity. However, this does not necessarily make it a core competence if it is not exceptional or if it is easy to copy. A computer assembly business might be very efficient and produce computers at low cost, but if it depends on easily available and cheap bought-in components from suppliers, this is not a core competence. It does not make the business very different from many other computer assembly firms.

Developing a core competence, according to Prahalad and Hamel, depends on integrating multiple technologies and product skills. Some of these may already exist in the business. It does not necessarily mean spending huge amounts on R&D, but patented production processes, such as Pilkington's float glass process, may give a core competence. If a management team can effectively bring together designers, production specialists and IT experts into a team to develop new and different competencies, then these may become differentiated and core competencies. Two excellent business examples are:

- the development of Philips's expertise in optical media
- Sony's ability to miniaturise electronic components, which led to many core products.

Core competencies and strategy

Once a core competence has been established, it opens up strategic opportunities for developing core products and new markets.

The business units (1–4) in Figure 8.6 are the divisions of a business that will use the core products. So, they might be the consumer products division or the industrial products division, but they would both use the core competencies of the business such as a very fast new microchip or a unique design of electric motor. By building up new products for new markets in this way, there will be a greater opportunity to gain economies of scale in the manufacture of the core products.

Figure 8.6: Core competencies can lead to a large number of end products Figure 8.6: Core competencies can lead to a large number of end products

The Ansoff matrix

This analytical tool is a widely used method of assessing alternative corporate business strategies and planning for their introduction. Igor Ansoff's best-known contribution to strategic planning was the development of the Ansoff matrix. This represents the different options open to a marketing manager when considering new opportunities for sales growth.

==Ansoff matrix:== a model used to show the degree of risk associated with the four growth strategies of market penetration, market development, product development and diversification.

The Ansoff matrix shows the two main variables in a strategic marketing decision are:

- the market in which the business is going to operate
- the product(s) it plans to sell. In terms of the market, managers have two options:
- to remain in the existing market
- to enter new ones. In terms of the product, the two options are:
- selling existing products
- developing new ones. When put into a matrix, these options can be presented as shown in Figure 8.7. As there are two options each for markets and for products, this gives a total of four distinct strategies that businesses can adopt when planning to increase sales. These are shown on the matrix and can be summarised as follows.

Figure 8.7: The Ansoff matrix Figure 8.7: The Ansoff matrix

Market penetration

Samsung has reduced the European prices of its range of 4k TVs by up to €1 200. This was in response to price cuts by other manufacturers, but Samsung's reductions were largely an attempt to increase market share. Market penetration is the least risky of all four possible strategies in the Ansoff matrix, because there are fewer unknowns – the market and product parameters both remain the same. However, it is not risk-free. If low prices are the method used to penetrate the market, they could lead to a potentially damaging price war that reduces the profit margins of all firms in the industry.

==Market penetration:== achieving higher market shares in existing markets with existing products.

Product development

The launch of Diet Pepsi took an existing product, developed it into a slightly different version and sold it in the soft drinks market where Pepsi was already available. Product development often involves innovation (as with 5G mobile (cell) phones) and these brand-new products can offer a distinctive identity to the business.

==Product development:== the development and sale of new products or new developments of existing products in existing markets.

Market development

Market development could include exporting goods to overseas markets or selling to a new market segment. Lucozade used to be promoted as a health tonic for people with colds and influenza. It was successfully repositioned into the sports drink market, appealing to a new, younger range of consumers. Dell or HP can use existing business computer systems and repackage them for sale to consumer markets.

==Market development:== the strategy of selling existing products in new markets.

Diversification

The Virgin Group is constantly seeking new areas for growth. The company's expansion from a media empire to an airline, then a train operator and more recently into finance, is an excellent example of diversification. Tata Industries in India is another good example of a very diversified business, manufacturing a huge range of products, from steel and cars to tea bags. Related diversification (e.g. backward or forward vertical integration in the same industry) can be less risky than unrelated diversification, which takes the business into a completely different industry.

==diversification:== the process of selling different, unrelated goods or services in new markets.

As the diversification strategy involves new challenges in both markets and products, it is the riskiest of the four strategies. It may also be a strategy that is outside the core competencies of the firm. However, diversification may be a possible option if the high risk is balanced out by the chance of high profits. Another advantage of diversification is the potential to gain a foothold in an expanding industry.

Evaluation of the Ansoff matrix

The risks involved in these four strategies differ substantially. By identifying the different strategic areas for business expansion, the matrix allows managers to analyse the degree of risk associated with each area. Managers can then apply decision-making techniques to assess the costs, potential gains and risks associated with all options.

While Ansoff's analysis helps to map the strategic business options, it also has limitations. It only considers two main factors in the strategic analysis of a business's options. It is important for managers to also consider SWOT and PEST analysis in order to give a more complete picture. Recommendations based purely on the Ansoff matrix would lack important environmental evidence.

Management judgement, based on experience of the risks and returns from the four options, is just as important as any one analytical tool for making the final choice.

The matrix does not suggest detailed marketing options. If a market development strategy is used by a business, the matrix does not indicate in which market and with which of the existing products. Further research and analysis will be needed to supply answers to these questions.

Force-field analysis

The technique of force-field analysis, first developed by Kurt Lewin, involves looking at all of the forces for and against a decision. It weighs up the potential advantages and disadvantages of a decision before a choice is made. The main purpose of the technique is to give managers an insight that will allow them to strengthen the forces supporting a decision, and reduce the forces that oppose it. In business, decisions such as introducing a new product or service, or implementing a major internal change, could be analysed using this approach.

==force-field analysis:== a technique for identifying and analysing the positive factors that support a decision (driving forces) and negative factors that constrain it (restraining forces).

The technique uses the force-field diagram. This is used to represent the forces that work in favour of a major change and those that work against it. Figure 8.8 shows such a diagram for the decision to introduce a big new IT system for the administration department of a business.

Conducting a force-field analysis

1. Analyse the current situation and the desired situation.
2. List all of the factors driving change towards the desired situation.
3. List all of the constraining factors against change towards the desired situation.
4. Allocate a numerical score to each force, indicating the scale or significance of each force: 1 = extremely weak and 10 = extremely strong.
5. Chart the forces on the diagram with driving forces on the left and restraining forces on the right.
6. Total the scores and establish from this whether the change is really viable. Is it worth going ahead? If yes, then the next stage is important.
7. Discuss how the success of the change or proposed decision can be affected by decreasing the strength of the restraining forces and increasing the strength of the driving forces. Looking at the example in Figure 8.8, the forces against the new IT system are greater than those that are positive towards it (11:10). Forcing through a decision to introduce the IT system without responding to this analysis could be very unwise. Staff may be

uncooperative and resistant if change is forced through with no attempt to reduce the forces against change.

Figure 8.8: A force-field diagram for introducing an IT system Figure 8.8: A force-field diagram for introducing an IT system

Possible management strategies to address the restraining forces include:

- Employees could be trained (increasing cost by +1) to help eliminate fear of technology (reducing staff concern about new technology by –2).
- It would be important to show staff that change is necessary for business survival (add a new force in favour, +2).
- Staff could be shown that new IT equipment would introduce new skills and interest to their jobs (add a new force in favour, +1).
- Managers could raise wages to reward staff for higher productivity (increase cost, +1, but reduce cost by loss of staff, −2).
- IT machines could be selected that are more energy efficient (environmental impact of new technology, −1). These changes would swing the balance of the force-field analysis from the original 11:10 against to 13:8 in favour of the decision.

Evaluation of force-field analysis

This technique is widely used in assessing strategic decisions that require major internal changes to the business. It has two main limitations as a strategic choice method:

- Unskilled or inexperienced managers could fail to identify all of the relevant forces involved in the change process.
- The allocation of numerical values to the driving and constraining forces is rather subjective. Two managers independently undertaking the same force-field analysis could arrive at rather different values for the forces and, consequently, propose very different decisions based on their assessments.

Decision trees

No decision-making technique can eliminate the risks involved in choosing between options, but managers can help themselves greatly if they adopt a logical approach to decision-making. One method of considering all the options available and the chances of them occurring is known as decision trees.

==decision trees:== a diagram that sets out the options connected with a decision and the outcomes and economic returns that may result.

This technique is based on a diagram that represents four main features of a business decision (see Figure 8.9):

- all of the options open to a manager
- the different possible outcomes resulting from these options
- the chances of these outcomes occurring
- the economic returns from these outcomes.

Figure 8.9: Decision tree for the fundraising auction Figure 8.9: Decision tree for the fundraising auction

By comparing the likely financial results from each option, the manager can minimise the risks involved and take a decision based on potential profitability.

Constructing decision trees

The tree is a diagram with the following features:

- It is constructed from left to right.
- Each branch of the tree represents an option together with a range of consequences or outcomes and the chances of these occurring.
- Decision points (decision nodes) are denoted by a square.
- A circle (chance node) shows that a range of outcomes may result from a decision.
- Probabilities are shown alongside each of these possible outcomes. These probabilities are numerical values that measure the chance of an outcome occurring.
- The economic returns are the expected financial gains or losses of a particular outcome.

Working out expected values on decision trees

Using the definition below, the expected value of tossing a coin and winning \$5 if it comes down heads is 0.5 × \$5 = \$2.50. In effect, the average return, if you repeated this a number of times, would be to win \$2.50. The purpose of a decision tree is to show the option that gives the highest expected value.

==expected value:== the likely financial result of an outcome obtained by multiplying the probability of an event occurring by the forecast economic return if it does occur.

Example: The manager of a business that organises events has to decide between holding a fundraising auction indoors or outdoors. The financial success of the event depends on the weather and also on the decision whether to hold it indoors or outdoors.

Table 8.8 shows the expected net financial returns or economic returns from the event for each of these different circumstances. From past weather records for

August, there is a 60% chance of fine weather and a 40% chance of it being poor. The indoor event will cost $2 000 to arrange and the outdoor event will cost $3 000.

Weather

Indoors

Outdoors

Fine

$5 000

$10 000

Poor

$7 000

$4 000

Table 8.8: The possible economic returns from the alternative options

The decision tree of the event is shown in Figure 8.9. It demonstrates the main advantages of decision trees:

- They force the decision-maker to consider all of the options and variables related to a decision.
- They put these on an easy-to-follow diagram, which allows for numerical considerations of risk and economic returns to be included.
- The approach encourages logical thinking and discussion among managers. Using the tree diagram above, which option would give the highest expected value: holding the event indoors or outdoors? The answer is obtained by calculating the expected value at each of the chance nodes. This is done by multiplying the probability by the economic return for both outcomes and adding the results. The cost of each option is then subtracted from this expected value to find the net return. This is done by working through the tree from right to left, as follows (see Figure 8.10).
- The expected value at node 1 is $5 800.
- The expected value at node 2 is $7 600.
- Subtract the cost of holding the event either indoors or outdoors: Therefore, the events manager would be advised to hold the event outdoors as, on average, this will give the highest expected value. The other option is blocked off with a double line in Figure 8.10 to indicate that this decision will not be taken.

Figure 8.10: Calculating expected values, working from right to left Figure 8.10: Calculating expected values, working from right to left

More complex decision trees

The examples used above have been based on fairly straightforward decisions where only one choice had to be made. Most strategic decisions are more complex than this. Figure 8.12 is a more complex decision tree, showing a construction company's strategic options for a derelict building. There are two options initially facing the business. The building could either be sold now for $1 million, or improved and updated at a cost of $0.5 million. After renovation, the building could be sold as one house. However, after renovation, another option would be to split the building into three apartments, which will cost a further $0.25 million.

The payoffs from these options will depend on interest rates at the time of sale. High rates will reduce the returns in both cases, as seen in Table 8.9. Based on past economic records, the chance of interest rates being high during the sale period for the house or flats is 60% and the chance of low rates is 40%.

Figure 8.12: The decision tree for the construction company's options Figure 8.12: The decision tree for the construction company's options

Interest rates

Revenue: sale of house

Revenue: sale of apartments

Low

$2.0m

$2.5m

High

$1.5m

$2.0m

Table 8.9: Interest rates and the revenue outcomes

The important rule of working from right to left in calculating expected values is still relevant with these more complex examples. The calculations must now be divided into two stages:

1. The expected values of selling either the house or the apartments must be worked out, taking the additional conversion cost of the apartments into account.
2. The values of the two initial options can be compared, using the higher of the two outcomes from the second decision. Which offers a better return: the immediate sale or the investment in the building? At node 3, the expected value is $1.7 million. At node 4, the expected value is $2.2 million. From this, must be subtracted the additional apartment conversion costs

of $0.25 million to leave $1.95 million. Verify these results with your own calculations. The apartment option is preferred to selling as one house. This is the return that is taken back to node 2.

Now subtract the renovation costs of the building from this return to give the overall net return of not selling the building immediately. This is compared with the $1 million from the sale of the building now. It is clear, based on quantitative issues alone, that the business would be advised to both develop the building and convert it into apartments. Therefore, working from right to left, the highest expected value at node 1 becomes $1.45 million, obtained from the apartments option.

Evaluation of decision trees

The potential limitations of this technique are:

- Accuracy of the data used. Estimated economic returns may be quite accurate when they concern projects where experience has been gained from similar decisions. In other cases, they may be based on forecasts of market demand or estimates of the most likely financial outcome. The possible inaccuracy of this data makes the results of decision-tree analysis no more than a useful guide for managers.
- Probabilities of events occurring may be based on past data, but circumstances may change. For example, what was a successful launch of a new store last year may not be repeated in another location if the competition has opened a shop there first.
- Decision trees aid the decision-making process, but they cannot replace either the consideration of risk or the impact of non-numerical, qualitative factors on a decision. The latter could include the impact on the environment, the attitude of the workforce or the approach to risk taken by the managers and owners of the business. There may be a preference for fairly certain but low returns, rather than taking risks to earn much greater rewards.
- The expected values are average returns, assuming that the outcomes occur more than once. With any single, one-off decision, the average will not, in fact, be the final result. Decision trees allow a quantitative consideration of future risks to be made but they do not eliminate those risks.

Image Image

Introduction

Developing new business strategies does not mean that senior business managers' work is completed. Strategies need to be introduced effectively within the business and this process starts with a corporate plan.

9.1 Corporate planning

Planning to develop and implement future strategies is an important function of senior managers. The planning process is aided by the development of a detailed corporate plan.

Components of corporate plans

A typical corporate plan will include:

- The overall objectives of the organisation to be achieved within a given time frame. These could be profit target-related, sales growth-related, or market share target-related.
- The strategy or strategies to be used to attempt to meet these objectives. For example, to achieve sales growth, the business could consider the choices as analysed by the Ansoff matrix:
- The main objectives for the key departments of the business derived from the overall objective. Once the strategies have been implemented, the results should be measured and evaluated. The results are then compared with the original objectives. They will also be used to help determine the corporate objectives for the next period (also shown in Figure 9.1).

Figure 9.1: The corporate planning process Figure 9.1: The corporate planning process

Potential benefits of corporate plans

- Senior managers have a clear focus and sense of purpose for what they are trying to achieve. Strategies are then chosen with the best chance of achieving the objective which has been set.
- The plan helps to communicate this sense of purpose and focus to all managers, employees and other stakeholders. This is an important requirement for corporate plans to be effective. This benefit of planning is important to any business, no matter what its size.
- An important benefit of any corporate plan is the control and review process. The original objectives can be compared with actual outcomes to see how well the business's performance matched its aims.
- The planning process itself is a very useful exercise. When effectively done, preparing for and producing the corporate plan forces senior managers to consider the organisation's strengths and weaknesses in relation to the business environment.

Potential limitations of corporate plans

Plans are great if nothing changes. The best-laid plans of any business can be made obsolete by rapid and unexpected internal or external changes. This does not mean that planning is useless. Part of the planning process is to look ahead to consider how to respond to unforeseen events (see Section 9.5). However, if a business puts a five-year plan into effect and then refuses to make any variations or adaptations to it, no matter how much external environmental factors might change, then inflexibility could be disastrous. The corporate planning process should be as adaptable and flexible as possible to allow corporate plans to continue to be relevant and useful during periods of change.

==corporate planning:== the process used by companies to set long-term plans to meet certain objectives, such as business growth and higher return on capital employed.

The main internal influences on a corporate plan

- Financial resources: Can the new proposed strategies be afforded?
- Operating capacity: Will this be sufficient if expansion plans are approved by directors?
- Managerial skills and experience: This may be a major constraint on the plan's success, especially if the diversification strategy is chosen.
- Employee numbers and skills: Workforce planning is a key factor in the success of any corporate plan.
- Culture of the organisation: See Section 9.2.

The main external influences on a corporate plan

- Macroeconomic conditions: Expansion may have to be put on hold during a recession.
- Central bank and government economic policy changes.
- Likely technological changes: These could make even the best-laid plans appear very outdated quite rapidly.
- Competitors' actions: The competitive nature of the market.

  TIP You should be able to explain that the relative importance of these factors will vary from business to business. For example, a company producing incomeelastic luxury products may find its corporate plan is most influenced by macroeconomic forecasts. The directors of a small company might think that the plan for their business is most constrained by internal financial limits.

9.2 Corporate culture

A commonly used definition of corporate culture is 'the way we do things around here'. This means how people within an organisation take decisions and interact with each other, and with other stakeholders.

==corporate culture:== the values, attitudes and beliefs of the people working in an organisation that affect the way they interact with each other, and with external stakeholders.

Different organisations have very different cultures. This is true of businesses as well as other organisations, such as schools and colleges. The culture of a steel company will be very different from that of a nursing home. Similarly, in some schools, the culture is driven by the need for better examination results, while others take the view that educating the complete person is more important. The culture of an organisation gives it a sense of identity. Culture is based on the values, attitudes and beliefs of the people who work in it — especially senior management.

Values, attitudes and beliefs have a very powerful influence on the way employees in a business act, take decisions and relate to others in the organisation. They define what is normal in an organisation. So, it is possible for the same person to act in different ways in different organisations. What we do and how we behave – in society in general, and in business in particular – are largely determined by our culture.

> TIP Culture is a powerful force in any business. You should take every opportunity in your A Level answers to refer to it as a factor that helps to explain managers' decisions and behaviour.

The main types of corporate culture

Many management writers have used different ways to identify and classify different types of organisational culture. These are the most widely recognised culture types:

- Power culture:a culture that concentrates power among just a few people. This is associated with autocratic leadership. Power is concentrated at the centre of the organisation. Swift decisions can be made as so few people are involved in making them.
- Role culture: a culture in which each member of staff has a clearly defined job title and role.This is most associated with bureaucratic organisations. People in an organisation with this culture operate within the rules and show little creativity. The structure of the organisation is well-defined, and each individual has clear delegated authority. Power and influence come from a person's position within the organisation.
- Task culture:a culture based on cooperation and teamwork. Groups are

formed to solve particular problems and there will be lines of communication similar to a matrix structure. Such teams often develop a distinctive culture because they are empowered to take decisions. Team members are encouraged to be creative.

- Person culture:a culture in which individuals are given the freedom to express themselves fully and make decisions for themselves. There may be some conflict between individual goals and those of the whole organisation, but this is the most creative type of culture.
- Entrepreneurial culture: a culture that encourages management and workers to take risks, to come up with new ideas and test out new business ventures.Success is rewarded in an organisation with this culture. However, failure is not necessarily criticised as it is considered an inevitable consequence of showing initiative and risk-taking.

  TIP It is important to remember that, as with leadership styles, there is no one right or wrong culture for a business. Take every opportunity to explain that an appropriate culture will depend on business objectives, the type of market it operates in, and the values and expectations of managers and employees.

  KEY CONCEPT LINK Business culture will influence the style of leadership used. An autocratic style will lead to difficulty in managing and leading change. Employees will not be convinced that change will benefit them.

Changing corporate culture

Many businesses have turned themselves around, transforming potential bankruptcy into commercial success. Very often, this transformation has been achieved by changing the culture of the business. The existing culture of a business can become a real problem when it restricts growth, development and success. Here are some examples of situations when changing culture would seem to be essential:

- A traditional family firm, which has always promoted members of the family into senior posts, converts to a public limited company. New investors demand more transparency and recognition of natural talent from externally recruited employees.
- A product-led business needs to respond to changing market conditions by encouraging more worker involvement. A team- or task-based culture may need to be adopted.
- A recently privatised business used to operate on bureaucratic principles when it was government-owned. It now needs to become more profit-oriented and customer-focused. An entrepreneurial culture may need to be introduced for the first time.

- A takeover may result in the business that was bought out adapting its culture to ensure consistency within the newly created larger company.
- Declining profits and market share may be the result of poorly motivated workers, low quality and poor customer service. A person-based culture might help to transform the prospects of this business. Changing the value system of a business and the attitudes of all employees is never easy. The process can take several years before all workers and processes have been converted to a new culture. It means changing the way people think and react to problems. It can mean directly challenging the way things have been done for years. It can also involve substantial changes of personnel, job descriptions, communication methods and working practices.

Much research has been done on analysing the best way to change an organisation's culture. The key common elements to these different approaches are:

- Concentrate on the positive aspects of the business and how it currently operates, and develop these. This will be much easier and more popular with employees than focusing on just trying to change negative aspects.
- Obtain the full commitment of all senior managers. If they cannot or will not change, it might be easier to replace them altogether. Unless the key personnel give examples of the behaviour they expect to see in others, change will be very difficult to achieve.
- Establish new objectives and a mission statement that accurately reflect the new values and attitudes being adopted. These need to be communicated to all employees.
- Encourage employee participation when discussing how the new culture should change the manner in which decisions are taken. The biggest mistake is to try to impose a new culture on workers without explaining the need for change and without giving them the opportunity to suggest alternative ways of working.
- Train employees in the new culture and the new value system of the business. If people believe in the change and understand its benefits, then it will become more acceptable to them.
- Change the employee reward system to avoid rewarding success using the old cultural ways. Ensure that appropriate behaviour is encouraged and receives recognition. People need to be reassured that if they adjust to the new culture, they will gain from it.

Corporate culture and business decision-making

Different business cultures make decisions and introduce changes in different ways. For example, a business that has a power culture will not consult or communicate with employees affected by major strategic changes. These changes will be imposed on the employees. This approach may create resistance to change. The cooperation of the workforce is most unlikely to be obtained in future.

In contrast, businesses that operate with task- or people-based cultures are more likely to encourage active participation in deciding on and implementing major strategic changes. Consultation and participation through two-way communication could lead to employees willingly accepting change. This will contribute to a successful change process.

The other link between culture and decision-making occurs when the culture is either strong or weak. Strong culture promotes and facilitates successful strategic decision-making, while weak culture does not. Strong culture means that there is very widespread sharing of common beliefs, practices and norms within the business. Everyone in the business has accepted what the business stands for and the 'way things are done around here'. If the business culture is people-focused and based on listening to customers and empowering workers, then this helps the implementation of a strategy that leads to an improvement in customer service.

In businesses with weak cultures, employees may have no agreed set of beliefs and there is no pride in ownership of work. People may form their own groups within this type of organisation. These groups are based around cultures that conflict with the weakly held business culture. Such situations provide little or no assistance to strategic decision-making or implementation.

The importance of corporate culture

The impact of culture goes beyond the desire of most people to accept the same values. It can have a significant impact on how new strategies are decided and implemented.

Figure 9.4: Why corporate culture is important Figure 9.4: Why corporate culture is important

The following examples help to reinforce the importance of corporate culture:

- The values of a business establish the norms of employee behaviour – what is and what is not acceptable. For example, is it acceptable for an organisation to offer bribes to gain a large contract?
- Culture determines the way in which managers and workers treat each other. If the chief executive is open and receptive to new ideas from senior managers, then this approach is likely to filter through the whole organisation.
- A distinctive organisational culture can support a business's brand image and relationships with customers. For example, The Body Shop almost invented the ethical trading culture. Some analysts believe that the business changed its approach after its takeover by L'Oréal.

- Culture determines not just how strategic decisions are made and implemented, but also the type of strategic decisions that are taken. A business with a people-based culture is most unlikely to take decisions that would damage workers' health or the local environment.
- Corporate culture is linked to the performance and long-term success of businesses. Companies dedicated to continuous improvement with workers' involvement have been shown to be more profitable in the long term. Toyota is a prime example of success based on this principle.

9.3 Transformational leadership

Transformational leadership is of most importance during periods of significant corporate change.

==Transformational leadership:== the leader works with teams to identify the need for change, creates a vision to inspire people to accept change and implements change with the cooperation of the team.

When introducing and implementing major changes in business a transformational leader will aim to:

- Influence employees with their own (the leader's) behaviour and qualities. Setting the right example is so important.
- Inspire other employees to accept change through a well-communicated vision for the future of the business.
- Demonstrate a genuine concern for the needs and feelings of employees. The leader will help them self-actualise (Maslow).
- Provide stimulating challenges to employees to encourage them to aim for higher levels of performance.

The importance of transformational leadership

- Transformational leadership increases the chances of successful change within a business. Change that is supported by employees and benefits from their input is likely to lead to continued business success.
- It increases the flexibility and adaptability of a business to cope with frequent change. The business world is becoming more dynamic and one change may be followed by the need for further flexibility in future.
- It focuses on leading change, not forcing it on employees with an autocratic style. That encourages workers to accept change and work towards making it a success.
- It improves employee motivation and performance. Encouraging workers to achieve above the normally expected level will benefit both the business

and the worker. This style of leadership is also discussed in Section 15.2.

9.4 Managing and controlling strategic change

Managers need to control the change process, not be controlled by it. Managing change involves the following steps.

1 Understand what strategic change means

Strategic change is the continuous adoption of business strategies in response to changing internal pressures or external forces. Change happens whether we encourage and welcome it, or not. Managers need to control it to ensure that it is a positive and not a negative process. Businesses must have a vision, a strategy and an adaptable process for change management.

==change management:== planning, implementing, controlling and reviewing the movement of an organisation from its current state to a new one.

Change in business is the rule not the exception. It has become an accelerating and ongoing process. Table 9.1 gives some common causes of change. 'Business as usual' will become increasingly rare as global, economic and technological upheavals require businesses to respond. Change management needs businesses to be able to cope with dramatic one-off changes as well as more gradual evolutionary change.

Evolutionary or incremental change occurs quite slowly over time. For example, the trend towards cars powered by electricity has been happening for several years. These types of changes can be anticipated or unexpected. The decisions being taken to ban diesel cars from some city centres are announced months in advance. In contrast, a sudden oil price increase may not be expected. Obviously, incremental changes that are easy to anticipate tend to be the easiest to manage.

Dramatic or revolutionary change, especially if unanticipated, causes many more problems. Civil conflict in Bolivia and Venezuela in 2019 forced many holiday companies to re-establish themselves in other countries or markets. In extreme cases, these dramatic changes might lead to totally rethinking the operation of an organisation. This is called business process re-engineering.

==business process re-engineering:== fundamentally rethinking and redesigning the processes of a business to achieve a dramatic improvement in performance.

> TIP When discussing how change will affect a business and its strategies, try to analyse whether the change is incremental or dramatic, anticipated or unanticipated.

2 Recognise the major causes of change

These are outlined in Table 9.1.

Major changes

Examples of change

Managing change

Technological advances in new products and new processes

- products (e.g. new computer games, AI and machine learning, hydrogen-powered cars)
- processes (e.g. robots in production, CAD in design offices, computer systems for inventory control)
- need for labour retraining
- purchase of new equipment
- additions to product portfolio and other products to be dropped
- need for quicker product development, which may need new organisational structures and teams

Macroeconomic change: fiscal policy, interest rates, fluctuations in the business cycle

- changes in consumers' disposable incomes and demand patterns that result from this
- boom or recession conditions, which require either extra capacity or rationalisation
- need for flexible production systems (including staff flexibility) to cope with demand changes
- explain need for extra capacity or the need to rationalise
- deal with redundancies in ways that encourage workers who remain to accept change

Legal changes

- changes to what can be sold or when (e.g. 24-hour licences for restaurants)
- employee training on company policy, e.g. selling certain goods to children
- flexible working hours and practices

Competitors' actions

- new products
- lower prices based on higher competitiveness / lower costs

- higher promotion budgets
- encourage new ideas from employees
- if employees accept the need for change, then they will accept the change itself
- ensure resources are available to meet the challenge

Table 9.1: Examples of changes affecting business

3 Understand the stages of the change process

Senior managers should follow this checklist:

- Where are we now and why is change necessary? It is important to recognise why a business needs to introduce change from its current situation.
- New vision and objectives: For substantial changes, a new vision for the business may be needed. This must be communicated to those affected by the change.
- Ensure resources are in place to enable change to happen: Starting a change and then finding that there is too little finance to complete it could be disastrous.
- Give maximum warning of the change: Employees should not be taken by surprise by change. This increases resistance to it.
- Involve employees in the plan for change and its implementation: This will encourage them to accept change and lead to proposals from them to improve the change process.
- Communicate: The vital importance of communication with the workforce runs through all these other stages.
- Introduce initial changes that bring quick results: This will help all involved in the change to see the point of it.
- Focus on training: This will allow employees to feel that they are able to make a real contribution to the changed organisation.
- Sell the benefits: Employees and other stakeholders may benefit directly from changes so these need to be explained to them.
- Remember the effects on individuals: A soft human resource approach will bring future rewards of employee loyalty, if the workforce has been supported and communicated with.
- Check on how individuals are coping and support them: Some people will need more support than others. Not supporting employees will damage the business if it leads to low-quality output or poor customer service because of poor motivation.

4 Lead change, do not just manage it

All strategic change must be managed. This means that:

- new objectives need to be established that recognise the need for change
- resources of finance and labour need to be available for the change to be implemented
- appropriate action needs to be taken to implement the planned changes. Managing change effectively is important to successful implementation. But managing change is not the same as leading change. Leading strategic change is much more than just managing resources. Change leadership involves having a much greater vision than just making sure the right resources are available to deal with change. Leading change means:
- dynamic leaders who will shake an organisation out of its complacency and away from resistance to change (corporate inertia)
- motivation of workers and managers so that change is seen as a positive force for improving people's lives (motivation leads to significant changes in the behaviour of workers)
- ensuring that acceptance of change is part of the culture of the organisation
- getting the visible support of all senior managers to help the change process become accepted at all levels and in all departments of the business.

  KEY CONCEPT LINK An effective decision-maker will be able to lead change in a positive way and this will encourage employees to accept the consequences of change.

Project champions

A project champion is often appointed by senior management to help drive a programme of change through a business. A champion will come from middle or senior management. They need to have enough influence within the organisation to make sure that things get done. They are like cheerleaders for the project. They will not necessarily be involved in the day-to-day running of the new scheme. Instead, they will smooth the path of the project team planning the change. They will remove as many obstacles as possible. They will speak in support of the changes being suggested at meetings of senior managers. They try to ensure that sufficient resources are available and that everyone understands the project's goals and objectives.

==project champion:== a person appointed to support a project and drive it forward by explaining the benefits of change and assisting and supporting the team putting change into practice.

Project groups or teams

Problem-solving through team building and using the power of project groups is a structured way of making a breakthrough in a difficult change situation.

Project groups should work with the manager responsible for introducing the change. A team meeting of experts should discuss and decide on an appropriate action plan being developed and agreed. The responsibility for carrying the plan out still lies with the original manager. Now, however, they will be better equipped to solve the problem that was preventing change from being effectively implemented.

==Project groups:== groups created by an organisation to address a problem that requires input from different specialists.

Promoting change

Gaining acceptance of change by both the workforce and other stakeholders is more likely to lead to a positive outcome than imposing change on unwilling people. According to John Kotter, a leading writer on organisational change, the best way to promote change in any organisation is to adopt the following eight-stage process:

1. establish a sense of urgency
2. create an effective project team to lead the change
3. develop a vision and a strategy for change
4. communicate this change vision
5. empower people to take action
6. generate short-term gains from change that benefit as many people as possible
7. consolidate these gains and produce even more change
8. build change into the culture of the organisation so that it becomes a natural process.

Resistance to strategic change

This is one of the biggest problems any organisation faces when it attempts to introduce changes. Employee resistance is increased when there is:

- Fear of the unknown: Change means uncertainty and this is uncomfortable for some people. Not knowing what may happen to one's job or the future of the business leads to increased anxiety.

- Fear of failure: The changes may require new skills and abilities that may be beyond a worker's capabilities. People know how the current system works, but will they be able to cope with the new one?
- Losing something of value: Workers could lose status or job security as a result of change and they want to know precisely how the change will affect them.
- False beliefs about the need for change: Some people fool themselves into believing that the existing system will be the best for a long time without the need for radical change.
- Lack of trust: Perhaps past experiences have led to a lack of trust between workers and the managers introducing the change. Workers may not believe the reasons given to them for change or the reassurances from managers about the impact of it.
- Inertia: Many people suffer from inertia or reluctance to change and try to maintain the status quo. Change often requires considerable effort, so the fear of having to work harder to introduce it may cause resistance. The importance of these resistance factors will vary from business to business. In businesses where previous change has gone well, where workers are kept informed and consulted about change, and where managers offer support to employees, resistance to change is likely to be low. In contrast to this is the high resistance to change in businesses where there are a lack of trust and poor communication.

  TIP When discussing the possible resistance to changes proposed by management, try to think of the leadership style being used to implement the change. This could be a major factor in determining the degree of resistance.

9.5 Contingency planning and crisis management

This is also known as disaster recovery planning, which perhaps gives a better idea of its purpose. Unplanned events can have a devastating effect on businesses of any size. Crises such as fire, floods, damage to inventory, illness of key employees, IT system failure, or accidents either on the business's premises or involving its vehicles could all make it difficult or impossible to carry out normal everyday activities. At worst, important customers could be lost or the business could cease operating completely.

Effective contingency planning allows a business to take steps to minimise the potential impact of a disaster and ideally prevent it from happening in the first place. If unexpected emergencies do occur, they require effective crisis management.

==contingency planning:== a plan for preparing an organisation's resources for unlikely events.

==crisis management:== the process of dealing with a sudden emergency event.

The key steps in contingency planning are as follows:

1 Identify the potential disasters that could affect the business

Some of these are common to all businesses, but others will be specific to certain industries. For example, the oil industry must plan for oil tankers sinking, explosions at refineries and leakages in oil and gas pipelines. Failure to do this can have serious consequences. One of the costliest disasters in recent years was the oil leak from the BP Deepwater Horizon oil rig. Compensation and fines cost the company $65 billion.

Figure 9.5: It is claimed that BP failed to make adequate contingency plans for oil spills, resulting in disaster when oil leaked from the Deepwater Horizon oil rig Figure 9.5: It is claimed that BP failed to make adequate contingency plans for oil spills, resulting in disaster when oil leaked from the Deepwater Horizon oil rig

2 Assess the likelihood of these occurring

Some incidents are more likely to occur than others and the degree of impact on business operations also varies. It seems obvious to plan for the most common disasters, but the most unlikely occurrences can have the greatest total impact on a business's future. Managers need to balance these issues carefully when choosing which disaster events to prepare for most thoroughly.

3 Minimise the potential impact of crises

Effective planning can sometimes cut out a potential risk altogether. When this is not possible, the key is to minimise the damage a disaster can do. This does not just mean protecting fixed assets and people, but also the company's reputation and public goodwill. This is often best done by the publicity department telling the truth and explaining the causes, if known. It should also give full details of how to contact the business and the actions being taken to minimise the impact on the public. Employee training and practice drills with mock incidents are often the most effective ways of preparing to minimise any negative impact.

4 Plan for continued operations of the business

Continuity planning is a key part of preparing for contingencies. As in Activity 9.9 below, prior planning can help a business find alternative accommodation and save IT data. The sooner the business can begin trading again, the smaller the impact on customer relationships.

==Continuity planning:== preparing resources so that the business can continue operations after a major crisis.

> TIP An excellent way to show evaluative skills is to explain that contingency planning does not guarantee that disasters will not occur. It could, however, reduce the chance of them occurring. Just as importantly, it prepares the business so that any disaster should have a less damaging impact.

Benefits and limitations of contingency planning

The examples and activities in this section demonstrate some of the benefits of contingency planning. There are limitations too. Table 9.2 summarises the benefits and limitations of contingency planning.

Benefits of contingency planning

Limitations of contingency planning

• It reassures employees, customers and local residents that concerns for safety are a priority.

• It minimises the negative impact on customers and suppliers in the event of a major disaster.

• The public relations response is much more likely to be speedy and appropriate, with senior managers explaining what the company intends to do, by when and how.

• It is costly and time-consuming, including the need to train employees and have practice runs of what to do in the event of a fire, IT failure, terrorist attack, an accident involving company vehicles, and so on.

• It needs to be constantly updated as the number and range of potential disasters can change over time.

• Employee training needs to increase if labour turnover is high.

• Avoiding disasters is still better than planning for what to do if they occur.

Table 9.2: Benefits and limitations of contingency planning

Image Image

10.1 Human resource management (HRM): purpose and role

Human resource management (HRM) aims to recruit capable, flexible and committed people. It manages and rewards their performance and develops their key skills to the benefit of the organisation. Managing employees is an important business function. If people are managed effectively, the business is more likely to achieve its overall objectives. In fact, efficient HRM is a key factor influencing the competitiveness of a business. Achieving and maintaining competitiveness is a major objective for all business organisations.

==Human resource management (HRM):== the strategic approach to the effective management of employees so that they help the business gain a competitive advantage.

HRM is broad and very far-reaching in scope. It focuses on:

- workforce planning to plan how many employees, and what skills, are needed for the business in the future
- recruitment and selection of appropriate new employees
- developing employees by appraising and training them
- preparing employment contracts for all employees
- dismissal and redundancy of employees
- taking responsibility for management and workforce relations
- monitoring and improving employee morale and welfare
- introducing and managing payment and other incentive systems
- measuring and monitoring employee performance.

10.2 Workforce planning

Workforce planning is the essential starting point for effective HRM.

Reasons for and role of a workforce plan

Human resource (HR) departments need to calculate the future employment needs of the business. Failure to do this can lead to too few workers with the right skills or too many workers with the wrong skills. Workforce planning means thinking ahead to establish the number of employees and the skills required in the future to meet the business's planned objectives. The first stage is always a workforce audit. Once this has been conducted, the next stage in workforce planning is to assess how many additional employees and skills might be needed.

==Workforce planning:== forecasting the numbers of workers and the skills that will be required by the organisation to achieve its objectives.

==workforce audit:== a check on the skills and qualifications of all existing workers/managers.

The number of employees required

The number of employees that a business requires in the future will depend upon many factors:

- Forecast demand for the product: This will be influenced by market and external conditions, seasonal factors, competitors' actions, trends in consumer tastes and so on. Demand forecasts may be necessary to help establish labour needs. Some businesses build provision for additional employees into the workforce plan to allow for unplanned increases in demand. An alternative could be to recruit temporary or part-time staff on flexible hours contracts. On the other hand, it might be a mistake to replace a worker who decides to leave the business if consumer demand is falling or if there is likely to be a seasonal downturn in demand.
- The productivity level: If productivity (output per worker) is forecast to increase – perhaps as a result of more efficient machinery – fewer workers will be needed to produce the same level of output.
- The objectives of the business: If the business plans to expand over the coming years, then employee numbers will have to rise to accommodate this growth. If the business aims to increase customer-service levels, possibly at the expense of short-term profits, then more workers might need to be recruited.
- Changes in the law regarding workers' rights: If a government introduces laws that establish a shorter maximum working week or a minimum wage level, then there could be a big impact on the workforce plan.
- The labour turnover and absenteeism rate: The higher the rate at which workers leave a business, then the greater the need will be to recruit replacements. If employees are frequently absent, then more workers will need to be recruited to cover for absences.

The skills of the workers required

The need for better-qualified workers or for workers with different skills should be included in the workforce plan. The skill levels required will depend on:

- The pace of technological change in the industry: for example, production methods and the complexity of the machinery used.
- The need for flexible or multi-skilled workers as businesses try to avoid excessive specialisation. Many businesses recruit workers with more than one skill who can be used in a variety of different ways. This gives the business greater flexibility to meet changing market conditions – and can also make the workers' jobs more rewarding.

  TIP Try to make links in your answers between HRM and the long-term objectives of the business. For example, if the aim is to improve customer service, then more workers might need to be recruited into managing customer complaints.

Labour turnover

Labour turnover is measured by the formula:

==Labour turnover:== measures the rate at which employees are leaving an organisation.

If a business employed 200 employees at the beginning of last year and 30 left during the year, then the labour turnover rate was 15%.

If the labour turnover is high and increasing over time, then it is a good indicator of employee discontent, low morale and, possibly, a recruitment policy that leads to the wrong people being employed. High labour turnover has costs and potential benefits (see Table 10.1).

Costs of high labour turnover

Potential benefits of high labour turnover

- costs of recruiting, selecting and training new staff

- poor output levels and customer service due to staff vacancies before new recruits are appointed

- difficult to establish customer loyalty due to a lack of regular, familiar contact

- difficult to establish team spirit

- low-skilled and less-productive staff might be leaving and could be replaced with more carefully selected workers

- new ideas and practices brought into an organisation by new workers

- high labour turnover can help a business plan to reduce employee numbers, as workers who leave will not be replaced

Table 10.1: Costs and potential benefits from high labour turnover

High labour turnover is more likely in areas of low unemployment, as there may be many better-paid and more attractive jobs available locally. It is also true that some industries typically have higher labour turnover rates than others. The fact that so many learners, looking for part-time and temporary employment, find jobs in fast-food restaurants leads to labour turnover rates that can exceed 100% in 1 year. In other organisations, labour turnover rates can be very low. This is typical in law practices and in scientific research.

Labour turnover calculations often do not include redundancies when employees leave a business involuntarily.

10.3 Recruiting and selecting employees

Effective recruitment and selection of employees should meet the needs of the business and increase the chances of achieving its long-term objectives.

==recruitment:== the process of identifying the need for a new employee, defining the job to be filled and the type of person needed to fill it, and attracting suitable candidates for the job.

==selection:== the series of steps by which candidates are interviewed, tested and screened to choose the most suitable person for a vacant post.

Recruitment and selection will be necessary when:

- the business is expanding and needs a bigger workforce
- employees leave and need to be replaced. Businesses often outsource the recruiting function to specialist recruitment agencies.

==recruitment agencies:== a business that offers the service of recruiting applicants for vacant posts.

Recruitment and selection

There are various stages in the recruitment and selection process. Recruitment requires a careful analysis of the job itself and the people required to do it well. The next stage is to encourage people to apply for the vacant job. Once applicants have applied, the selection process can begin.

Establishing the exact nature of the job and drawing up a job description

This provides a complete picture of the job that is vacant and will include:

- job title
- details of the tasks to be performed
- responsibilities involved
- place in the hierarchical structure
- working conditions
- how the job will be assessed and how performance will be measured. The advantage of the job description is that it should attract the right type of people to apply for the job, as potential recruits will have a good idea whether they are suited to the position or not.

==job description:== a detailed list of the key points about the job to be filled, stating all its key tasks and responsibilities.

Drawing up a person specification

This is an analysis of the qualities, skills and qualifications that will be looked for in suitable applicants. It is clearly based on the job description because these factors can only be identified once the nature and complexity of the job have been determined. The person specification helps in the selection process by eliminating applicants who do not match the necessary requirements.

==person specification:== a detailed list of the qualities, skills and qualifications that a successful applicant will need to have.

> TIP You should avoid making the common error of confusing the job description and the person specification when answering questions. Make a clear distinction between these terms by remembering the definitions for them.

Preparing a job advertisement

The job advertisement needs to reflect the requirements of the job and the person specification. It can be displayed within the business premises or in government job centres, recruitment agencies and newspapers. Increasingly, businesses are using the internet to advertise vacancies.

The most common way to apply for a vacant job is to complete an application form, so the HR department needs to design the form and make it available to applicants, usually online.

==application form:== a set of questions answered by a job applicant to give a potential employer information about the applicant, such as educational background and work experience.

People interested in the job are encouraged to apply online. This saves time for both the recruiting business and potential applicants. Some specialist businesses offer online recruitment services. They help businesses prepare effective online advertisements for vacant positions.

Care must be taken that the advertisement does not imply any element of discrimination, as nearly all countries outlaw unfair selection on the basis of race, sexuality, gender, age, religion or national origin.

> KEY CONCEPT LINK Change can occur within a business, for example when starting to use new machines. Change can also occur in the external environment, such as a global economic crisis. Both types of changes will impact on the workforce plan and HRM decision-making of most businesses.

Making a shortlist of applicants

Once application forms have been received, then the selection process can begin. This can be achieved by using a range of different techniques.

A small number of applicants are chosen based on their application forms and their personal details and work experience, often contained in a CV (curriculum vitae) or résumé. References may have been obtained from previous employers to check on the character and previous work performance of the applicants. Much of this information can now be delivered online and not in paper format. Artificial intelligence is being increasingly used to help select appropriate candidates for a shortlist.

==CV (curriculum vitae):== a detailed document highlighting all of a person's professional and academic achievements, work experience and awards.

==résumé:== a less detailed document than a CV, which itemises work experience, educational background and special skills relevant to the job being applied for.

==References:== comment from a trusted person about an applicant's character or previous work performance.

Selecting between the applicants

Interviews are the most common method of selection. Interviewers question the applicant on their skills, experience and character to see if they will both perform well and fit into the organisation. Some interviewers use a six-point plan to carry out a methodical interview. Candidates are assessed according to: achievements, intelligence, skills, interests, personal manner and personal circumstances.

Figure 10.2: Job interviews allow managers to question a new applicant in person Figure 10.2: Job interviews allow managers to question a new applicant in person

Other selection tests might be conducted, such as aptitude tests and psychometric tests. The former are designed to test an applicant's ability in a specific task, for example retooling a machine. Psychometric tests are designed to test character, attitudes and personality by using a series of role plays, questions and problem-solving situations.

Assessment centres are increasingly popular for selecting between graduates and other well-qualified applicants for high-profile jobs. A group of applicants undergo a series of personality tests, group problem-solving exercises, written tests and role play situations. These sessions can last for one day or for longer. It is argued that they are a more effective way of selecting applicants than a traditional interview as applicants are given competitive, real-life situations to respond to. Some larger employers organise their own assessment centres. Others use the services of specialist assessment centre providers.

==Assessment centres:== a place where a range of tests is used to judge job applicants on their potential ability to perform a particular role.

If the selected candidate already works for the organisation, this is referred to as internal recruitment. External recruitment is when the successful applicant does not currently work for the business. Internal recruitment and external recruitment have different advantages (see Table 10.2).

==internal recruitment:== when a business aims to fill a vacancy from within its existing workforce.

==External recruitment:== when a business aims to fill a vacancy with a suitable applicant from outside of the business, such as an employee of another organisation.

Advantages of internal recruitment

Advantages of external recruitment

• Applicants may already be known to the selection team.

• Applicants will already know the organisation and its internal methods so there is no need for induction training.

• The culture of the organisation will be well understood by the applicants.

• It is often quicker than external recruitment.

• It is likely to be cheaper than using external advertising and recruitment agencies.

• It gives internal staff a career structure and a chance to progress.

• If the vacancy is for a senior post, workers will not have to get used to a new style of management.

• External applicants will bring new ideas and practices to the business, which helps to keep existing employees focused on the future rather than the past.

• There is a wider choice of potential applicants, not just limited to internal staff.

• It avoids the resentment sometimes felt by existing staff if one of their colleagues is promoted above them.

• The standard of applicants could be higher than if the job is open only to internal applicants.

Table 10.2: Advantages of internal recruitment and external recruitment

> TIP The disadvantages of each method of recruitment are the opposite of the advantages of the other method. For example, a drawback of external recruitment is that it does not give internal staff a career structure or a chance to progress.

Employment contracts

Once the successful applicant has been appointed, they must be given a contract of employment.

Employment contracts are legally binding documents. Care needs to be taken to ensure that they are fair and comply with current employment laws where the worker is employed. A typical employment contract will contain the following features:

==Employment contracts:== a legal document that sets out the terms and conditions governing a worker's job.

- the employee's work responsibilities and the main tasks to be undertaken
- whether the contract is permanent or temporary (see Chapter 16)
- working hours and the level of flexibility expected, including whether the job is part-time or full-time (see Chapter 16), whether it includes working weekends or not, the payment method and the pay level
- holiday entitlement and other benefits such as pensions
- the number of days' notice that must be given by the worker (if they wish to leave) or the employer (if they want to make the worker redundant). The contract imposes responsibilities on both the employer (to provide the conditions of employment as set out in the contract) and the employee (to work the hours specified and to the standards expected in the contract). The precise legal requirements of employment contracts are likely to vary slightly between different countries.

In most countries, it is illegal for an employer to employ workers without offering the protection of a written employment contract. However, in some countries, a verbal agreement between worker and employer can also be legally binding. There would still have to be some evidence to prove that both sides intended a contract to be formed.

10.4 Redundancy and dismissal of employees

There are very important differences between these two aspects of HRM. Redundancy is not the same as dismissal and the two should not be confused. Redundancy occurs when workers' jobs are no longer required, perhaps because of a fall in demand, a change in technology or the need to cut costs. Often, this is part of a company policy of retrenchment to save on costs to remain competitive. China's four big state-owned banks have made 19 000 jobs redundant recently, as mobile phones and automated services reduced the demand for cashiers at the banks' branches. Senior managers argued that unless these jobs were cut, the banks' profits would be cut and competitiveness reduced.

==Redundancy:== when a job is no longer required, the employee doing this job becomes unnecessary through no fault of their own.

==dismissal:== being dismissed or fired from a job due to incompetence or breach of discipline.

If redundancies are to take place, then guidelines are normally followed to ensure that the correct person or people are made redundant. Many businesses faced with having to lose some members of the workforce will often try to do so by natural wastage. This means not replacing all of those who leave. Where this does not work or is insufficient, firms will often pursue a policy of voluntary redundancy. However, an invitation to leave voluntarily is a high-risk strategy because workers who are easily employable elsewhere are often the ones a business needs to keep.

Dismissal is a different matter. It may be necessary for an HR manager to discipline an employee for continued failure to meet the obligations set out in the contract of employment. Dismissing a worker is not a matter that should be undertaken lightly. It withdraws a worker's immediate means of financial support and some social status. Also, if the conditions of the dismissal are not in accordance with company policy or with the law, then civil court action might result. This can lead to the company having to pay very substantial financial compensation to the employee.

Before dismissal can happen, the HR department must do all that it can to help the employee reach the required standard or stay within the conditions of employment. There should be support and training for the person concerned. It is important from the organisation's point of view that it does not leave itself open to allegations of unfair dismissal.

==unfair dismissal:== ending a worker's employment contract for a reason that the law regards as being unfair.

Sometimes employees become involved in gross misconduct, which may be stealing or some other serious offence. If this happens, the organisation can dismiss them with immediate effect, without pay or notice.

However, if an employee's misconduct is less serious, such as regularly arriving late for work, then the organisation must give verbal and written warnings. The organisation must follow the agreed disciplinary procedure before dismissal can take place.

Only a tribunal (or another type of court, depending on the country) can decide whether a dismissal is unfair or not. To show that a dismissal is fair, employers need to be able to show that one of the following is true of the employee:

- inability to do the job even after sufficient training has been given
- continuous negative attitude at work
- disregard of required health and safety procedures

- deliberate destruction of an employer's property
- bullying of other employees. There are certain reasons for dismissal that can be considered unfair or in breach of employment law. In most countries these include:
- pregnancy
- a discriminatory reason, for example the race, gender or religion of a worker
- being a member of a union.

10.5 Employee morale and welfare

HR managers should not just focus on making sure the business has enough workers. Employee productivity and work satisfaction have been shown to be much higher in those businesses that put strategies in place to improve levels of employee morale and employee welfare.

==employee morale:== overall outlook, attitude and level of satisfaction of employees when at work.

==employee welfare:== employees' health, safety and level of morale when at work.

Most HR departments will offer advice, counselling and other services to employees who are in need of support, perhaps because of family or financial problems. These support services can reflect well on the caring attitude of the business towards its workforce. Improving the working conditions with excellent hygiene facilities and safety equipment is another effective way of improving employee welfare. When workers feel that the employer wants to improve their long-term welfare, it often leads to high morale and a strong sense of loyalty to the business, together with a desire for it to do well. If employee morale is high, productivity often increases and labour turnover is low.

Work–life balance

The hours and times that people work have always been subject to change, but the pace of this change is now more rapid than ever because:

- Customers expect to have goods and services available outside traditional working hours.
- Organisations want to match their business needs with the way their employees want to work.
- Globalisation has led to much greater levels of competition, so efficiency and flexibility are important for a business to remain competitive. The demands of working long and often unsociable hours that many businesses

impose on their employees can lead to stress and poor health. Some analysts suggest that HR departments should assist employees to achieve a better work–life balance, which will reduce stress but also increase employee efficiency.

==work–life balance:== a situation in which employees are able to allocate the right amount of time and effort to work and to their personal life outside work.

The following methods have been used by some businesses to allow employees to take more control of their working lives and to allow for more time for leisure, relaxation, creativity and their families:

- flexible working (see Chapter 16)
- teleworking – working from home for some of the working week
- job sharing – allows two people to fill one full-time vacancy although each worker will only receive a proportion of the full-time pay
- sabbatical periods – an extended period of leave from work of up to 12 months. Some businesses pay employees during this period. All employers guarantee to keep the job open for the employee on their return to work.

Impact of diversity and equality in the workplace

Most organisations have policies that try to ensure equality and diversity in the workforce. Many countries have strict laws that govern equality issues. Businesses that promote equality in the workplace do not base recruitment and dismissal decisions, pay, promotions and other benefits on employees' race, sexuality, gender, age, religion or national origin.

==equality:== practices and processes aimed at achieving a fair organisation where everyone is treated in the same way without prejudice and has the opportunity to fulfil their potential.

==diversity:== practices and processes aimed at creating a mixed workforce and placing a positive value on diversity in the workplace.

Promoting equality in the workplace impacts on business by:

- creating an environment with high employee morale and motivation
- developing a good reputation and the ability to recruit top talent based on fairness
- measuring employee performance by their achievements at work, not by any discriminatory factor. In contrast, if a company uses discriminatory practices to decide who is promoted, employees who are discriminated against are likely to become discouraged and demotivated.

Workplace diversity means acknowledging differences between employees and deliberately creating an inclusive environment that values those differences. A workplace that encourages diversity employs individuals of various races, genders, ages, religions and ethnicities. Many businesses implement diversity programmes, which educate employees on the definition of diversity and how it helps every member of the workforce.

Promoting diversity in the workplace impacts on business by:

- capturing a bigger market share as consumers are attracted by a diverse sales force
- employing a more qualified workforce as selection is based on merit and not on discrimination
- increasing creativity because individuals from different backgrounds approach problem-solving in different ways
- achieving cultural awareness, leading to improved knowledge about foreign markets
- promoting diverse language skills, which allows businesses to provide products and services internationally.

10.6 Training and developing employees

Having spent a great deal of time and effort on recruiting and selecting the right staff, the HR department must ensure that they are well equipped to perform the duties and undertake the responsibilities expected of them. This will nearly always involve training in order to develop the full abilities of every worker.

==training:== work-related education to increase workforce skills and efficiency.

Types of training

Induction training should be given to all new recruits. It aims to introduce them to the people they will be working with most closely, to explain the internal organisational structure, outline the layout of the premises and make clear essential health and safety issues, such as procedures during a fire emergency.

==Induction training:== introductory training programme to familiarise new recruits with the systems used in the business and the layout of the business site.

On-the-job training involves instruction at the place of work. This is often conducted by either the HR managers or departmental training officers. Watching or working closely with existing experienced members of staff is a frequent component of this form of training. It is cheaper than sending recruits on external training courses and the content of the training is controlled by the business itself.

==On-the-job training:== instruction at the place of work on how a job should be carried out.

Figure 10.3: On-the-job training allows less-skilled workers to learn from experienced employees Figure 10.3: On-the-job training allows less-skilled workers to learn from experienced employees

Off-the-job training covers any course of instruction away from the place of work. This could take place in a specialist training centre belonging to the company itself or it could be a course organised by an outside body, such as a college, university or computer manufacturer. Outside training has the added potential of being a source of new ideas. These courses can be expensive but may be indispensable if the business lacks anyone with the required degree of technical knowledge.

==Off-the-job training:== training undertaken away from the place of work.

Figure 10.4: Off-the-job training is often undertaken in a specialist college Figure 10.4: Off-the-job training is often undertaken in a specialist college

Impact of training on a business and its employees

Training can be expensive. It can also lead to well-qualified employees leaving for a better-paid job once they have gained qualifications from a business with a good training programme. When one business seeks to employ well-trained workers from another business, it is sometimes referred to as 'poaching'. These factors can discourage some businesses from setting up expensive training programmes. In addition, workers may be less productive during the training programme, especially if off-the-job training is used.

The costs of not training are also substantial. Untrained employees will be less productive, less flexible and less adaptable. Poorly trained workers often give unsatisfactory customer service. Accidents are likely to result from workers untrained in health and safety matters, especially in manufacturing businesses or in the food industry.

There is a significant link between the importance given to the training and development of employees in a business and the levels of employee satisfaction and motivation. The link between training and the sense of achievement that can result from it was identified by motivational theorists (see Section 11.4). Without being pushed to achieve a higher standard or more skills, workers may become bored and demotivated. The multi-skilling of workers can be a great benefit to a business, especially in times of rapid economic and technological change.

==multi-skilling:== the process of assessing the effectiveness of an employee judged against pre-set objectives.

> TIP You may need to analyse why some businesses spend very little on employee training. One reason firms often give for not train-

ing their employees is that these well-trained workers will then be recruited by other businesses.

Development and appraisal of employees

This should be a continuous process. Development might take the form of new challenges and opportunities, additional training courses to learn new skills, promotion with additional delegated authority and chances for job enrichment. To enable a worker to continually achieve a sense of self-fulfilment, the HR department should work closely with the worker's functional department to establish a career plan that the individual feels is relevant and realistic. The HR department should analyse the likely future needs of the business when establishing the development plan for each member of the workforce. In this way, an individual's progress and improvement can also be geared to the needs of the company.

Employee appraisal is often undertaken annually. It is an essential component of a staff-development programme. The analysis of performance against pre-set and agreed targets, combined with the setting of new targets, allows the future performance of the worker to be linked to the objectives of the business.

==Employee appraisal:== the process of assessing the effectiveness of an employee judged against pre-set objectives.

Both employee appraisal and employee development are important features of Herzberg's motivators (see Section 11.3). These are intrinsic factors that can provide the conditions for high levels of motivation at work.

Employee development to encourage intrapreneurship

Many businesses have training and development programmes with the specific aim of encouraging employees to become successful intrapreneurs. Most employees can demonstrate intrapreneurship if they are:

- encouraged to be independent thinkers and creative
- given opportunities to mix and work with other skilled employees from different departments
- empowered with the authority and resources they need to introduce innovations
- assured that some failure is expected and acceptable. Removing the 'don't fail' ethos is important – intrapreneurs are meant to take risks and some of their ideas will not work!
- encouraged to start with small ideas and innovations – before moving on to the bigger issues.

10.7 Management and workforce relations

The relations between managers and the workforce have a great impact on the success or failure of a business. In most countries, employees are able to join trade unions. Many of the discussions and negotiations needed between managers and workers can then take place through trade union officials.

Benefits of cooperation between management and the workforce

In some countries, such as France and the UK, there is a long tradition of conflict and disagreement between business managers and their workforce. In other countries, such as Germany and Japan, the relationship between these two groups is much more cooperative.

Cooperation can result in real benefits to managers and workers:

- Fewer days are lost through strikes and other forms of industrial action-measures taken by the workforce or trade union to put pressure on management to settle an industrial dispute in favour of employees..
- It will be much easier for management to introduce change in the workplace. For example, a decision to automate part of a factory could be made with the cooperation of the workforce.
- The contribution of the workforce is likely to be recognised by management, and pay levels and other benefits might reflect this.
- Agreement on more efficient operations will increase the competitiveness of the business.
- Workers' practical insight into the way the business operates can contribute to more successful decisions.

Impact of trade union involvement in the workplace

There are various reasons for a worker to join a trade union:

- The basis of trade union influence has been 'power through solidarity'. This is best illustrated by the unions' ability to engage in collective bargainingthe process of negotiating terms of employment between an employer and a group of workers who are usually represented by a trade union official., negotiating on behalf of all of their members within a business. This puts workers in a stronger position than if they negotiated individually to gain higher pay deals and better working conditions.
- Individual action – for example, one worker going on strike – is unlikely to be very effective. Collective industrial action could result in much more influence over employers during industrial disputes.

- Unions provide legal support to employees who claim unfair dismissal or poor working conditions.
- Unions put pressure on employers to ensure that all legal requirements are met, for example health and safety rules regarding the use of machinery. Many employers have a policy of trade union recognition, which allows for collective bargaining. However, some employers prefer to negotiate with individual workers over pay and work conditions. These employers argue that they do not want to be pressurised through collective bargaining with trade unions into paying higher wages or improving work conditions.

==trade union recognition:== when an employer formally agrees to conduct negotiations on pay and working conditions with a trade union rather than bargain individually with each worker.

Benefits of collective bargaining

- Employers can negotiate with one trade union officer rather than with individual workers. This saves time and prevents workers from feeling that one individual has obtained better pay and conditions than others.
- Union officials can provide a useful channel of communication with the workers. This two-way communication through the trade union allows workers' problems to be raised with management and employers' plans could be discussed with workers.
- Unions can impose discipline on members who plan to take hasty industrial action that could disrupt a business. This makes industrial action less likely.
- The growth of responsible, partnership unionism has given employers a valuable forum for discussing issues of common interest and making new workplace agreements. These discussions should lead to increased productivity, helping to secure jobs and raise profits.

Disputes between trade union and management

When cooperation between managers and the workforce does not exist, there is a great chance of industrial action. Trade union leaders can use several forms of industrial action during a dispute with employers over improvements in pay and conditions:

- Continue collective bargaining, perhaps with the help of an independent arbitrator.
- Go slow – a form of industrial action in which workers keep working but at the minimum pace demanded by their contract of employment.
- Work-to-rule – a form of industrial action in which employees refuse to do any work outside the precise terms of the employment contract. Overtime

will not be worked and all non-contractual cooperation will be withdrawn.

- Overtime bans – industrial action in which workers refuse to work more than the contracted number of hours each week. During busy periods, this could lead to lost output for the employer.
- Strike action – the most extreme form of industrial action in which employees totally withdraw their labour for a period of time. Strike action leads to production stopping and the business shutting down during the industrial action. Employers can use various methods to try to resolve an industrial dispute:
- negotiations to reach a compromise solution with the aim of avoiding industrial action
- public relations campaign to gain public support for the employer during a dispute and put pressure on the union to settle for a compromise
- threats of redundancies to pressurise unions to agree to settle the dispute
- changes of contract, which require workers to work overtime, accept more flexible working or agree not to take industrial action
- lock-outs – short-term closure of the business or factory to prevent employees from working and being paid
- closure of the business, leading to the redundancy of all workers. This extreme measure would clearly damage the long-term interests of both workers and business owners. All of these actions, taken by trade unions and employers while in dispute, are damaging to industrial relations in the long term. It is much more beneficial for the long-term interests of the business and employees if effective cooperation takes place between the management and the workforce.

Image Image

11.1 What is motivation and why does it matter?

Motivation gives workers the desire to complete a job quickly and well. People work in order to satisfy certain needs. A worker can become well motivated by a business successfully meeting the needs of that person. As a result of having those needs satisfied, the best-motivated workers will then help an organisation to achieve its own objectives as cost-effectively as possible. Managers need to be aware of workers' needs and objectives. The highest motivation levels result from employees being able to satisfy their own needs, but at the same time working towards the aims of the organisation.

Well-motivated workers benefit the businesses they work for in several ways:

- The level of productivity will be high, increasing the competitiveness of the business.
- Workers will be keen to stay with the business, reducing the costs of labour turnover.
- Workers will be more likely to offer useful suggestions to help the business achieve its objectives.
- They will often work hard to seek promotion and responsibility. All of these benefits have an impact on business efficiency, levels of customer service and unit costs (see Figure 11.2). Businesses that manage and motivate their employees effectively will gain a loyal and productive workforce. This can be a real competitive advantage.

Figure 11.2: Business benefits of having well-motivated workers Figure 11.2: Business benefits of having well-motivated workers

11.2 Human needs

People work to satisfy some or all of their needs. Which human needs can be satisfied at work? Obviously, people need money to be able to satisfy basic wants for food, housing and other consumer goods. But what other needs do people have and how far can these needs be met at work? See Figure 11.3.

If employment does not provide the conditions for these human needs to be met, workers are likely to be very demotivated.

Figure 11.3: How human needs can be satisfied at work Figure 11.3: How human needs can be satisfied at work

11.3 Motivation theories

Research has led to many theories of motivation. These attempt to identify which human needs can be satisfied at work and how workers can be motivated to work hard. These motivation theories attempt to explain the key factors that business managers should focus on to achieve a highly motivated workforce.

Content theories of motivation

These theories focus on the assumption that individuals are motivated by the desire to fulfil their inner needs. These approaches focus on:

- those human needs that energise and direct human behaviour
- how managers can create conditions that allow workers to satisfy these needs.

Taylor and scientific management

Frederick Taylor (1856–1917) made the first serious attempt to analyse worker motivation. He wanted to advise management on the best ways to increase worker performance and productivity. Taylor's research techniques are still used in industry. They include establishing an idea or a hypothesis, studying and recording performance at work, altering working methods and re-recording performance. This approach is known as scientific management.

Taylor's aim was to reduce the level of inefficiency that existed in the American manufacturing industry. He argued that any productivity gains could then be shared between business owners and workers.

The scope for efficiency gains in early twentieth-century manufacturing plants was huge because:

- most workers were untrained and non-specialised
- they were poorly led by supervisors and managers who had little training
- there was rarely any formal selection or appraisal system of employees
- most workers were recruited on a daily basis with no security of employment. Taylor's scientific approach to improving worker output or productivity

1. Select workers to perform a task.
2. Observe them performing the task and note the key elements of it.
3. Record the time taken to do each part of the task.
4. Identify the quickest method recorded.
5. Train all workers in this quickest method and do not allow any changes to it.
6. Supervise workers to ensure that this best way is being carried out and time them to check that the set time is not being exceeded.
7. Pay workers on the basis of results, based on the economic man theory. The economic man theory suggests that people are motivated by money alone and the only factor that could stimulate further effort is the chance of earning more money. This formed the basis of Taylor's main motivational suggestion: wage levels based on output. He always maintained that workers should be paid a fair day's pay for a fair day's work. The amount paid should be directly linked to output through a system known as piece rate. This means paying workers a certain amount for each unit produced. To encourage high output, a low rate per unit can be set for the first units produced. Higher rates then become payable if output targets are exceeded.

==piece rate:== payment to a worker for each unit produced.

Results of Taylor's work

Business managers considered Taylor's emphasis on increasing efficiency and productivity to be the route towards greater profits. Workers' leaders were more suspicious as they believed that this approach would lead to more work but no more pay or benefits.

Taylor's approach was widely adopted by manufacturers in the early twentieth century. At this time, the first mass-production and production-line techniques were being introduced. Workers specialising in one task, strict management control over work methods, and payment by output levels were important features of these early production lines. These principles were the driving forces behind all mass production until the participative style of working and people management became more widespread from the 1960s onwards. Even before this, other research had been undertaken on people's behaviour at work and doubts were raised about the simplistic nature of many of Taylor's assumptions on worker motivation. (See Table 11.1.)

Figure 11.4: Early mass-production manufacturers adopted Taylor's approach as in this Ford factory in the 1920s Figure 11.4: Early mass-production manufacturers adopted Taylor's approach as in this Ford factory in the 1920s

Taylor's approach

Relevance to modern industry

Economic man

Although some managers still believe that money is the only way to motivate workers, the more common view now is that workers have a wide range of needs that can be met from work.

Select the right people for each job

Before Taylor there had been few attempts to select employees carefully. The importance of this today is reflected in the emphasis on effective employee selection in nearly all businesses.

Observe and record the performance of workers

This was widely adopted and became known as a time and motion study. Initially this was viewed with suspicion by workers as a way of making them work harder. In modern industry it is still used but with the cooperation and involvement of employees.

Establish the best method of doing a job

This method study is still accepted as important, as efficiency depends on using the best ways of working. However, Taylor's use of managers to give instructions to workers with no discussion is demotivating. Worker participation in devising the best working methods is now encouraged.

Piecework payment systems

This is still used but much less widely than in Taylor's time. In service industries, in particular, it has become very difficult to measure the output of individual workers. See Table 11.4 for the impact of piecework payment.

Table 11.1: Evaluation of how relevant Taylor's views and methods are today

Mayo and human relations theories

Elton Mayo (1880–1949) is best known for his Hawthorne effect conclusions. These were based on a series of experiments he conducted at the Hawthorne factory of Western Electric Co in the USA. He initially assumed that working conditions, such as lighting, heating and rest periods, had a significant effect on workers' productivity. Experiments were undertaken with groups of workers to establish the best working conditions. The output of a control group was also recorded. This group experienced no changes in working conditions at all.

The results surprised all of the observers. As conditions of work were either improved or worsened, productivity rose in all groups including the control group. Mayo had shown that:

- Working conditions in themselves were not important in determining productivity levels.
- Other motivational factors needed to be investigated before conclusions could be drawn. Further experiments were carried out with a group of assembly-line workers. Changes to rest periods, payment systems, assembly bench layout and canteen food were made at 12-week intervals. Before every major change, the researchers discussed the new changes with the group. At the end of the experiments, the working conditions and hours of work were returned to how they had been before the start of the trial. Output rose far above the original level. Clearly, other motivational factors were operating to increase productivity that were completely separate from the conditions of work.

The Hawthorne effect: the conclusions of Mayo's work

Mayo drew the following conclusions from his work:

- Changes in working conditions and pay levels have little or no effect on productivity.
- Consultation with workers improves motivation.
- Working in teams and developing a team spirit can improve productivity.
- Giving workers some control over their own working lives, such as deciding when to take breaks, improves motivation.
- Groups can establish their own targets, and these can be greatly influenced by the informal leaders of the group. Evaluation of Mayo's research for today's businesses

- Since Mayo's findings were published, there has been a trend towards giving workers more of a role in business decision-making. This is called worker participation.
- Human Resources departments have been established to try to put the Hawthorne effect into practice.
- Team or group working is applied in many types of modern business organisation. It offers the greatest opportunities for workers and businesses to benefit from the Hawthorne effect.
- The idea of involving workers, taking an interest in their welfare and finding out their individual goals, has opened up new fields of research for industrial psychologists.

Maslow and human needs

Abraham Maslow (1908–1970) is best known for his research into identifying and classifying the main needs that humans have. The importance of his work to business managers is this:

- Our needs determine our actions – we will always try to satisfy them, and we will be motivated to do so.
- If work can be organised so that some or all needs of employees can be satisfied at work, then they will become more productive and satisfied. Maslow summarised these human needs in the form of a hierarchy (see Figure 11.5 and Table 11.2). Maslow interpreted this hierarchy as follows:
- Individuals' needs start on the lowest level.
- Once one level of need has been satisfied, humans will work to achieve the next level.
- Self-actualisationa sense of self-fulfilment reached by feeling enriched and developed by what one has learned and achieved., or self-fulfilment, is not reached by many people, but everyone is capable of reaching their potential.
- Once a need has been satisfied, it will no longer motivate individuals to action. So, when physical needs have been satisfied, the offer of more money will not increase productivity.
- Reversion is possible. It is possible for individuals to feel less satisfied at one level and for satisfaction to move down to the next level. A loss of job security is one example of this.

Figure 11.5: Maslow's hierarchy of needs Figure 11.5: Maslow's hierarchy of needs

Level of need

How needs may be satisfied at work by effective HRM

Self-actualisation – fulfilment of potential

challenging work that stretches the individual will give a sense of achievement; opportunities to develop and apply new skills will increase potential

Esteem needs

recognition for work done well – status, advancement and responsibility – will gain the respect of others

Social/belonging needs

working in teams or groups and ensuring good communication to make workers feel involved

Safety needs

a contract of employment with some job security; a structured organisation that gives clear lines of authority to reduce uncertainty; ensuring health and safety conditions are met

Physical needs

income from employment high enough to meet essential needs

Table 11.2: Significance of the hierarchy of needs to HRM

Limitations of Maslow's approach

Criticisms of Maslow's hierarchy include:

- Not everyone has the same needs, as is assumed by the hierarchy.
- In practice it can be very difficult to identify the degree to which each need has been met and which level a worker is on.
- Money is necessary to satisfy physical needs, yet it might also play a role in satisfying the other levels of needs. High incomes can increase status and esteem.
- Self-actualisation is never permanently achieved. Jobs must continually offer challenges and opportunities for fulfilment, otherwise regression will occur.

Herzberg and the two-factor theory

Frederick Herzberg (1923–2000) developed the two-factor theory from research based around questionnaires and interviews with 200 skilled employees. His aim was to discover:

- those factors that led to them having very good feelings about their jobs; and,

- those factors that led to them having very negative feelings about their jobs. His conclusions were that:
- Job satisfaction results from five main factors: achievement, recognition for achievement, the work itself, responsibility and advancement. He called these factors the motivatorsaspects of a worker's job that can lead to positive job satisfaction, such as achievement, recognition, meaningful and interesting work, responsibility, and advancement at work.. He considered the last three motivators to be the most significant.
- Job dissatisfaction also resulted from five main factors: company policy and administration, supervision, salary, relationships with others and working conditions. He termed these hygiene factorsaspects of a worker's job that have the potential to cause dissatisfaction, such as pay, working conditions, status and over-supervision by managers.. These were the factors that surround the job (extrinsic factors) rather than the work itself (intrinsic factors). Herzberg considered that the hygiene factors had to be addressed by management to prevent dissatisfaction. However, even if they were in place, they would not, by themselves, create a well-motivated workforce. The consequences of Herzberg's two-factor theory

Higher pay and better working conditions will help to remove dissatisfaction about work. However, on their own, they will not lead to effective motivation. Herzberg argued that it is possible to encourage someone to do a job by paying them – he called this movement. However, movement does not mean that someone wants to do the job well – that would require motivation. Motivation to do the job well would exist only if the motivators were in place. Herzberg did not claim that pay does not matter, but that it moves people to do a job and does not motivate them to do it well.

A business could offer higher pay, improved working conditions and less heavy-handed supervision of work. These would all help to remove dissatisfaction, but they would all be quickly taken for granted. If work is not interesting, rewarding or challenging, then workers will not be satisfied or be motivated to offer their full potential. This does not change whatever the pay level offered to them.

The motivators need to be in place for workers to be prepared to work willingly and to always give of their best. Herzberg suggested that they could be provided by adopting the principles of job enrichment. There are three main features of job enrichment and, if these are adopted, then the motivators exist:

==job enrichment:== aims to use the full capabilities of workers by giving them the opportunity to do more challenging and fulfilling work.

- Complete units of work: Typical mass-production methods often lead to worker boredom. The work involves the assembly of one small part of the finished product. Herzberg argued that complete and identifiable units of work should be assigned to workers. This might involve teams of workers rather than individuals on their own. These complete units of work could be whole sub-assemblies of manufactured goods, such as a complete engine in a car factory. In service industries, it could mean that a small team of multi-skilled people, such as waiters, chefs and IT technicians, provide all of the conference facilities in a hotel. 'If you want people motivated to do a good job, give them a good job to do,' as Herzberg put it.

- Feedback on performance: Regular two-way communication between workers and managers should give recognition for work well done and could provide incentives for workers to achieve even more.
- A range of tasks: To challenge and stretch a worker, a range of tasks should be given. Some of these may, at least initially, be beyond the worker's current experience. This fits in well with the self-actualisation level in Maslow's hierarchy (see Figure 11.7). Evaluation of Herzberg's work for today's businesses

There is little doubt that the results Herzberg drew from his work have had a significant impact on business practices today:

- Teamworking is now much more widespread, with whole units of work being delegated to these groups.
- Workers tend to be made much more responsible for the quality of their own work rather than being closely supervised by quality-control inspectors.
- Most firms are continually looking for ways to improve effective communication, and group meetings allowing two-way communication are often favoured.

Figure 11.7: The nature of job enrichment Figure 11.7: The nature of job enrichment

McClelland and motivational needs theory

David McClelland (1917–1998) pioneered workplace motivational thinking, developed an achievement-based motivational theory and promoted improvements in employee assessment methods. He is best known for describing three types of motivational need, which he identified in his book, The Achieving Society (1961):

Achievement motivation

A person with a strong motivational need for achievement will seek to reach realistic and challenging goals and job advancement. There is a constant need for feedback regarding progress and achievement. This helps provide a sense of accomplishment. Research suggests that this result-driven attitude is almost always a common characteristic of successful business people and entrepreneurs.

Authority/power motivation

A person with this dominant need is motivated by having authority. The desire to control others is a powerful motivating force. This includes the need to be influential, to be effective and to make an impact. Such a person has a strong leadership instinct and when they have authority over others, they value the personal status and prestige gained.

Affiliation motivation

A person whose strongest motivator is the need for affiliation has a need for friendly relationships and is motivated by interaction with other people. These people tend to be good team members as they need to be liked, popular and held in high regard.

McClelland stated that these three motivational needs are found to varying degrees in all workers and managers. The mix of needs characterises a worker's or manager's behaviour, in terms of both what motivates them and how they believe other people should be motivated. McClelland believed that achievement-motivated people are generally the ones who make things happen and get results. However, they can demand too much of their staff in the achievement of targets and prioritise this above the many and varied needs of their workers.

Process theories

Process theories emphasise how and why people choose certain behaviours in order to meet their personal goals and the thought processes that influence behaviour. Process theories study what people are thinking about when they decide whether to put effort into a particular activity. Vroom is one of the best-known process theorists.

Vroom and expectancy theory

Victor Vroom (1932–) suggested that individuals choose to behave in ways which they believe will lead to results that they value. His expectancy theory states that individuals have different sets of goals. They can be motivated if they believe that:

- There is a positive link between effort and performance.
- Favourable performance will result in a desirable reward.
- The reward will satisfy an important need.
- The desire to satisfy the need is strong enough to make the work effort worthwhile. His expectancy theory is based on the following three beliefs:
- Valence – the depth of the desire of an employee for an extrinsic reward, such as money, or an intrinsic reward, such as satisfaction.
- Expectancy – the degree to which people believe that putting effort into work will lead to a given level of performance.

- Instrumentality – the confidence of employees that they will actually get what they desire, even if it has been promised by the manager. Vroom argued that if even one of these conditions or beliefs is missing, workers will not have the motivation to do the job well. Therefore, according to Vroom, managers should try to ensure that employees believe that increased work effort will improve performance and that this performance will lead to valued rewards.

  TIP If you are answering a question about motivational theorists, try to do more than just list their main findings. It is much better to apply their ideas to the business situation given.

11.4 Motivation methods in practice

This section considers practical ways in which HR managers might best achieve a motivated workforce, including financial and non-financial motivators.

The theories in practical situations

All motivational theorists recognise that very few people would be prepared to work without financial reward. Pay is necessary to encourage work effort – all theorists understand this. They can, however, disagree over whether pay is sufficient to generate motivation and how pay should be calculated. The following methods of motivation can be related back to the ideas of the main motivational theorists. They provide examples of these motivation theories in practical situations.

If pay or other financial motivators are insufficient to ensure that workers are motivated to work to their full potential, then non-financial methods need to be considered. The attraction of these is obvious: if non-financial methods can promote motivation without adding to labour costs, then unit costs should fall and competitiveness increases.

> TIP Questions on this topic will rarely just ask you to describe and explain different methods of financial and non-financial motivation. It is much more likely that you will be asked to suggest which methods might be most suitable in different business situations, and why.

Financial motivators

There are many types of financial motivators or payment methods.

Time-based wage rate

This is the most common way of paying manual, clerical and non-management workers. A time-based wage rate means that a payment per hour is set. The total wage level is determined by multiplying this by the number of hours worked. This total wage is often paid weekly.

==time-based wage rate:== payment to a worker made for each period of time worked (e.g. one hour).

Main advantages of time-based wage rate

Main disadvantages of time-based wage rate

Often used in situations where…

- It offers some security over pay levels (e.g. during slack periods of demand).
- Different rates can be offered to different types of workers.
- There is no incentive to increase output as pay level is not directly linked to output.
- Labour cost per unit will depend on output, which may vary.
- The output of non-managerial jobs is not easy to measure.
- Focus on quality is more important than quantity.

Table 11.3: Advantages and disadvantages of time-based wage rate

Piece rate

A piece rate is fixed for the production of each unit. The workers' wages therefore depend on the quantity of output produced. The piece rate can be adjusted to reflect the difficulty of the job and the standard time needed to complete it. It can be combined with a low basic wage and then the piece rate is paid if output rises above a set level. This is called partial piece rate.

Figure 11.8: Piece rates should be agreed before work starts Figure 11.8: Piece rates should be agreed before work starts

Main advantages of piece rate

Main disadvantages of piece rate

Often used in situations where…

- It motivates workers to increase output.
- It is easy to calculate the labour cost per unit.
- Quality might fall.
- In many jobs, individual worker output cannot be calculated.
- There is no security over the level of pay (e.g. in the event of production delays).
- Workers may become stressed and unwell by trying to earn more.

• The output of each worker is easy to identify and measure.

• There is a need to keep unit costs as low as possible.

Table 11.4: Advantages and disadvantages of piece rate

Salary

A salary is the most common form of payment for professional, supervisory and management staff. The salary level is fixed each year. It is not dependent on the number of hours worked or the number of units produced. Salaried jobs will be put into one of a number of salary bands and the precise income earned within each band will depend upon the experience and performance of the individual. Businesses that want to create a single status within their organisation are now increasingly putting all employees – manual and managerial – on to annual salaries to give the benefits of security and status to all employees.

==salary:== annual income that is usually paid on a monthly basis.

Main advantages of salary

Main disadvantages of salary

Often used in situations where…

• It offers the security of a pay level to employees.

• There are different salary levels for different grades of workers.

• It is suitable for jobs where output is not measurable.

• It is often fixed for one year, so labour costs are easier to forecast.

• It is not directly linked to output so complacency may be a problem.

• It may lead to low achievement/motivation if the effort and achievement of the employee are not regularly checked with appraisal.

• Status and security of income are important motivators in managerial or non-manual jobs.

• Overtime pay for extra hours is not expected.

Table 11.5: Advantages and disadvantages of salary

Commission

Commission payments can make up 100% of the total income or they can be in addition to a base salary. They are usually paid to salespeople, not just in retail but also in industry (e.g. machines and equipment for businesses). They provide an effective financial incentive to sell more but they might reduce income security. Also, they might encourage sales staff to put too much pressure on customers to buy.

==Commission:== a payment to a salesperson for each sale made.

Main advantages of commission

Main disadvantages of commission

• It creates the incentive to increase sales.

• It may be in addition to a basic salary so it could offer some security of pay too.

• It discourages teamwork amongst sales employees.

• It may lead to pressurised selling which damages customer relationships.

Table 11.6: Advantages and disadvantages of commission

Bonus payment

A bonus payment is one that is made to employees in addition to their contracted wage or salary. While the base salary is usually a fixed amount per month, bonus payments may be based on criteria agreed between managers and workers, such as an increase in output, productivity or sales.

==bonus:== a payment made in addition to the contracted wage or salary.

Main advantages of bonus payment

Main disadvantages of bonus payment

Often used in situations where…

• It is paid to individuals for outstanding work or to teams for reaching targets.

• It creates the incentive for employees to do well.

• It is in addition to basic salary, so it offers some security too.

• It can cause resentment if the bonus is not received.

• It damages team spirit if some members receive a bonus and others do not.

• It reduces motivation if no bonuses are paid, e.g. if sales are falling.

• The business wants to make one-off payments which are not part of an employment contract.

• The business wants to reward employees for good performance.

Table 11.7: Advantages and disadvantages of bonus payment

Performance-related pay (PRP)

Performance-related pay is usually a bonus payable in addition to the basic salary. It is widely used for those workers whose output is not measurable in quantitative terms, such as management, supervisory and clerical posts. It requires the following procedure:

==Performance-related pay:== a bonus scheme to reward employees for above-average work performance.

- regular target setting, establishing specific objectives for the individual
- annual appraisals of the worker's performance against the pre-set targets
- paying each worker a bonus when targets have been exceeded. PRP bonuses are usually paid on an individual basis, but they can also be calculated and awarded on the basis of teams or even whole departments.

Main advantages of performance-related pay

Main disadvantages of performance-related pay

Often used in situations where...

• Individual bonuses for meeting pre-determined targets may encourage workers to work hard to meet these targets.

• Target setting can form part of the hierarchy of objectives to meet the company's aims.

• It requires frequent target setting and appraisal interviews.

• If the bonus is low, it may not lead to greater effort as motivation will not be increased.

• Managers might show favouritism to some employees by giving generous bonus payments.

• Managers want to encourage target setting and target achievement.

• Employee performance cannot be measured in terms of output produced or sales achieved.

Table 11.8: Advantages and disadvantages of performance-related pay

Profit sharing

The essential idea behind profit-sharing arrangements is that employees will feel more committed to the success of the business and will strive to achieve higher performances and cost savings.

==profit-sharing:== a bonus for employees based on the profits of the business, usually paid as a proportion of basic salary.

Main advantages of profit sharing

Main disadvantages of profit sharing

Often used in situations where...

• It aims to increase the commitment of the workforce to make the business profitable.

• It might lead to suggestions for cost cutting and ways to increase sales.

• It might only be a very small proportion of total profits so is not motivating.

• Shareholders might object as it could reduce profit for them.

• It reduces profit retained for expansion.

• Managers want to increase employee focus on business profits to encourage cost-cutting and revenue-increasing ideas.

Table 11.9: Advantages and disadvantages of profit sharing

Share-ownership schemes

This financial incentive gives workers shares – or the chance to buy discounted shares – in the company they work for. It is claimed that these share-ownership schemes reduce the division between business owners and workers. This helps to make workers more involved in the success of the organisation that employs them. As shareholders, employees will be able to participate at the company's annual general meeting.

==share-ownership schemes:== a scheme that gives employees shares in the company they work for or allows them to buy those shares at a discount.

Main advantages of share ownership

Main disadvantages of share ownership

Often used in situations where...

• It reduces the conflict of objectives between owners and workers.

• It encourages an increased sense of belonging and commitment.

• Workers are more likely to participate in decision-making aimed at business success.

• It may be a very small number of shares so is not motivating.

• Shares might just be sold so there is no long-term commitment.

• Managers often receive more shares so the workforce may feel resentment towards the managers.

• Senior managers need to increase their commitment to the success of the business.

• The business wants to encourage loyalty and participation from all employees.

Table 11.10: The main advantages and disadvantages of share ownership

Fringe benefits

Fringe benefits are also known as perks of the job. They are non-cash forms of reward and there are many alternatives that can be used. These include company cars, free insurance and pension schemes, private health insurance, discounts on company products, and low interest rate loans. They are used by businesses in addition to normal payment systems in order to give status to higher-level employees and to recruit and retain the best staff. As no cash changes hands between the employer and the employee, these are sometimes classified as non-financial benefits – although they do, obviously, have financial value.

==Fringe benefits:== benefits given, separate from pay, by an employer to some or all employees.

> KEY CONCEPT LINK A well-motivated workforce is essential for long-term business success. The decision-making function of human resources management needs to consider the business context before determining which methods of motivation to use.

Non-financial motivators

Various methods create conditions for motivating employees, regardless of payment, as outlined below.

Job rotation

Job rotation allows workers to do several different jobs, increasing their skills and the range of work they can do. There are various benefits and limitations of job rotation.

==Job rotation:== a scheme that allows employees to switch from one job to another.

Benefits:

- Rotation may relieve the boredom of doing one task.
- It can give the worker several skills, which makes the workforce more flexible.
- Workers are more able to cover for a colleague's absence. Limitations:
- Job rotation is more limited in scope than job enrichment (see below).
- It does not increase empowerment or responsibility for the work being performed.
- It does not necessarily give a worker a complete unit of work to produce, but just a series of separate tasks of a similar degree of difficulty.

Job enlargement

Job enlargement refers to increasing the loading of tasks on existing workers, perhaps as a result of a shortage of employees or redundancies. It is unlikely to lead to long-term job satisfaction, unless the tasks given to employees are made more interesting or challenging.

==Job enlargement:== an attempt to increase the scope of a job by broadening or deepening the tasks undertaken.

Job enrichment

The process of job enrichment often involves a reduction of direct supervision as workers take more responsibility for their own work and are allowed some degree of decision-making authority. Herzberg's findings formed the basis of the job-enrichment principle. Applying the three key features of his theory can result in considerable benefits to businesses.

Benefits:

- Complete units of work are produced so that the worker's contribution can be identified and more challenging work can be offered – for example, by using team (or cell) production.
- Direct feedback on performance, for example by two-way communication, allows each worker to have an awareness of their own progress.
- Challenging tasks are offered as part of a range of activities, some of which are beyond the worker's recent experience. These tasks will require training and the learning of new skills. Obtaining further skills and qualifications is a form of gaining status and recognition (see Maslow's hierarchy of human needs). Limitations:
- Lack of employee training or experience to cope with the greater depth of tasks can result in lower productivity. It is important not to take a worker too far from the type of work they are comfortable with.
- Employees may see the enrichment process as just an attempt to get them to do more work. Enrichment must be planned carefully with the employees involved so that the benefits to both individuals and the business can be understood.
- If employees are just not able to cope with the additional challenges imposed by job enrichment, then this can lead to frustration and demotivation.
- Managers must accept reduced control and supervision over the work of employees, which they might find difficult.

Figure 11.9: Traditional mass production – each worker performs a single task
Figure 11.9: Traditional mass production – each worker performs a single task

Figure 11.10: Team production allows for job enrichment – all workers contribute to producing the completed unit Figure 11.10: Team production allows for job enrichment – all workers contribute to producing the completed unit

Job redesign

Clearly, job redesign is closely linked to job enrichment, which usually involves the employee's input and agreement. The following examples show how adding – and sometimes removing – certain tasks and functions can lead to more rewarding work. Journalists now have to be IT experts to communicate through the wide range of technological media. Bank employees are encouraged and trained to sell financial products to customers, not just to serve at tills. Hairdressers may be given opportunities to add beauty therapies to their total job skills.

==job redesign:== the restructuring of a job to make the work more interesting, satisfying and challenging.

Production lines (see Figure 11.9) have been reorganised in many factories and teamworking has been introduced in many industries, so that it is easier to redesign and enrich jobs (see Figure 11.10). These job changes can lead to improved recognition by management of the work undertaken by workers and can increase workers' chances of gaining promotion as a result of the wider skills gained.

Training and development

Most businesses offer schemes for the training and development of their employees.

==development:== the gaining of new or advanced skills and knowledge as well as opportunities to apply what is gained.

Benefits:

- Improving and widening the skills of employees can increase the productivity and flexibility of the workforce and its ability to deal with change.
- Training and development increase the status of workers and give them access to more challenging, and probably better-paid, jobs within the business.
- Developing employees and encouraging them to reach their full potential increase the opportunities for self-actualisation.
- Training and development are often important incentives for employees to stay with a business as they feel that they are being fully recognised and appreciated by the company. Limitations:
- Training can be expensive as trainers and training facilities are needed or off-the-job courses must be paid for.

- Training and development programmes can take employees away from their work for some time so other employees will need to cover for them.
- Training can lead to employees leaving a business as they become better qualified to gain employment within other companies. This discourages some businesses from paying for training programmes in case competitors benefit from the people they have trained.

Opportunities for promotion and increased status

There are benefits to both the employee and the employer if the business offers a clear career structure. It allows employees to work towards advancement to a higher level within the business. Employee promotion to a higher-level job is seen as a reward for hard work. Promotion results in increased employee status, which satisfies a key human need. If employees think there is no career structure and no opportunity for promotion, they will not be motivated to perform to the best of their abilities. Businesses that do not recognise hard work and exceptional performance through promotion always risk losing a talented employee.

==Employee promotion:== the advancement of an employee within a business to a higher level of responsibility and status.

==employee status:== the level of recognition offered by an employer to a worker in terms of pay, level of responsibility and benefits.

Employee participation in management and the control of business activity

Employee participation can be introduced at different levels of a business operation. Workers can be encouraged to become involved in decision-making at the team or work group levels. Opportunities for worker participation in a workshop or factory might include involvement in decisions on break times, job allocations to different workers, job redesign, ways to improve quality and ways to cut down wastage and improve productivity.

==Employee participation:== active encouragement of employees to become involved in decision-making within an organisation.

At the level of strategic decision-making, workers could be encouraged to participate through electing a worker director to the board of directors or speaking for employees at works council meetings. The benefits of participation include job enrichment, improved motivation and greater opportunities for workers to show responsibility. In addition, better decisions could result from worker involvement as they have in-depth knowledge of operations, whereas some managers lack this.

The limitations of participation are that it may be time-consuming to involve workers in every decision. Autocratic managers would find it hard to adapt to the idea of asking workers for their opinions. Such managers may set up a participation system but have no intention of actually responding to workers' input. This approach could eventually prove to be very demotivating for workers.

Teamworking

In teamworking, each worker operates within a small group of employees. The team will be given tasks to perform but will be empowered with some decision-making over how the task is completed. Teamworking has advantages and disadvantages, as outlined in Table 11.11.

==teamworking:== production is organised so that groups of workers undertake complete units of work.

Advantages of teamworking

Disadvantages of teamworking

• Teams are empowered by being given decision-making authority over their work and the planning of it. This is a good example of job enrichment.

• Workers will not want to let down other team members so absenteeism should fall.

• Workers are likely to be better motivated as social and esteem needs are more likely to be met.

• Better-motivated team members increase productivity and labour turnover is reduced.

• It makes full use of all of the talents of the workforce. Better solutions to problems will often be found.

• It can lead to lower management costs as it is often associated with delayering of the organisation so fewer middle managers will be required.

• Complete units of work can be given to teams.

• Not everyone is a team player as some individuals are more effective working alone. Training may need to be offered to team members who are not used to working collaboratively in groups. Some workers may feel left out of team meetings unless there are real efforts to involve all team members.

• Teams can develop a set of values and attitudes which may conflict with those of the organisation itself, particularly if there is a dominant personality in the group. Teams will need clear goals to ensure that they are working towards the objectives of the organisation.

• The introduction of teamworking will require training to improve employee flexibility and this could be costly.

• There may be some disruption to production as the teams establish themselves.

Table 11.11: Advantages and disadvantages of teamworking

> TIP In your answers on this topic you could suggest that teamworking might not always be a suitable way to organise a workforce. Some very good workers do not make effective team members.

Empowerment

This method of motivation is increasingly being used in most businesses. As the standard of education improves in most countries, employees are becoming increasingly able to accept more freedom in how their jobs are organised and managed. In fact, more employees are now expecting this increased level of accountability to be offered to them.

Benefits:

- Empowermentthe giving of skills, resources, authority and opportunity to employees so that they can take decisions and be accountable for their work. leads to quicker problem-solving. Employees are able to respond to problems immediately and not take time referring them to managers. Workers often have more relevant experience than managers in solving work-related problems.
- Higher levels of motivation and morale result as workers are given more challenging work and are recognised for it.
- Higher levels of involvement and commitment improve two-way communication and help to reduce labour turnover.
- Managers are able to focus on bigger strategic issues as they are released from more routine issues and problem-solving. Limitations:
- Lack of experience increases risk, which is why employees must be trained in accepting the additional authority that comes with empowerment.
- Reduced supervision and control might lead to poor decisions.
- There may be lack of coordination between teams as, for example, one manager is no longer making consistent decisions and different groups might take different approaches to problems.
- Some employees may be reluctant to accept more accountability but feel that they have to in order to keep their job secure.

Quality circles

A quality circle (QC) is a group of five to ten employees who have experience in a particular work area. They meet regularly to identify, analyse and solve the problems arising in their area of operation. Quality circles are used to identify problem areas in business processes and members work on these to improve product quality and productivity.

==quality circle (QC):== a voluntary group of workers who meet regularly to discuss, and try to resolve, workrelated problems and issues.

Quality circles are not just concerned with quality, although improving quality of the product or service can be a major benefit. The meetings are not formally led by managers or supervisors. They are informal and all workers are encouraged to contribute to discussions.

Benefits:

- Workers have hands-on experience of work problems and they often suggest the best solutions.
- The results of the quality circle meetings are presented to management. The most successful ideas are often adopted, not just in that location, but across the whole organisation.
- Quality circles are an effective method of allowing the participation of all employees. They fit in well with Herzberg's ideas of workers accepting responsibility and being offered challenging tasks. Limitations:
- Quality circle meetings can be time-consuming and reduce the time available for production.
- Not all employees will want to be involved in quality circles, preferring to get on with their own job.
- Quality circles may not have the management power to make the changes that they recommend. If management ignores the proposals from quality circles too often, employees will become discouraged and unwilling to participate.

Image Image

12.1 Management and managers

Managers get things done – not by doing all jobs themselves, but by working with and delegating to other people.

Traditional manager functions

It has become accepted over time that the main functions of managers – the 'traditional functions' – are:

Planning – giving the business a direction for the future

Organising – the people and other resources needed

Directing – leading and motivating people in the organisation

Controlling – ensuring that the original plan is being followed.

These functions are explained in detail in the next section.

The role of managers: Fayol and Mintzberg

Not all managers use the same style of managing people or taking decisions. Different managers will approach problems and decisions in very different ways, but the key functions or roles of management are common to all. These are effectively explained by reference to two of the best-known management writers, Fayol and Mintzberg.

==management:== the organisation and coordination of activities in order to achieve the defined objectives of the business.

Fayol: the functions of management

Henri Fayol (1841–1925) was one of the first management theorists. He defined five functions of management and these are still seen as relevant to businesses and other organisations today. These five functions are necessary to facilitate the management process. They focus on the relationship between employees and managers.

Planning

All managers need to think ahead. Senior management will establish overall objectives and these will be translated into tactical objectives for less senior managers. The planning needed to put these objectives into effect is also important. For example, new production or marketing objectives will require the planning and preparation of sufficient resources.

Organising resources to meet objectives

Employees need to be recruited carefully and encouraged, via delegation, to take some authority and accept some accountability. Senior managers should ensure that the structure of the business allows for a clear division of tasks. Each functional department, such as marketing, is organised to allow employees to work towards the common objectives.

Commanding, directing and motivating employees

This means guiding, leading and overseeing employees to ensure that business objectives are being met. Employee development will help motivate employees to use all of their abilities at work. Managers should be capable of motivating a team and encouraging employees to show initiative.

Coordinating activities

As businesses grow there is a greater need to ensure consistency and coordination between different parts of the business. The goals of each branch, division, region and employee must be welded together to achieve a common sense of purpose. At a practical level, this avoids the situation where, for example, two divisions of the same company both spend money on researching into the same new product, resulting in wasteful duplication of effort.

Controlling and measuring performance against targets

Establishing clear objectives for the business, and for each section within it, establishes targets for all groups, divisions and individuals. It is management's responsibility to appraise performance against targets and to take action if underperformance occurs. It is just as important to provide positive feedback when things go right.

Mintzberg: management roles

To carry out their functions, managers have to undertake many different roles. Henry Mintzberg (1939–) was quite critical of Fayol's functions of management idea. He was quoted as saying that: 'They do not describe the actual work of managers. They describe vague objectives of managerial work' (The Nature of Managerial Work, 1973).

Mintzberg's work on the role of managers was based on the observation of many managers at work. His approach considered that the activities of managers can be summed up by his ten roles of management.

The roles he identified are, he believed, common to the work of all managers. They are divided into three groups (see Table 12.1):

- Interpersonal roles – dealing with and motivating employees at all levels of the organisation.
- Informational roles – acting as a source, receiver and transmitter of information.
- Decisional roles – taking decisions and allocating resources to meet the organisation's objectives.

Role title

Description of role activities

Examples of management action in performing the role

1 Interpersonal roles

Figurehead

symbolic leader of the organisation, undertaking duties of a social or legal nature

opening new factories/offices; hosting receptions; giving important presentations

Leader

motivating subordinates; selecting and training other managers/workers

any management tasks involving subordinate employees

Liaison

linking with managers and leaders of other divisions of the business and other organisations

leading and participating in meetings; business correspondence with other organisations

2 Informational roles

Monitor (receiver)

collecting data relevant to the business's operations

attending seminars, business conferences, research groups; reading research reports

Disseminator

sending information collected from external and internal sources to the relevant people within the organisation

communicating with staff within the organisation, using appropriate means

Spokesperson

communicating information about the organisation – its current position and achievements – to external groups and people

presenting reports to groups of stakeholders (e.g. annual general meeting); communicating with the press and TV media

3 Decisional roles

Entrepreneur

looking for new opportunities to develop the business

encouraging new ideas from within the business; holding meetings aimed at putting new ideas into effect

Disturbance handler

responding to changing situations that may put the business at risk; assuming responsibility when threatening factors develop

taking decisions on how the business should respond to threats, such as new competitors or changes in the economic environment

Resource allocator

deciding on the spending of the organisation's financial resources and the allocation of its physical and human resources

drawing up and approving estimates and budgets; deciding on staffing levels for departments and within departments

Negotiator

representing the organisation in all important negotiations (e.g. with government)

conducting negotiations and building up official links between the business and other organisations

Table 12.1: Mintzberg's ten managerial roles

KEY CONCEPT LINK Decision-making is a key management role.

Differences between Fayol and Mintzberg's approaches

The differences between the approaches of Fayol and Mintzberg should not be exaggerated. Mintzberg did not strongly disagree with Fayol. He just thought that the simple division of managerial tasks into five functions was too closed and limiting. He considered that the role of managers was much more open ended. In particular he stressed the interpersonal nature of many of the tasks that the managers he observed were performing. Mintzberg believed that he had demonstrated, through his systematic framework, that management is much more than the five functions. It must include interpersonal relationships and open-ended discussions with workers and customers.

Despite their apparent differences, these two management thinkers have provided a useful foundation for analysing what it is that managers must do to be effective.

The contribution of managers to business performance

The functions and roles of managers, as outlined above, show how significant their work is. Effective managers lead successful businesses. The part managers play in the performance of the businesses they control cannot be underestimated. The key indicators that managers are having a positive impact on business performance are:

- the business regularly meets its objectives
- high levels of customer satisfaction
- high employee motivation levels and low labour turnover
- a respected brand image
- high regard from external stakeholders such as environmental and social pressure groups
- excellent communication both within the business and with external stakeholders.

Management styles

Before considering the different styles of management that can be used, it is useful to consider briefly the main managerial positions in a business (see Table 12.2).

Chief executive officer (CEO)

A CEO is the highest-ranking executive in a company. The primary responsibilities include: making major corporate decisions, managing overall operations, managing company resources.

Director

An appointed or elected member of the board of directors of a company who, with other directors, has the responsibility for determining and implementing the company's policy. They report to the CEO.

Manager

Any individual responsible for people, resources or decision-making can be termed a manager. They have authority over other employees below them in the hierarchy. They direct, motivate and, if necessary, discipline the employees in their section or department.

Supervisors

These are appointed by management to watch over the work of others. This is usually not a decision-making role. They have responsibility for leading and controlling a team of people in working towards pre-set goals.

Table 12.2: The main managerial positions

Management style refers to the way in which managers take decisions and communicate with employees. There are four distinct management styles (see also Table 12.3).

Autocratic management

Autocratic managers take decisions on their own, with no discussion. They set business objectives, issue instructions to workers and check to ensure their instructions are carried out. Workers can become so used to this style that they are dependent on managers for all guidance and will not show initiative. Motivation levels are likely to be low, so supervision of workers will be essential. Managers with this style use one-way communication. They issue instructions but do not encourage any feedback from the workforce.

==Autocratic managers:== a management style where one manager takes all decisions with very little, if any, input from others.

This style of management does have some useful applications. The armed forces and police are likely to adopt this approach, as orders may need to be issued quickly with immediate response. In crises, managers may have to take full charge and issue orders to reduce the unfortunate consequences of the incident. Major events such as a leak from an oil tanker or a major rail accident require clear and prompt management instructions to employees. It would be inappropriate to discuss these instructions with the workers concerned before they are put into effect.

Democratic management

Democratic managers encourage discussion with workers before taking decisions, or may allow workers to take decisions themselves. Communication is two-way. Workers have opportunities to start and respond to a discussion. Managers using this approach need good communication skills to be able to explain issues clearly. Full participation in the decision-making process is encouraged.

==Democratic managers:== a management style that encourages the active participation of workers in taking decisions.

This style may lead to better final decisions, as workers have much to contribute and can offer valuable work experience to help solve problems. Herzberg suggested that this style of management should improve workers' motivation. Employees are given some responsibility for the objectives and strategy of the business. This makes most employees feel more committed to ensuring that the decisions they influenced are put into effect successfully.

Employing the democratic approach can be a slow process, however, and this could make it unsuitable in certain situations.

Paternalistic management

The word 'paternalistic' means father-like. Paternalistic managers listen, explain issues and consult with workers, but do not allow them to take decisions. The paternalistic manager decides what is best for the business and the workforce, but delegation of decision-making is unlikely. These managers are less concerned with Herzberg's motivators than with satisfying the safety and security needs of the workers (Maslow). Therefore, this approach is not democratic and, as in some families, is more autocratic than it might at first appear.

==Paternalistic managers:== a management style based on the view that the manager is in a better position than the workers to know what is best for an organisation.

This style could be suitable in a business with unskilled, untrained or newly appointed workers. It may lead to the demotivation of more experienced workers who would prefer to be given responsibility for decision-making and opportunities for participation.

Laissez-faire management

The term 'laissez-faire' means 'let them do it'. Laissez-faire management allows workers to carry out tasks and take decisions themselves within very broad limits. This is an extreme version of democratic management. There is very little input from management into the work to be undertaken by subordinates.

==Laissez-faire management:== a management style that leaves much of the business decision-making to the workforce.

This style could be particularly effective in the case of research or design teams. These experts often work best when they are not tightly supervised and when they are given freedom to work on an original project. Many scientific discoveries would have been prevented if the researchers had been restricted in their work by senior management.

In other cases, a laissez-faire management style could be a disaster. Leaving workers to their own devices with little direction or supervision might lead to a lack of confidence, poor decisions and poor motivation, as the workers are never sure if what they are doing is right.

Main features

Limitations

Possible applications

Autocratic:

• leader takes all decisions

• they give little information to workers

• they supervise workers closely

• only one-way communication is used

• workers are given only limited information about the business

• demotivates workers who want to contribute and accept responsibility

• decisions do not benefit from employee input

• defence forces and police where quick decisions are needed and the scope for discussion must be limited

• in times of crisis when decisive action might be needed to limit damage to the business or danger to others

Democratic:

• participation encouraged

• two-way communication is used, which allows feedback from workers

• workers are given information about the business to allow their full involvement

• consultation with workers can be time-consuming

• on occasions, quick decision-making will be required

• some business issues might be too sensitive to allow worker involvement (e.g. job losses) or too secret (e.g. new product development)

• most likely to be useful in businesses that expect workers to contribute fully to the production and decision-making processes, thereby satisfying their higher-order needs

• an experienced and flexible workforce will be likely to benefit most from this style

• in situations that demand a new way of thinking or a new solution, employee input can be very valuable

Paternalistic:

• managers do what they think is best for the workers

• some consultation might take place, but the final decisions are taken by the managers – there is no true participation in decision-making

• managers want workers to be happy in their jobs

• some workers will be dissatisfied with the apparent attempts to consult, while not having any real power or influence

• used by managers who have a genuine concern for workers' interests, but feel that managers know best in the end

• when workers are young or inexperienced this might be an appropriate style to employ

Laissez-faire:

• managers delegate virtually all authority and decision-making powers

• very broad criteria or limits might be established for the staff to work within

• workers may not appreciate the lack of structure and direction in their work – this could lead to a loss of security

• lack of feedback – as managers do not closely monitor progress – may be demotivating

• when managers are too busy (or too lazy) to intervene

• may be appropriate in research institutions where experts are more likely to arrive at solutions when not constrained by narrow rules or management controls

Table 12.3: Summary of management styles

12.2 McGregor's Theory X and Theory Y

What factors determine the management style used by each manager? According to Douglas McGregor (1906–1964), as a result of his studies in the 1950s, one of the most important determinants is the attitude of managers towards their workers. He identified two distinct management approaches to the workforce – he called these Theory X and Theory Y.

==Theory X:== the view that some managers believe that employees are lazy, fear-motivated and in need of constant direction.

==Theory Y:== the view that some managers believe employees are internally motivated, enjoy their work and are prepared to take on additional responsibilities.

Theory X managers, according to McGregor, view their workers as lazy and disliking work. These managers think workers are unprepared to accept responsibility and need to be controlled and made to work. Clearly, managers with this view will be likely to adopt an autocratic style of leadership.

On the other hand, McGregor considered that managers who hold Theory Y views believe that workers enjoy work. These managers think workers find work as natural as rest or play. They think workers are prepared to accept responsibility, be creative and take an active part in contributing ideas and solutions to work-related problems.

It is important to note that McGregor did not suggest that there were two types of workers, X and Y. The X and Y refer to different attitudes of management towards workers. In practice, most managers will have views somewhere between these two extremes.

What is the significance of McGregor's work? It is a very widely quoted piece of research. The general view is that workers behave in a particular way as a result of the attitude that managers have towards them. For instance, if a manager believes that all workers behave in a Theory X way, there will be control, close supervision and no delegation of authority. The workers, as a result of this approach, will certainly not enjoy their work and may indeed try to avoid it and fail to contribute in any meaningful way. Therefore, they will become like Theory X because of the way they are treated. The exact reverse could be the case for workers treated in a more democratic style, based on the Theory Y view (see Table 12.4).

Theory X managers believe that workers:

Theory Y managers believe that workers:

- dislike work
- will avoid responsibility
- are not creative

- can derive as much enjoyment from work as from rest and play
- will accept responsibility
- are creative

Table 12.4: Summary of Theory X and Theory Y management attitudes

The best management style depends on many factors

There is not one management style that is best in all circumstances and for all businesses. The style used will depend on many factors:

- The training and experience of the workforce and the degree of responsibility that they are prepared to accept.
- The amount of time available for consultation and participation.
- The attitude of managers, or the management culture of the business. This is influenced by the personality and business background of the managers, such as whether they have always worked in an autocratically run organisation.
- The importance of the issues under consideration. Different styles may be used in the same business in different situations. If the business is at risk, resulting from poor or slow decisions, then it is more likely that management will make decisions in an autocratic way. Democratic leadership – involving participation and two-way communication – is increasingly common for a number of reasons. Working people are better educated than before and have higher expectations of their experience from work. They expect their higher-level needs to be satisfied at work. Many managers realise that the rapid pace of changes at work, as a result of technological and other factors, has increased the need to consult workers and involve them in the process of change. People find change less threatening and more acceptable if they have been involved in some meaningful way in managing it.

Despite these factors, many managers still avoid consultation and worker participation, perhaps because they find it very difficult to adapt to these ways. Others may doubt their own ability to discuss issues with workers or to persuade them to take a particular decision. Some managers would rather issue instructions that do not allow for any feedback from workers.

> TIP Whichever style of management is used in a business or case study scenario, it is important to remember that there is no right or wrong way of managing people, but there is always an appropriate style for any situation.

> KEY CONCEPT LINK The selection of the most appropriate management styles clearly depends on the context in which the business operates.

Image Image

13.1 Organisations need structure

A sole trader has no employees, does all the work and makes all the business decisions. But if this sole owner was to take on just one worker or one partner, a formal structure would become necessary. Without any idea of structure, it would be impossible to answer these questions:

- Who does which job?
- Who is responsible for which decisions? If the business expanded further, with more employees – including supervisory staff, different departments or divisions – then the need for a structure would be even greater. This would allow:
- the division of tasks and responsibilities to be made clear to all
- the workers to understand which manager they would be responsible to. A typical business structure is one that is based on departments or functions. These departments are divided according to the type of work carried out. Structures can be illustrated by means of an organisation chart. A traditional one, showing functional structure, is shown in Figure 13.3. This chart displays a number of important points about the internal organisation of this business.

==functional structure:== departments have clearly defined roles and responsibilities in a specialist area such as marketing, finance, human resources or operations.

Figure 13.3: An example of an organisational structure Figure 13.3: An example of an organisational structure

This structure indicates:

- who has overall responsibility for decision-making
- the formal relationships between different people and departments
- the position of each individual in the business and who their line manager is
- the way in which accountability and authority may be passed down the organisation
- the number of subordinates reporting to each more senior manager
- formal channels of communication, both vertical and horizontal
- the identity of the supervisor or manager to whom each worker is accountable.

Business objectives and organisational structure

An organisation consists of any number of individuals who work together to achieve the mission of the organisation. Each individual fills a certain role within the structure, performing tasks that help achieve the objectives set by management. Each person in the organisation needs to have a specific role defined, including a certain amount of personal accountability to complete tasks that help the organisation reach its goals.

The internal structure of a business should be designed to help achieve its objectives. When these objectives change, as they often do over time or in new circumstances, then the structure needs to change. The division of responsibilities and the relationships between different sections of the business change considerably in different circumstances, as follows.

New competitors enter the industry

A more competitive market will demand a quicker-acting and more flexible structure, as shown in the feature on Tata's organisational structure at the start of this chapter. The key point here is flexibility. An organisational structure is not fixed for all time. It needs to adapt and be flexible enough to allow the business to be responsive to meet changing conditions, including different objectives. This flexibility will allow the structure to meet the needs of the business as they change over time.

The business grows and develops

As a business expands, its internal structure must change. Figure 13.4 shows an example structure for a small business making wooden furniture with five employees. This entrepreneurial structure would only be suitable for small businesses, as it could place too much pressure on the owner or the entrepreneur at the centre of the structure.

Figure 13.4: An entrepreneurial structure Figure 13.4: An entrepreneurial structure

If the business grows, another manager or supervisor might be required. It could become too time-consuming for one person to control the work of all the employees, even if delegation is used. A decision would then need to be made about how responsibilities were to be divided – by function or by product. Figure 13.5 shows two options for the furniture business after it starts to produce metal garden furniture as well.

Figure 13.5: Alternative structures for a furniture-making business Figure 13.5: Alternative structures for a furniture-making business

If the business is very successful and further expansion is achieved – possibly by producing in other geographical areas – then further structural changes will become necessary. One option for a new structure is shown in Figure 13.6.

Figure 13.6: Further structural changes Figure 13.6: Further structural changes

The organisational structure will therefore change with the size of the business and the range of activities that it is involved in. The structure must be flexible enough to meet the changing needs of a business as it grows and develops.

Business objectives change

For example, if one of the long-term objectives of the business is to increase sales in other countries, then the organisational structure must be adapted to create a regional marketing department. If the objective becomes one of making innovative products using the latest technology, then the business structure must include a research and development department. Structure must reflect the objectives of the business.

Intrapreneurship is being encouraged

Many businesses are now seeing intrapreneurship as a way of giving them a competitive advantage. Traditional bureaucratic hierarchies are often poor at innovation as they are inflexible, focused on top-down communication and do not encourage teamworking between departments. Structural changes are needed to encourage intrapreneurs:

- Intrapreneurial teams or task forces from different departments and divisions should be created (see the matrix structure in Section 13.2). These will help to stimulate new ideas that are not just focused on one department.
- High levels of delegation and trust must be shown, with only minimum direct management control on a day-by-day basis.
- Flexibility of team membership is important. A team should be able to call on a specialist for a short or a long period to help with its project.

13.2 Types of organisational structure

There are several structures that a business might adopt. We will analyse the three most widely adopted ones: functional, hierarchical and matrix.

The functional structure

This type of structure has already been referred to above. A functional structure splits an organisation into departments based on their major area of responsibility. The most common departments in a business are marketing, production (or operations), finance and human resources. Each of these departments is led by a functional manager. All authority rests with this departmental head. Other employees are grouped according to their role. For example, in the marketing department there might be sales managers, market researchers and promotions managers. This type of structure is usually also organised hierarchically.

==functional manager:== senior employee who has authority over a complete organisational unit.

Advantages of functional structure

- Employees often display a high level of departmental loyalty and pride in the work of their department.
- It encourages employees to become specialists and this can increase efficiency and productivity.
- Departments are led by managers who are specialists in the functional area.

Disadvantages of functional structure

- The structure is a vertical one and this often does not allow for good connections between departments.
- Coordination between departments is therefore difficult, for example, when developing a new major project.
- Communication flows through the department heads to the top management, so employees may feel remote from senior management.
- There might be competition between departments, which may not benefit the whole organisation. For example, competition for financial resources is based on getting the most for the department and not necessarily considering what is best for the business as a whole.

The hierarchical structure

In a hierarchical structure, there are different layers of the organisation with fewer and fewer people at each higher level. Refer back to Figure 13.3, which shows a typical hierarchical structure. In general terms, this structure is often presented as a pyramid (see Figure 13.7).

==hierarchical structure:== a structure consisting of multiple levels in which all members of the organisation, apart from one, are subordinate to someone else.

Figure 13.7: A typical hierarchical pyramid Figure 13.7: A typical hierarchical pyramid

Features of a hierarchical structure

The main features of a hierarchical structure are levels of hierarchy, chain of command and span of control.

Levels of hierarchy

Each level in the hierarchy represents a grade or rank of staff. Lower levels are subordinate to superiors on a higher level. The greater the number of levels, the greater the number of different grades or ranks in the organisation. A narrow (or tall) organisational structure has many levels of hierarchy and this creates three main problems:

==levels of hierarchy:== a stage of the organisational structure where all personnel have equal status and authority.

- Communication through the organisation can become slow, with messages becoming distorted or filtered in some way.
- Spans of controlthe number of subordinate employees directly accountable to a manager. are likely to be narrow as there is a clear relationship between the number of levels in a hierarchy and the average span of control (see Spans of control below).
- Those on lower levels can feel remote from the decision-making power at the top. In contrast, a flat organisational structure will have few levels of hierarchy but will tend to have wider spans of control.

Chain of command

Typically, instructions are passed down the hierarchy. Information, for example about sales or output levels, is sent upwards. The taller the organisational structure, the longer will be the chain of command, thus slowing down communications.

==chain of command:== this is the route through which authority from the chief executive and the board of directors is passed down through an organisation.

Spans of control

Spans of control can be either wide (with a manager directly responsible for many subordinates) or narrow (a manager has direct responsibility for a few subordinates). This difference can be illustrated as a flat organisational structure (see Figure 13.8) and as a tall organisational structure (see Figure 13.9).

Figure 13.8: Wide span of control of eight, which is likely to encourage delegation Figure 13.8: Wide span of control of eight, which is likely to encourage delegation

Figure 13.9: Narrow span of control of three, which is likely to lead to close control of subordinate employees Figure 13.9: Narrow span of control of three, which is likely to lead to close control of subordinate employees

The benefits of a flat organisational structure with wide spans of control are that:

- Each worker is delegated more authority as there is less direct control from a manager who is responsible for many other employees.
- Employee empowerment can be an important motivational force.
- A short chain of command results in better communications: there is a clear link between the number of hierarchy levels and the spans of control.
- There are few levels of hierarchy so fewer middle managers are needed, reducing business costs. This increases the average size of each span of control. This helps to demonstrate the clear link between the number of levels of hierarchy and spans of control.

Advantages of a hierarchical structure

Many businesses are still organised in a hierarchical structure as decision-making power starts at the top, but may be passed down to lower levels. The rungs on the career ladder for a keen and ambitious employee are illustrated by the different levels of hierarchy. The role of each individual will be clear and well-defined. There is a clearly identifiable chain of command. This traditional hierarchy is most frequently used by organisations based on a role culture, where the importance of the role determines the position in the hierarchy.

Disadvantages of a hierarchical structure

A hierarchical structure tends to indicate that one-way (top downwards) communication is standard practice. This is rarely the most efficient type of communication. There are no horizontal links between the departments or the separate divisions, and this can lead to lack of coordination between them. Managers are often accused of having a narrow vision because they are not encouraged to look at problems in any other way than through their experience of their own department. This type of structure is very inflexible and often leads to change resistance. This is because all managers tend to defend both their own position in the hierarchy and the importance of their own section or department.

Structure by product or geographical area

The vertical divisions in a hierarchy do not have to be based on functional departments. They could be based on region, country or product category.

When the structure of a business is based on the different ranges of products that it makes or areas that it operates in, it can be referred to as a divisional organisational structure. Each of these product divisions will be self-contained. They have their own marketing, production and research teams. A senior manager in these teams will report to the head of the product type. Key functions such as strategic decision-making and finance are usually still centralised.

==divisional organisational structure:== a structure that organises the activities of a business around geographical areas or product groups.

Examples of structure by product include a steelmaking company structured into divisions for steel girders, steel sheets and specialist steels, or an IT hardware manufacturer structured into divisions for business computers, consumer electronics, laptops and tablets.

Product structure can help a business:

- focus on specific market segments
- respond to consumer needs and market changes more quickly
- measure the performance and profitability of each division separately. Potential disadvantages include:
- duplication of roles, for example, each division has its own sales team
- rivalries between divisions might develop as they each focus on divisional objectives
- loss of overall central control over each division. The same general advantages and disadvantages apply to businesses that are structured by geographical area. This is most likely to be suitable for a business that operates and sells in several different markets with distinct cultures and characteristics. There could be great benefits in taking marketing decisions within each area division rather than centrally. These benefits might outweigh the cost of duplicating the roles of the marketing teams.

Delayering

Narrow hierarchical structures often have communication and employee motivation problems. One approach many senior managers use to solve these problems is to remove whole layers of management to create shorter structures. This process is known as delayering, which has various advantages and disadvantages (see Table 13.1).

==delayering:== removal of one or more of the levels of hierarchy from an organisational structure.

This development in organisational structures has been assisted by improvements in IT and communication technology. These allow senior managers to communicate with and monitor the performance of junior employees and widely dispersed departments much more effectively. This diminishes the importance of the role of middle managers.

Advantages of delayering

Disadvantages of delayering

• Delayering reduces business costs.

• It shortens the chain of command and should improve communication through the organisation.

• It increases spans of control and opportunities for delegation.

• It may increase workforce motivation due to less remoteness from top management and greater chance of having more responsible work to perform.

• There could be one-off costs of making managers redundant (e.g. redundancy payments).

• Managers who remain have increased workloads, which could lead to overwork and stress.

• Fear that redundancies might be used to cut costs could reduce the sense of security of the whole workforce (one of Maslow's needs).

Table 13.1: Advantages and disadvantages of delayering

The matrix structure

This approach to organising businesses aims to eliminate many of the problems associated with the hierarchical structure. The matrix structure cuts across the departmental lines of a hierarchical chart and creates project teams made up of people from all departments or divisions. The basic idea is shown in Figure 13.10 and the advantages and disadvantages are summarised in Table 13.2.

==matrix structure:== an organisational structure that creates project teams that cut across traditional functional departments.

This method of organising a business is task- or project-focused. The matrix organisation gathers together a team of specialists with the objective of completing a task or project, instead of highlighting the role or status of individuals. Emphasis is placed on an individual's ability to contribute to the team rather than their position in the hierarchy. The use of matrix project teams has been championed by Tom Peters, one of the best-known writers on organisational structure. In his book In Search of Excellence (1982), he suggested that:

- Organisations need flexible structures that remove as much bureaucracy as possible by getting rid of as many rigid rules and regulations as possible.
- The use of project teams should lead to more innovative and creative ideas, as employees will be more motivated to contribute.

Figure 13.10: A matrix organisational structure Figure 13.10: A matrix organisational structure

Advantages of a matrix structure

Disadvantages of a matrix structure

• It allows good communication between all members of the team.

• It cuts across traditional boundaries between departments in a hierarchy.

• There is less chance of people focusing on just what is good for their department as the aim is to focus on the project and the business as a whole.

• Crossover of ideas between people with specialist knowledge in different areas tends to create more successful and innovative solutions.

• New project teams can be created quickly so this system is well-designed to respond to changing markets or technological innovations.

• There is less direct control from senior managers as the teams may be empowered to undertake and complete a project.

• Passing down of authority to more junior employees can be difficult for some senior managers to accept.

• Reduced bureaucratic control may be resisted by some senior managers.

• Team members may have two managers to report to. If the business retains levels of hierarchy for departments but allows cross-departmental teams to be created, each team member has two bosses. This could cause a conflict of interests.

Table 13.2: Advantages and disadvantages of a matrix structure

13.3 Delegation and accountability

Delegation is a very important principle that can have far-reaching effects on both the organisational structure and the motivation levels of subordinate employees. Delegation means the passing down of authority from higher to lower levels in the organisation, in order for subordinate employees to perform tasks and take decisions. As Herzberg and other researchers point out, this process can be very beneficial to motivation. Generally, the wider the span of control, the greater the degree of delegation that is undertaken. Imagine a manager with a span of control of 15 subordinates. It might be impossible to closely control the work of each subordinate every day. The manager would be allowed no time for more important strategic matters. So, the manager will delegate authority to his subordinate employees, and he will trust them to perform well. Subordinates then have accountability for the work they do. If a job is done poorly, then the worker is accountable to his or her immediate manager. They can be held to account and be disciplined for an inadequate performance.

==Delegation:== passing authority down the organisational hierarchy.

==accountability:== the obligation of the individual to account for and explain their actions and to disclose the results of their work honestly.

Processes of accountability

Effective accountability does not mean telling an employee, 'You must do this job well'. There needs to be a clear set of guidelines so that the worker knows what is expected of them and how their work will be assessed. The following five steps should be followed in the accountability process:

- Give clear expectations before the employee starts the job.
- Make sure the employee has the appropriate skills, providing training if necessary.
- Establish two-way communication to provide feedback on how the employee is performing while doing the job, not just at the end of the task.
- Agree a clear measurement of performance so that the worker knows when they will be assessed as having done a job well or poorly.
- The consequences of good or poor performance need to be made clear to the employee.

The impact of delegation on a business

Delegation has advantages and disadvantages for a business, as summarised in Table 13.3.

Advantages of delegation

Disadvantages of delegation

• Delegation gives senior managers more time to focus on important strategic roles.

• It shows trust in subordinates and this can motivate and challenge them.

• It develops and trains employees for more senior positions.

• It helps employees to achieve fulfilment through their work (self-actualisation).

• If the task is not well-defined or if inadequate training is given, then delegation is unlikely to succeed.

• Delegation will be unsuccessful if insufficient authority (power) is given to the subordinate who is performing the tasks.

• Managers may only delegate the boring jobs that they do not want to do, which will not be motivating.

Table 13.3: Delegation: advantages and disadvantages

> TIP You would show very good understanding of the links between delayering and delegation if you explained that taking out layers of middle management must lead to higher levels of delegation to employees. Senior managers would have to trust employees to perform tasks that used to be done by middle managers.

13.4 Control, authority and trust

There is a clear relationship between these concepts. There is also a link between spans of control and levels of hierarchy. As explained in Section 13.2, the fewer the levels of hierarchy, the wider the spans of control tend to be. The wider the span of control, the more trust must be placed in each individual employee as there is less direct supervision.

==control:== to measure and supervise an employee's performance.

Authority and responsibility

It is important to understand the relationship between authority and responsibility. Delegation gives subordinates the authority to perform certain tasks. This means that they have the power to undertake jobs and make decisions necessary for these jobs to be completed.

==authority:== the power to give orders and make decisions.

However, the overall responsibility for the work of each employee or department remains with the manager. The manager delegates authority, but not responsibility. The manager must take the ultimate blame for underperformance or mistakes within the department.

The thinking behind this important principle is that it is the manager who:

- selects the employee (or delegatee) to undertake the task
- allocates resources
- arranges training. If any of these were the reasons for poor performance, then the manager should ultimately take responsibility.

Accountability still exists with the employee, however. A worker cannot perform a delegated task without believing that they will be held accountable for their actions. This ultimate control over their work is achieved by:

- setting and agreeing targets
- regular appraisal
- monitoring of performance against targets.

Control and trust

Delegation involves a manager showing trust in a subordinate because less control will be exercised over the employee's work. Many managers do not like giving up control. Some managers feel less important if they reduce control over workers. They may not want to take any risks by giving up control. These managers do not make good delegators.

There is a conflict between showing trust in a worker and controlling the worker's efforts. Effective delegation means slowly releasing management control in order to show more trust. This trust allows the worker to gain a greater sense of achievement when the work is done well.

A modern development of delegation is called empowerment. This approach not only delegates tasks and authority to individuals and groups but also allows them to decide on the best method to complete the job. This gives even more chance for employees to show initiative and creativity (Herzberg's motivators). However, it requires an even greater level of trust from managers as there is even less direct control over the work being carried out.

13.5 Centralisation and decentralisation

These two principles are linked to delegation. With centralisation there is minimum delegation to managers in other areas, departments or divisions of the business. All, or most, major decisions are taken by a few senior managers at the centre of the organisation, which could be based at its head office.

==centralisation:== keeping all the important decisionmaking powers within head office or the centre of the organisation.

Decentralisation passes decision-making authority to managers down the hierarchy. Managers in functional areas, departments or divisions in the business take decisions that, in a centralised structure, would be taken at head office. Decentralisation must involve delegation. A centralised organisation insists on all sections of the business following the same procedures, which gives the business a feeling of uniformity and consistency. Head office is able to exert considerable control over all operations. Decentralised organisations allow employees to be empowered and this demonstrates trust in them. Decisions are taken closer to the action in terms of junior managers being more aware of local factors or consumers' preferences. Table 13.4 gives a summary of the advantages of centralisation and decentralisation.

==Decentralisation:== decision-making powers are passed down the hierarchy to empower subordinates and area or product managers.

Advantages of centralisation

Advantages of decentralisation

• A fixed set of rules and procedures in all departments/divisions of the business should lead to rapid decision-making as there is no opportunity for discussion.

• The business has consistent policies throughout the organisation. This prevents any conflicts between the divisions and avoids confusion in the minds of consumers.

- Senior managers take decisions in the interest of the whole business, not just one division of it.

- Centralised buying should allow for greater economies of scale.

- Senior managers at head office will be experienced decision-makers, which should reduce risks.

- More local decisions can be made that reflect different conditions. The managers who take the decisions will have local knowledge and are likely to have closer contact with consumers.

- More junior managers can develop their skills, and this prepares them for more challenging roles.

- Delegation and empowerment are possible, and these will have positive effects on motivation.

- Decision-making in response to changes (e.g. in local market conditions) should be quicker and more flexible as head office will not have to be involved in every decision.

Table 13.4: Advantages of centralisation and decentralisation

Good examples of decentralised businesses are multinationals which allow regional and cultural differences to be reflected in the products they sell. Clothing retailers with operations in several countries often allow local managers to decide on the exact range of clothing to be sold in each country. It could be disastrous for a business to try to sell European winter clothes in Singapore, for example. Centralised businesses will want to maintain exactly the same image and product range in all areas. This may be because of cost savings or to retain a carefully created business identity in all markets.

> KEY CONCEPT LINK Decision-making in geographically decentralised businesses can often respond quickly and appropriately to local changes.

13.6 Line and staff management functions

Line managers are those who have authority over others in a hierarchical structure. For example, the sales director will have line authority over the sales managers for each of the different products the firm sells. Line managers carry out line functions that directly impact on the core activities of the business.

==Line managers:== managers who have direct authority over people, decisions and resources within the hierarchy of an organisation.

Staff managers do not have line authority over others. They are specialists who are employed to give advice to senior line managers. They might be economists, specialist market researchers or scientific experts advising on the environmental impact of certain products or processes. These managers carry out staff functions. They support the line managers and help the organisation by offering specialised advice and analysis.

==Staff managers:== managers who, as specialists, provide support, information and assistance to senior line managers.

There is always potential for conflict between line and staff functions. Due to their professional status and experience, staff managers can be very well paid. They are often accused of having less loyalty to the business as their services might be in great demand by a wide range of firms. This could lead to them being attracted by better rewards in other organisations. The line managers might resent experts coming into the organisation and telling them how to do their jobs. Some staff managers might have frequent access to, and communications with, the directors of the business. This can cause jealousy from line managers who do not have the same easy access to directors.

Image Image

14.1 Purposes of communication

Communication is effective only if the message has been received and understood by the receiver, and the sender knows that it has been understood. Figure 14.1 shows the key features of effective communication:

==effective communication:== the exchange of information between people or groups, with feedback.

- sender (or transmitter) of the message
- message that is clear enough for the receiver to understand it
- appropriate medium (the way in which the message is sent)
- receiver of the message
- feedback from the receiver to confirm receipt and understanding.

Figure 14.1: Effective communication – barriers must be reduced or overcome
Figure 14.1: Effective communication – barriers must be reduced or overcome

The best way to assess whether communication has been effective is if the receiver provides feedback to the sender of the message. Feedback is the response to a message by the receiver.

Situations in which communication is essential

All businesses communicate. They communicate externally with stakeholders such as suppliers, customers, shareholders, the government and other groups. Internal communication is between different people or groups within the organisation.

Effective external communication is essential for:

- Communicating with customers: for example, about new products, variations in existing products, safety warnings about products purchased, constant feedback as part of customer relationship marketing, special offers and other promotions.
- Communicating with suppliers: for example, about details of the next supply order, delivery details, discount requests, and queries about incorrect products supplied.
- Communicating with shareholders: for example, about the date of the next AGM, the latest dividend payments, the election of new directors, and the latest reports and accounts. Effective internal communication is essential for:
- Communicating with employees: for example, about employment contracts, training programmes, annual pay increases, performance appraisals, new working practices, new work schedules and workplace problems when employee input is required.
- Communicating between managers: for example, about coordinating the activities and decisions of different departments, reporting to senior management, passing decisions and instructions to subordinate managers, and giving managers an opportunity to express their opinions.

  KEY CONCEPT LINK Business communication can be to both internal and external receivers. Effective external communication to customers is essential in any business context.

14.2 Methods of communication

The choice of the method used to communicate a message will have a significant impact on its effectiveness. Whichever method is used, it is important to realise that communication can take place without a word ever being spoken. When two or more people are in the same room together, the way that one of them stands or sits, their facial expressions or their general appearance will send out messages between them. These signs of non-verbal communication allow people to form an impression about that person's role, personality, intentions or even emotional state. Although there might be no intention to communicate, people will still receive messages through these non-verbal indicators.

The range of communication methods available includes spoken, written, electronic and visual communication.

==communication methods:== the media used to communicate messages.

==visual communication:== conveying information or ideas in forms that can be seen.

Figure 14.2: Facial expressions are one form of non-verbal communication Figure 14.2: Facial expressions are one form of non-verbal communication

Spoken communication

Spoken communication can be undertaken through one-to-one conversations, interviews, appraisal sessions, group meetings or team briefings. Table 14.1 outlines its strengths and weaknesses.

==Spoken communication:== sending messages by word of mouth between two or more people.

Strengths of spoken communication

Weaknesses of spoken communication

• It allows for two-way communication and feedback, and this should encourage good motivation. Herzberg considered that frequent feedback was a powerful motivational factor.

• It is instantaneous as there is no delay between sending and receiving the message.

• Evidence of who attended a meeting and, therefore, of who received the message delivered at the meeting, can be kept for future reference.

• If any points are not made clearly, then the receiver(s) should be able to ask for immediate clarification.

• It allows the sender to reinforce the message with appropriate body language.

• Some spoken communication can be ambiguous and, in a large group, some receivers may be reluctant to ask for further detail.

• There may be no written record of what was said so the message cannot be referred to again.

• It might not be appropriate for complicated and technical matters, which would be better sent in written form.

• Spoken communication, especially on a one-to-one basis, can be time-consuming.

Table 14.1: Strengths and weaknesses of spoken communication

Written communication

Many managers still like everything to be in writing. They will, therefore, tend to use letters, memos, notices on boards, reports, minutes of meetings and diagrams for technical matters, for example, house plans. Much written communication is now sent electronically. See Table 14.2 for its strengths and weaknesses.

==written communication:== any type of message that makes use of written words.

Strengths of written communication

Weaknesses of written communication

- Written messages can be referred to more than once to aid the receiver's understanding.

- Written communication allows detailed information, figures and diagrams to be sent.

- It provides a permanent record which might be useful legally (e.g. with employment contracts).

- Non-verbal communication cannot be used to support the message.

- Written communication does not allow for immediate feedback and clarification of the message cannot be obtained quickly.

- There is evidence that the message has been sent but not that it has been received and/or understood.

Table 14.2: Strengths and weaknesses of written communication

Electronic communication

Electronic communication includes email, instant messaging, websites, blogs, text messaging, voicemail, video conferencing and video messaging. It has changed the way businesses communicate with each other and the way they communicate internally. See Table 14.3 for its strengths and weaknesses.

==Electronic communication:== sending messages using media such as computers, email or video conferencing.

Strengths of electronic communication

Weaknesses of electronic communication

- Messages are transmitted rapidly as it requires only a few seconds to communicate through electronic media.

- Global coverage is possible as the internet allows communication with, potentially, many millions of receivers all over the world.

- Once the hardware and training costs have been covered, electronic communication is low cost. It can save time and money compared to more traditional methods (e.g. SMS text messaging is cheaper than a traditional letter and a video conference can save spending thousands of dollars bringing delegates to one geographical location).

- Electronic communication allows for the instant exchange of feedback.

• It improves the flow of information for managers, enabling them to control a large, perhaps globally spread, business. This is particularly useful for multinationals.

• Most legal systems around the world now admit email as evidence and legal proof of contracts and transactions.

• Electronic communication may require employees to be trained and the young are usually much more proficient in its use than older employees.

• It reduces social contact and can create a sense of isolation. An important social need may go unsatisfied.

• Employees may use company time to send personal messages.

• Direct interpersonal contact is lost and most electronic communication does not allow the use of body language to help convey messages.

• There are security and technical issues with computer technology and hard copies of important messages are often also kept in case of a virus.

• There is increasing evidence that IT can lead to information overloadthe receipt of too much information, preventing important messages being identified and acted upon.. Too many messages, such as emails, can prevent the really important communications from being acted upon. Too many messages can cause employee stress and a feeling of overwork.

Table 14.3: Strengths and weaknesses of electronic communication

Visual communication

This form of communication makes an impact on the receiver by presenting information in a non-verbal form. This method includes maps, charts, posters, graphic design, animation, short films, diagrams, pictures, charts and other computer images. Strengths and weaknesses are outlined in Table 14.4.

Strengths of visual communication

Weaknesses of visual communication

• It is effective for receivers with poor skills in the language being used for communication, especially when exchanging information with people from several different countries.

• It supports spoken communication, which becomes more meaningful if graphs, pictures and diagrams are used with it. They can create a real impact to support the sender's message.

• It is a simple way of presenting complex information, such as an organisational chart.

• The receiver can understand messages presented in this form more quickly than if information is transmitted in pages of text.

• Visual methods of communication can be costly and time-consuming to produce (e.g. videos used in training).

• It cannot be the only method used when detailed technical data or accounting information needs to be transmitted.

• Visual methods do not allow for non-verbal communication such as body language.

• The visual images might be so dramatic that they deflect the receivers' attention away from the key message.

Table 14.4: Strengths and weaknesses of visual communication

14.3 Formal communication channels

The internal communication structure of a business can be organised in a number of different ways. These systems are called formal communication channels.

==formal communication channels:== the official communication networks and routes used within an organisation.

One-way or two-way communication

Many methods of communication do not allow for or encourage feedback from the receiver of the message. This is called one-way communication. Any form of communication which encourages feedback is referred to as two-way communication.

==one-way communication:== messages sent in one direction, from the sender to the receiver, with no feedback expected.

==two-way communication:== communication between two or more people involving the transmission of messages that encourage response and feedback.

Examples of messages using the one-way communication approach include safety notices on machinery, messages pinned on noticeboards or written instructions that need to be acted upon immediately.

Problems with one-way communication are:

- The receiver cannot question the meaning of the message or ask for further explanation.
- There is no discussion between sender and receiver.
- The sender is not sure that the message has been received, understood and acted upon.
- It is usually associated with authoritarian managers. Two-way communication allows for all of these problems to be overcome. Such communication can be either remote, via telephone or video-conferencing, or conducted

in person, such as works council meetings, team briefings or one-to-one conversations. These all allow the receiver to contribute to a debate about the message or to question the sender about it. This two-way communication can prove much more motivating because it allows for participation. Two-way communication is essential for democratic leadership to operate. It meets some of the conditions for effective employee motivation as explained by Mayo and Herzberg.

An example of a communication network that allows for two-way communication is shown in Figure 14.3.

Figure 14.3: A two-way communication network Figure 14.3: A two-way communication network

Problems with two-way communication are:

- It is time-consuming and employees may have to stop work to attend meetings.
- It may be inappropriate for some messages that give clear information that cannot be argued with and requires no discussion, such as a list of telephone extension numbers for all employees on a noticeboard. A very important issue about communication channels is how they affect employee motivation. This link can operate in two ways:
- Motivation leads to effective communication. Well-motivated employees are more likely to listen and respond positively to messages, resulting in better and more accurate two-way communication.
- Two-way communication leads to motivation. Two-way communication means employees are more likely to feel involved and receive constant feedback. Shorter communication channels reduce remoteness from the top and lead to better-motivated workers. These links are important. They could lead to a virtuous circle in an organisation. The more workers are involved and given the opportunity to participate through two-way communication and groups, then the more motivated they should become. This will increase their ability and willingness to respond positively to communication.

Vertical and horizontal communication

Messages can be transmitted in different directions within an organisation. The two most common directions used are vertical communication and horizontal communication.

==vertical communication:== when people from different levels in a hierarchy communicate with each other.

==horizontal communication:== when people on the same level of hierarchy communicate with each other.

Vertical communication is the main direction of communication in formal hierarchies. A senior manager starts the communication, which is passed to the next person on a lower level. The message is passed down the hierarchy until it is received by the final person it is intended for. A vertical communication network is shown in Figure 14.4.

Figure 14.4: The chain or vertical network Figure 14.4: The chain or vertical network

Problems with vertical communication are:

- It is nearly always down the organisation, for example from senior managers to the production employees.
- It is usually used by authoritarian managers using one-way communication.
- If there are many intermediaries in the chain, the message might become distorted.
- Messages take time to be received by the final person in the chain. However, this method does give the leader control and allows an overview, from the top of the organisation, of the communication system.

Horizontal communication occurs across an organisation, between people who have the same status but different areas of responsibility. Apart from during team meetings or committees, this type of communication is not as common as might be supposed. This is often because most line managers are concerned with their day-to-day responsibilities, which are concerned with their subordinates. There can also be a widespread feeling that meetings with equals will bring either compromise solutions or disputes over the allocation of resources.

Problems with horizontal communication are:

- Different departments may not understand the culture, ways of working, objectives, problems or technical language of the others.
- The outlook and objectives of different departments could conflict, for example, spending money on an advertising campaign that the finance department feels is unnecessary. The blinkered approach often created by hierarchical and functional organisations means that there is a lack of sympathy with the needs of other sections. The establishment of a matrix structure could help to eliminate these problems. This type of structure brings together, in a horizontal fashion, people of similar status from different departments and greatly improves the communication flows between them.

  TIP Try to link communication effectiveness with organisational structure. Traditional structures will tend to use vertical communication, while matrix structures will use horizontal communication.

TIP When discussing suitable communication methods for any business situation, try to assess which formal communication network would be most appropriate.

14.4 Barriers to effective communication

Any factor that prevents a message being received, or correctly understood, is termed a barrier to communication. These communication barriers are often a bigger problem for large businesses with operations in more than one location and with several levels of hierarchy.

==communication barriers:== reasons why communication fails.

There are three broad reasons why barriers to communication occur:

Failure in one of the stages of the communication process

- The method chosen might be inappropriate. For example, if the message contained detailed technical language and flow diagrams, trying to explain these over a mobile (cell) phone could lead to misunderstanding.
- If details of a lengthy verbal message are likely to be forgotten, then a written version would be more appropriate.
- A misleading or incomplete message will result in poor understanding, for example 'send the goods soon' may be interpreted as 'send tomorrow' when in fact the sender meant 'send now', or 'as soon as possible'.
- Excessive use of technical language or jargon may prevent the receiver from understanding what is required. Messages sent to branches or employees in another country may not be understood unless they are translated into the local language.
- If there is too much information, the threat of information overload leads to 'noise'. This is unnecessary information that actually prevents the receiver from grasping the important elements of the message.
- If the channel of communication is too long, messages are slow to reach their intended receiver and may become distorted or have their meaning changed along the way. This problem is particularly significant in large organisations with long chains of command.

Poor attitudes of senders or receivers

- If the sender is not trusted (perhaps because of previous misleading messages or unpopular decisions), then the receiver may be unwilling to listen to or read the message carefully.

- Unmotivated or alienated workers make poor receivers. If workers have never been consulted on important issues before, they may become very suspicious if the management style seems to be changing towards a more participative one. Workers with little interest in their work will not want to take the trouble to ensure that communication is effective.
- Intermediaries are people on the communication channel. Sometimes, if they are poorly motivated, they may decide not to pass on a message or to change it. This could occur, for example, if there has been a supplier query about an order or a customer complaint.
- The sender may have such a poor opinion of the receiver that no effort is made to ensure the message is clear or to check it has been understood.

Physical reasons

- Noisy factories are not the best environment for communication. This is one example of an environment that can limit effective communication.
- Geographical distance can inhibit effective communication – interpersonal communication will certainly be very difficult. Modern electronic methods, such as videoconferencing, are designed to overcome some of these problems.

Overcoming communication barriers

Management should aim to facilitate communication by minimising barriers. If managers are successful in reducing or eliminating barriers, then communication will be improved in all situations.

There are six steps managers should take to minimise the impact of communication barriers:

- Ensure the message is clear and precise, but adequately detailed.
- Keep the communication channel as short as possible.
- Make sure that the channels of communication are understood by all involved.
- Ensure feedback is part of the communication process, so that problems with receiving or understanding the message can be checked quickly.
- Establish trust between senders and receivers. This could be most easily achieved in a business where the culture is to accept that all staff are important and have useful contributions to make.
- Ensure that physical conditions are appropriate for messages to be received (or heard, in the case of oral communication).

14.5 Role of management in facilitating communication

Senior managers decide the methods and channels of communication used by a business. Management has a very important role in trying to ensure that both internal and external communications are effective. Most managers support the growing trend towards electronic media for communication. Increasingly, managers are also recognising the benefits of two-way communication, especially with employees.

The remainder of this chapter analyses other factors that managers need to consider when trying to facilitate communication.

Informal communication

Have you ever heard about important events in, or decisions about, your school or college through chatting to friends, before any official announcements? If so, you have been part of an informal communication channel. There is unofficial communication in every organisation. It takes place in the rest room, over the lunch table, in the queue next to the photocopier, or in meetings before the official agenda begins. It may be no more than gossip, but it can also be well-informed information about the organisation. In fact, much informal communication is not necessarily about work at all – it might just be social interactive chat. Some managers discourage informal communication because of its potential disadvantages. Other managers see it as a potential force for good within the business. Table 14.5 summarises the limitations and benefits of informal communication.

==informal communication:== unofficial channels of communication that exist between informal groups within an organisation.

Whatever managers might think about informal communication, they will find it very hard indeed to stop people chatting in groups or with friends at work. Communication is, after all, a natural human activity.

Limitations of informal communication

Benefits of informal communication

• It could take up valuable working time.

• If it is used to spread gossip and rumours, these can be unsettling and lead to feelings of insecurity.

• It may result in informal groups banding together to resist management decisions, even though they may not have been officially communicated yet.

• Informal communication can help create important feelings of belonging and social cohesion.

• Management can use this channel to test out new ideas and see what the unofficial reaction might be. If it is too negative, they might never make an official announcement.

• It can help to reduce barriers between departments and encourage the development of new ideas.

Table 14.5: Limitations and benefits of informal communication

How communication can impact on business efficiency

Effective external communication can impact on business efficiency in the following ways:

- Suppliers know which products to deliver and when, therefore reducing the chance of a halt in production.
- If local communities are made aware of business plans that might affect them, such as expansion, they are more likely to support them.
- Creditors (accounts payable) know when they are likely to be paid, encouraging them to supply on credit.
- Debtors (accounts receivable) know when they should pay, helping to improve liquidity.
- Investors in – and lenders to – the business will be more confident if the business keeps them regularly informed of its performance. Effective internal communication can impact on business efficiency as follows:
- It increases employee motivation and labour productivity. If workers are encouraged to participate through group discussion, then effective communication will aid motivation. Workers will feel out of touch and isolated if there is poor communication.
- More and better ideas are generated by employees. If workers are asked for their ideas, then this can assist with problem-solving.
- It increases the speed of decision-making, as up-to-date information is required for successful decisions to be made.
- It increases the speed of response-to-market changes if consumer preferences are communicated quickly to the operations department.
- It reduces the risk of errors. Incorrect understanding of a poorly expressed message will lead to incorrect responses. This could lead to many internal problems, such as the wrong products being made or incorrect prices being set.
- It improves coordination between departments, especially if horizontal communication is encouraged.

Improving communication in a given situation

Making management decisions to improve communication in a given business situation requires analysis of the following factors:

- The importance of a written record of the message that has been sent and received, such as an important new legal contract.
- The advantages from employee participation through two-way communication. For example, a new employee shift system proposal could be discussed with workers before implementation.
- Cost: electronic media often requires expensive capital resources but, once these are obtained, electronic communication is cost-effective. The cost of management time in meetings should not be overlooked. It would be quicker and cheaper, but may be less effective, to email all those at the meeting instead.
- Speed: electronic methods can be quick, but that may not be as important as allowing time for opinions to be discussed at a meeting.
- Quantity of data to be communicated – the longer and more detailed the message, the less likely it is that oral communication will be effective.
- Whether more than one method should be used for clarity to ensure that the message has been received. For example, a quick telephone call, followed up by an official letter or order form, will achieve both speed and accuracy.
- Size and geographical spread of the business – regular and frequent meetings of senior regional managers may be impossible in a multinational business.
- The actual content of the message to be communicated. For example, health and safety information will need different methods and channels to those used for communicating a proposed change in production methods. For these reasons, it is important for managers to think carefully about how messages are sent and the methods used to reduce barriers. Poor communication will lead to demotivated staff, uncoordinated departments, poor customer service, bad relations with suppliers and a lack of overall direction for the organisation. Managers have the responsibility of improving poor communication. They can do this by selecting appropriate communication methods and reducing communication barriers to a minimum.

Image Image

15.1 The purpose of leadership and qualities needed

Leadership can have a big impact on business success. It involves setting a clear direction and vision for an organisation that others will be prepared to follow. If circumstances change, a new direction and vision might be needed and then the leadership of change will be important to success.

Employees want to follow an effective leader and will respond positively to them. A poor leader often fails to win people's trust and has problems communicating with and organising workers effectively. The best managers are also good leaders of people. However, managers who focus on employee control and the allocation of resources can fail to provide a sense of purpose or focus that workers understand and are prepared to follow. Without clear and charismatic leadership, workers may be well managed, but will they be inspired to help the leader and the business take a fresh direction and achieve new goals?

What makes a good leader? Many studies have been conducted on this very point. Some argue that leaders are born with natural assets that create an aura or charisma that others find appealing. Other research is more inclined to support the view that leaders can be trained to adopt the key attributes of good leadership. (See Section 15.2 for further discussion of these theories.)

A number of personal qualities have been identified as being common among the most successful leaders:

- the desire to succeed and sufficient self-confidence that they will succeed
- the ability to be innovative and think beyond the obvious, and to encourage others to do the same
- multi-talented, so that they can understand discussions about a wide range of issues affecting their business
- an incisive mind, to identify the heart of an issue rather than unnecessary details
- being inspirational so others want to follow their example and be part of their success
- complete honesty, integrity and the highest ethical standards
- being a good communicator, so their passion and vision are transmitted to employees
- empathy and emotional intelligence, to better understand their followers. It is rare to work for people with this combination of qualities and characteristics, which is why successful leaders are so highly rewarded in our society. Different circumstances will demand different qualities, but a complete leader is one who can bring all of these characteristics into their role when the situation demands it.

Important leadership positions in business

These are the most significant leadership positions in business:

Directors

These senior managers are elected into office by shareholders in a limited company. They are usually head of a major functional department, such as marketing or finance. They are responsible for delegating tasks, assisting in the recruitment of senior employees in the department, meeting the department's objectives set by the board of directors and communicating these objectives to their department.

Managers

Any individual responsible for people, resources or decision-making – or often all three – can be termed a manager. They have some authority over other employees below them in the hierarchy. They direct, motivate, praise and, if necessary, discipline workers in their section or department.

Supervisors

These are appointed by management to watch over the work of others. This is usually not a decision-making role, but supervisors have responsibility for leading a team of people in working towards pre-set goals. The modern role of these employees is less of an inspector and much more of a work colleague who is appointed to help workers achieve objectives in a cooperative spirit.

Workers' representatives

These are elected by the workers, either as trade union officials or as representatives on works councils in order to discuss with managers areas of concern to the workers.

Informal leadership

Formal leaders or managers are appointed by the organisation to exercise authority over others. In any group of people, at work or in a social context, it is very common for informal leaders to be established. Many researchers have recognised that the impact of informal leaders can be very important for business performance.

==informal leaders:== a person who has no formal authority but has the respect of colleagues and some power over them.

Informal leaders are people who have the ability to lead without formal power, perhaps because of their experiences, personality or special knowledge. They may have more influence over workers than formal leaders, especially if the latter are just seen as supervisors of work rather than true leaders and motivators.

How should management react to these informal leaders? Appointing them as formal leaders might be a wise move. However, the person concerned could quickly lose support from workers if they were seen to be joining management on ‘the other side’. It could also be unwise for management to ignore informal leaders completely. This could lead to disruption of production, or other types of industrial action, because informal leaders tend to have loyal support from employees.

In a business where workers and employers work together in a trusting relationship, managers should attempt to work with informal leaders to help achieve the aims of the business. This is best done by trying to ensure that the informal leader supports the aims of the business. Managers would be advised not to ignore the potential influence of an informal leader or to diminish their influence either by switching them to another group or cutting them off from their colleagues.

15.2 Theories of leadership

Leadership theories are a series of connected ideas that have been proposed to explain how and why certain individuals become good leaders. The theories focus on the traits and behaviour that individuals can focus on to improve their leadership skills and abilities.

Great man (Great person) theory

The key ideas are:

- The ability to lead is inherent and cannot be taught.
- Leaders are just born with the right traits and abilities for leading: charisma, intellect, confidence, communication skills and social skills.
- Leaders are viewed as heroic, intelligent and destined to rise to leadership when the situation arises.
- The term ‘great man’ was originally used because leadership was reserved for males, particularly in terms of military leadership. In recent years, the term ‘great person’ has become more appropriate.

Trait theory

This is similar to the great person theory. It believes that people are either born with the personality characteristics (or traits) required for leadership, or they are not. Traditionally, the most determined supporters of trait theory see these leadership characteristics as innate – some people are born as future leaders due to their psychological makeup.

Some of the most common leadership traits identified by researchers are:

- initiative
- determination and energy
- good judgement and decision-making skills
- flexibility
- creativity
- charisma
- emotional intelligence
- drive and motivation to succeed
- confidence, honesty and integrity. Traditionally, the theory is used to predict whether someone will make an effective leader or not. The identified characteristics of successful leaders are compared to those of potential leaders to determine their likelihood of leading effectively.

A more modern approach is to suggest that the above traits can be possessed naturally, but that some can also be learned and developed. So, for example, flexibility and decision-making skills can be developed and built into a person's behaviour and thinking. This would improve their leadership potential. This approach led to behavioural theory.

Behavioural theory

Behavioural theory is very different from traditional trait theory. It assumes that capable leaders can learn the skills needed rather than having inherent qualities. Rather than analysing inborn traits, this theory looks at what leaders actually do by studying their behaviour in response to different situations. Leadership effectiveness is assessed by analysing a leader's actions and then recording whether this behaviour leads to success. The practical application of the theory is that a leader's behaviour affects business performance and different leadership behaviours could be appropriate at different times. The best leaders are those who can change their behaviour by choosing the most suitable style for each situation.

Behavioural theory suggests that a leader uses three sets of skills to lead their followers:

- technical skills (knowledge of the business process or technique)
- human skills (ability to interact with people)
- conceptual skills (ability to create new ideas to solve problems). This approach assumes that a particular behaviour of a manager makes them a good leader. Determining goals, motivating employees towards achieving the goals, effective communication, the ability to interact effectively and building team spirit are examples of the behaviour of a successful leader.

Contingency theory

Put simply, this theory suggests that the most successful leaders adapt their leadership style to different situations. Just because one leadership style has worked well before, does not mean that it will be effective in a different situation. It is not easy for some managers/leaders, who may be set in their ways, to adapt their style to very different situations. This is why some businesses fail to adapt quickly enough to changing circumstances.

Changing situations that can create a need for a different approach to leadership include:

- Levels of experience and maturity of the subordinates – if these are high, then a more relaxed approach to leadership should be possible.
- The relationship between leader and followers – if this is a positive one, then the leader has already established an excellent foundation for working together.
- Amount of time needed to complete the task – if time is very limited, then the leader may have to lead and direct employees more closely to ensure deadlines are met.
- The level of power of the leader's position – the higher the authority level, the greater the chance that subordinates will want to impress and perform to expectations.

Power and influence theories

These theories of leadership are based on the different ways in which leaders use power and influence to get things done. The best-known research on power as an influence on subordinates and leadership style was conducted by social psychologists John R. P. French and Bertram Raven. Their theory suggests that there are two sources of personal power:

- Expert knowledge of the leader – the greater this is, then the greater the chance that subordinates will follow their guidance.
- Charm of the leader – the greater the personal appeal of the leader, the more likely it is that subordinates will want to be led and influenced by them. In addition, the leader's formal position in the business organisation as a senior manager gives them power and influence over their followers.

Another approach to power and influence is called transactional leadership. This assumes that employees will only undertake tasks in exchange for reward. If this view is adopted by the leader, then employees should be given clear direction and managed by a system of rewards and punishments. This style is about developing tasks and creating reward systems for those who complete the tasks satisfactorily. On the other hand, if they do not achieve their targets and are underperforming, they get punished as a result. All leaders, whatever their overall style, use elements of this transactional approach on occasions – perhaps when time to deliver a project is limited and the cost of not meeting objectives is high.

Transformational leadership

This style of leadership has much greater focus on leading, rather than managing workers, which is the main feature of transactional leadership. Transformational leadership is most effective during periods of significant change for the business.

Transformational leaders attempt to change or transform the culture of the organisation to achieve improved performance. The new culture should focus on employee satisfaction, productivity and working for success through motivated employees. By concentrating on the needs of employees, the transformational leader demonstrates the importance of:

- charisma in influencing subordinates
- inspiring workers towards achieving the leader's vision
- stimulation in the working environment by offering new challenges for employees
- understanding individual needs of each team member.

Summary of leadership theories

Analysing these theories in detail might lead to some confusion over what makes a successful leader. Perhaps the key is that, to be successful, a leader should study all of the main leadership theories available. Then they can come to their own conclusions about how they, as an individual, can make people want to follow them. Above all else, leaders must lead by example, act with integrity, communicate effectively and show an understanding of other people's emotions. If these forms of behaviour can be combined with good decision-making skills and an ability to adapt to different situations, any leader has the potential to become a great leader.

> TIP When answering a question about leadership, you could try to incorporate a reference to one or more leadership theories. This would help to give your answer a clear Business focus.

15.3 Emotional intelligence

This is a relatively new area of study. Some people who are brilliant at school, with very high levels of intelligence, cannot handle people well or make social contact easily. Does being super-intelligent make a person a good manager or leader? No, not necessarily, according to many recent studies. These studies put much more emphasis on emotional intelligence (EI), which involves:

==emotional intelligence (EI):== the ability to understand one's own emotions, and those of others, to achieve better business performance.

- understanding yourself, your goals, your behaviour and your responses to people
- understanding other people and their feelings. It is argued that the more managers understand the feelings and emotions of others, the more effective they become as leaders of people and decision-makers. The more emotionally intelligent a person is, then the higher their measurable emotional quotient (EQ)will be. Many studies have suggested that business performance can be improved by appointing people with high levels of emotional intelligence, even though they may not be the brightest in traditional academic terms.

==emotional quotient (EQ):== the level of a person's emotional intelligence as recorded in a standardised test.

Goleman's competencies of emotional intelligence

Daniel Goleman is the best-known researcher into EI. He suggests that there are four main EI competencies that managers should try to develop and improve on:

- self-awareness – knowing what we feel ourselves and using that to guide decision-making, having a realistic view of our own abilities and having self-confidence in our abilities
- self-management – being able to recover quickly from stress, being trustworthy and conscientious, showing initiative and self-control
- social awareness – sensing what others are feeling, being able to take their views into account, being able to get on with a wide range of people
- social skills – handling emotions in relationships well, accurately understanding different social situations, using social skills to persuade, negotiate and lead. Can you imagine working for a manager without these emotional intelligences – or with very low levels of them? Managers with low EI would:
- attempt projects beyond their abilities but lack self-confidence that they would be able to meet the targets
- lack the trust and confidence of others and become so stressed that they would be difficult to approach
- fail to take the views of others into account when making decisions
- perform poorly in social situations, finding it difficult to talk and negotiate with others, and lacking the ability to build a team. Working with this type of manager would almost certainly lead to low levels of motivation,

achievement and performance. Such managers would, in brief, be poor leaders.

Image Image

16.1 Approaches to human resource management strategy

Developing an HRM strategy is one of the most important roles of an HR director or manager.

==HRM strategy:== a long-term plan for the management of an organisation's human resources.

All resources need to be planned for: finance, materials, business accommodation and employees. Without a long-term plan for human resources (HR), a business will almost certainly have:

- the wrong number of employees, many with inappropriate skills
- unsuitable payment methods
- inappropriate employment contracts for different types and grades of employee
- poor employee performance
- poor application of information technology (IT) to HR issues. The first two of these major planning issues were analysed in Chapters 10 and 11. This chapter analyses the other three issues.

Hard and soft human resource management

Some business analysts use the two terms hard HRM and soft HRM to define two approaches to HRM strategy.

==hard HRM:== an approach to managing employees that focuses on cutting costs.

==soft HRM:== an approach to managing employees that focuses on their development so that they reach selffulfi lment and are motivated to work hard and stay with the business.

In reality, not many businesses would use completely soft HRM or hard HRM. However, there are certainly major differences in how business managers view human resources. The hard approach is to view employees as resources just like any other business resource. According to this view, people have to be managed in a similar way to equipment and raw materials. They must be obtained as cheaply as possible, used sparingly and exploited as much as possible to keep labour costs per unit as low as possible. There is certainly little concern for a work–life balance. This approach may remind you of the Theory X view of workers (see Section 12.2) and Taylor's approach to motivation (see Section 11.3).

The soft view of human resources is that employees are an asset to the business who must be cared for and developed. As a result, employees will contribute to the success of the business in several ways, not just with their physical effort. This approach may remind you of the Theory Y view of workers (see Section 12.2) and Herzberg's views on motivation (see Section 11.3).

It may be viewed as unfair, and possibly unethical, but many businesses now adopt a hard approach to their less important or peripheral workers, compared with a soft approach to their core workers. Core workers are those that the business does not want to lose. It is argued that, as the core workers are key to the business's future success, they should be developed, trained and motivated in ways that will greatly increase the chances of them having high morale and a desire to stay with the business.

The hard approach might save money on peripheral workers' costs in the short term, but:

- It could increase recruitment and induction training costs in the long term as temporary workers have to be frequently recruited.
- Demotivated workers with little job security might be unproductive, reducing company efficiency and profitability.
- Bad publicity regarding the insecure employment contracts might lead to negative consumer and pressure-group actions against the company.
- Hard HRM ignores the research findings of Maslow, Mayo and Herzberg, as workers are not offered job security, esteem or job enrichment.

Employment contracts

It is a legal requirement in most countries for employers to provide workers with an employment contract. However, it is not a legal requirement that firms should offer jobs with full-time employment contracts or permanent employment contracts (see Table 16.1 for the advantages and disadvantages to businesses of both types of contract). Some employment contracts, especially for key employees, do offer this level of certainty.

==full-time employment contracts:== an employment contract that is for a complete working week.

==permanent employment contracts:== a contract that employs a worker unless they are dismissed, made redundant or decide to leave the organisation.

Advantages

Disadvantages

• They help satisfy employees' safety or security needs, as defined by Maslow.

• They can result in employee loyalty to the business being high and labour turnover low.

• Employers are usually prepared to finance training programmes for employees on these contracts as the workers are more likely to stay with the business.

• Labour costs become fixed costs as they cannot easily be varied with output or demand for the products of the business.

• The contracts are inflexible as they do not allow employers to vary the number of workers or the number of hours they work quickly.

Table 16.1: Advantages and disadvantages of full-time and permanent employment contracts for businesses

As a consequence of the disadvantages to business of full-time and permanent contracts, some employers have switched to employing most workers on temporary employment contracts. For example, a bank might employ a cashier on a temporary contract to cover the absence of a worker on maternity leave.

==temporary employment contracts:== the contract is only offered for a fixed period of time, such as six months. The contract can be renewed, but the employer does not have to do this

In addition, many of the workers given temporary contracts are only expected to work a proportion of the full working week. This means they have part-time employment contracts. For example, a shop may employ some part-time workers to provide additional customer service at busy periods during each day.

==part-time employment contracts:== workers are only contracted to work for a certain number of hours each week (less than the full-time working week)

An extreme form of a part-time contract is a zero-hours contract. For example, a warehouse has a problem of worker absenteeism that is difficult to predict. It recruits a number of people on zero-hours contracts. If there is no absenteeism from employed workers, there is no work for those on zero-hours contracts.

==zero-hours contract:== an employment contract that does not guarantee a minimum number of hours per week, but the worker is expected to be available for work when called by the employer

These three types of contracts are often a key feature of hard HRM. The main advantage of using them is the ability to adjust labour costs flexibly. By only employing workers and calling them in for work when they are actually required, labour costs become much more variable. Some businesses are taking this one step further. They recruit people to work on a particular contract, not as employees, but as contractors who are self-employed. Once this contract is completed there might be no further offers of work. Such offers of work are referred to as gigs and the growth of this form of contract has given rise to the gig economy.

==gig economy:== an employment mix in which temporary, flexible jobs are common and workers are hired as independent contractors or freelance employees (also called contract labour)

The advantages and disadvantages of these hard HRM employment contracts to business are summarised in Table 16.2.

Advantages

Disadvantages

• Fixed labour costs are reduced. Employees can be required to work at particularly busy times of the day or week, but not during less busy periods.

• Flexibility offers firms real competitive advantages, as they can give good customer service without substantial cost increases.

• More workers are available to be called upon should there be sickness or other causes of absenteeism.

• The efficiency of employees can be assessed before they are offered a full-time contract.

• Zero-hours contracts mean that there is no fixed cost element in a worker's pay. No guaranteed work or pay is offered and a wage is only paid if the worker is called in to work for a specified number of hours.

• One-off gig contracts for a particular job remove all employment costs other than payment for the job being performed. These workers are not employees.

• There are more employees to manage than if they were all full-time.

• Effective communication will be difficult. There are more employees in total, so it may be impossible to hold meetings with all the workers at any one time and the business will have to rely on good IT communication methods.

• Motivation levels may be low. Temporary/part-time workers can feel less involved and committed to the business than full-time workers.

• It will be more difficult to establish a teamwork culture if workers never meet because of their different working hours, or they only attend to complete their contract.

• Workers may have more than one zero-hours contract with different employers, so may not be available for work immediately.

• One-off gigs are increasingly being made illegal in some countries where workers must be offered employee status.

Table 16.2: Advantages and disadvantages of temporary, part-time, zero-hours and gig employment contracts to business

The different types of employment contracts that businesses can offer create the potential to divide workers into two broad groups. Permanent and full-time contracts could be offered to key workers that the business wants to try to keep on a long-term basis. Employees offered these contracts are often termed core workers. Part-time, temporary, zero-hours and gig contracts can then be offered to workers who perform less important tasks or to those who are relatively easy to replace if they leave. These employees are often termed peripheral workers.

Figure 16.1: Core and peripheral workers Figure 16.1: Core and peripheral workers

A way of representing this trend towards fewer core employees on permanent and salaried contracts was devised by the business writer Charles Handy. He first used the term 'Shamrock organisation', which has three components (see Figure 16.2), made up of:

- core managerial and technical employees, who must be offered full-time, permanent contracts with competitive salaries and benefits
- outsourced functions fulfilled by independent providers or gig workers, who may once have been employed by the company
- flexible workers on temporary and part-time contracts, who are called on when the situation demands their labour.

Figure 16.2: Charles Handy's 'Shamrock organisation' Figure 16.2: Charles Handy's 'Shamrock organisation'

Therefore, one of the most important differences between hard and soft HRM is the type of employment contracts that are offered. Hard HRM will mainly use temporary, part-time, zero-hours or gig contracts. Some managers believe that these contracts also offer some advantages to employees. These and possible disadvantages are summarised in Table 16.3. In contrast, soft HRM will prefer most employees to be on permanent, full-time contracts. These offer security and a greater opportunity to train and develop employees for the benefit of the business.

Advantages

Disadvantages

• Some workers prefer flexibility and some control over when to work (e.g. parents with young children, learners or elderly people who do not want to work a full week). A better work–life balance could result.

• Workers may be able to combine jobs in different businesses, giving greater variety to their working lives and wider work experience.

• Gig workers often claim they prefer the independence and control over their lives offered by this form of work.

• Two or more part-time jobs may give a similar income to a full-time one.

• Part-time pay will be less than on a full-time contract.

• Security of employment with these contracts will be less than for permanent contract workers.

• Other working conditions are often inferior to those of full-time, permanent employees (e.g. holiday entitlement or pension rights). In many countries the law does not give as many employment rights to part-time, temporary workers as to full-time workers.

• There may be fewer training opportunities than those offered to full-time/permanent workers.

Table 16.3: Advantages and disadvantages of temporary, part-time, zero-hours and gig contracts to employees

Flexible employment contracts

Flexibility is increasingly becoming a feature of employment contracts. Flexible employment contracts are not just of importance to employers, but also can have important benefits to employees.

==Flexible employment contracts:== a contract that allows employees more control over their work–life balance, including options to work from home, flexible start and finish times, to work part-time or to job share.

The nature of work is changing with increased use of IT. This is creating more opportunities for flexible working. Although unemployment is a major problem in many countries, businesses often report that they find it hard to attract and retain enough well-qualified and experienced employees. Employers are being forced to consider ways in which they can make the jobs they offer more attractive. Offering the following forms of flexibility is one way of doing this: flexitime arrangements, home working, annualised hours contracts, job sharing and compressed working hours. See Tables 16.4–16.8 for the advantages and disadvantages of each.

==flexitime arrangements:== a flexible way of working that allows employees to fit their working hours around their individual needs, and to accommodate other commitments outside of work.

==home working:== when an employee works from home, often for a specific number of days per week, but keeps contact with the office by means of modern IT communications (also referred to as teleworking).

==annualised hours contracts:== a contract offering a specific number of hours of work over the whole year, but with some flexibility about when those hours are worked.

==job sharing:== a work schedule in which two employees voluntarily share the responsibilities of one full-time job. They receive a salary and benefits on a pro-rata basis.

==compressed working hours:== the number of hours per week of a full-time job, but worked in fewer days (e.g. 4/10: working 4 days for 10 hours per day)

Benefits of flexitime

Limitations of flexitime

• The benefits to employees include: more choice over working hours; the ability to plan for other activities.

• The benefits for employers include: being able to attract well-qualified recruits; having a longer working day; improving customer service; improved workforce motivation.

• There may not be enough employees in attendance at all times so careful employee scheduling will be needed.

• Teamworking becomes more difficult.

• Holding meetings and communication become more difficult, as not all employees will be attending work at the same times.

Table 16.4: Benefits and limitations of flexitime working

Benefits of home working

Limitations of home working

• This suits many employees who have a long journey to work.

• It reduces time wasted in travel.

• It reduces business costs of accommodating all employees at one time.

• Employees can share desks or workstations, sometimes called hot-desking.

• It is easier to recruit good-quality employees.

• It can be difficult to assess employee performance when working from home.

• No face-to-face contact is possible during home working days.

• The employee has less social contact.

• Teamworking becomes more difficult.

Table 16.5: Benefits and limitations of home working

Benefits of annualised hours contracts

Limitations of annualised hours contracts

• A period of regular hours – or shifts – forms the core of the arrangement, with the remaining time left unallocated and used as and when needed.

• Offers employees more flexibility for planning other activities.

• More flexible for employers as they can call in workers as and when they are needed.

• Workers may have less freedom than intended if they can be called to work at very short notice.

• If annual hours are used up before the end of the year, high-cost overtime rates might have to be offered.

Table 16.6: Benefits and limitations of annualised hours contracts

Benefits of job sharing

Limitations of job sharing

• Employees can cover for each other in case of illness.

• Workers may be more productive (being less tired and stressed) when they do work.

• The business is able to keep two experienced employees per job role.

• Workers have greater freedom to achieve a work–life balance.

• Offers more time for family commitments.

• HR administration has to be provided for two workers rather than one.

• There may be some confusion over who does what and who is responsible and accountable.

• If the workers who are sharing a job do not trust each other, this scheme is unlikely to be successful.

Table 16.7: Benefits and limitations of job sharing

Benefits of compressed hours contracts

Limitations of compressed hours contracts

• Offers employees more opportunities for three-day weekends.

• Employees with long journeys to work may appreciate having an extra day off.

• Working parents may not be able to accommodate longer workdays.

• Some people prefer to work in shorter bursts rather than for long stretches.

• Must ensure sufficient workers are in attendance each day, which might be a problem as some days are popularly taken off as holidays.

Table 16.8: Benefits and limitations of compressed hours contracts

Shift work

Working shifts may be a contractual obligation of employees. Although shift work does offer some flexibility to both employer and employee, the main benefits are to increase output and reduce unit costs.

==shift work:== work that takes place on a schedule outside the traditional 9.00 a.m. to 5.00 p.m. day. It can involve evening or night shifts, early morning shifts and rotating shifts.

Many industries rely heavily on shift work. Millions of people work in jobs that require shift schedules – perhaps up to 20% of the world's workforce.

Benefits of shift work

- It increases the output of the business.
- It ensures expensive capital equipment is fully used, for example, on a three-shift system, equipment will be operating 24 hours a day.
- It is more flexible for business. If demand falls, one shift can be eliminated.
- Workers may be able to switch shift, so there is some flexibility.

Limitations of shift work

- Machine maintenance and repair schedules have to be built into the shift system.
- About 20% of night and rotating shift workers are thought to have a sleep disorder known as 'shift work disorder'. This can reduce productivity and cause long-term, stress-related health issues.

Measurement, causes and consequences of employee performance

The consequences of poor workforce performance can be damaging for business prospects. However, improvements in performance should be recognised and fed back to the employees. There are several indicators that HRM can use to assess the level of employee performance, including labour productivity and absenteeism.

Labour productivity

Most managers consider that labour productivity is the key test of employee performance. If output per worker increases over time, then labour productivity is increasing.

It also means that, given constant wage rates, labour costs per unit of output are falling. This is, therefore, a major factor influencing the competitiveness of a business. The calculation of labour productivity is explained in Section 23.2.

To assess employee performance, productivity results are usually compared with data from other employees, other businesses in the same industry and over time. There are several reasons why labour productivity might increase over time:

- improved employee motivation and higher levels of effort
- more efficient capital equipment, such as automated robots
- better employee training
- increased worker involvement in problem-solving to speed up methods of production
- improved operations efficiency (e.g. no waiting for new supplies of materials to arrive). Measuring productivity in service industries is usually more complex than in manufacturing or primary sector industries. Here are some examples:
- Transport industry – kilometres travelled per driver per year.
- Hotels – number of guest nights per employee per year.
- IT and banking/finance service – revenue earned on average per employee per year. It can be difficult to increase labour productivity in service industries. In the case of luxury hotels, for example, top-quality services for guests depend upon having staff permanently on call. This means, for example, that prices in the hotel industry have not fallen as they have for consumer electronics products. One way in which a hotel owner could improve labour productivity would be to use IT as much as possible in the support services of booking, billing and ordering supplies.

Absenteeism

Employee absenteeism can cause many problems for the effective operation of a business. Absenteeism rates can be calculated for the whole business or department, over a period of time.

==absenteeism:== a measure of the rate of workforce absence as a proportion of the employee total.

Absenteeism is commonly measured by this formula:

Example:

Last week a business recorded 225 days of employee absence. It employs 1 000 workers on 5-day a week full-time contracts. Total number of workdays therefore = 5 000.

Absenteeism can also be measured by expressing the average daily number of workers absent as a proportion of the number of workers. Alternatively, absenteeism can be calculated for each individual employee.

Employee absenteeism is disruptive in all businesses, especially those providing consumer services. These services cannot be held as inventory for use during periods of absence. Once a consumer has experienced poor service due to a worker being absent, that consumer may never return. It is expensive to employ extra people just to cover for absent employees or to ask other workers to work overtime.

Absenteeism rates can be an indicator of motivation. Very well-focused and motivated employees will avoid missing days off work at all costs. In contrast, it is possible that Herzberg's 'hygiene factors' of the job might contribute to high absenteeism. For instance, poor working conditions might lead to illness, or over-supervision could lead to worker stress. Days off work could be a consequence of either problem.

For absenteeism to be an effective measure of employee performance, it is important for HRM to investigate the cause of absence. If the absence results from poor health or family problems, then HRM may need to be supportive and offer appropriate help. However, if it is discovered that absenteeism results from laziness or the employee having a second job, then disciplinary action may be required.

Other measures of employee performance

There are several other measures of employee performance. Some are not applicable to all types of business activity. They include:

- wastage rates (the proportion of materials that are wasted and the proportion of total output that is damaged)
- quality levels and reject rates (proportion of output that is of unacceptable quality)
- consumer complaints as a proportion of total customers served
- comparing an individual's performance against pre-set targets (see the section on management by objectives below).

  TIP You should be prepared to comment on the likely causes and consequences of poor employee performance in the context of the business in the case study.

Strategies for improving employee performance

There is no single solution to a problem of poor employee performance. In fact, the most important first step after calculating the performance measures is to find out why performance is poor. Managers need to analyse why:

- productivity is falling or below that of competitors
- workers are taking unexplained absences

- customer complaints about poor service are increasing. There is no point in spending large amounts on modern technology to increase efficiency if the main reason for low productivity is a poorly motivated team of employees. This chapter focuses on HRM strategies to improve employee performance. Chapter 23 analyses some operations strategies to improve productivity.

The HRM strategies used by businesses to improve employee performance can be divided into 'hard' and 'soft' approaches.

Hard strategies

Hard strategies focus on warnings to employees, discipline if targets are not met and flexible contracts so that frequent 'poor performance' can easily lead to dismissal. One benefit of hard strategies is lower cost, in the short term, rather than focusing on Herzberg's motivator factors and training and developing employees. On the other hand, hard strategies are likely to lead to low motivation of employees, which could worsen performance.

Soft strategies

HRM strategies that adopt a soft approach stress the need to consider employees as a resource to be nurtured and developed. The soft HRM strategies that can be used to improve employee performance include:

- Regular performance appraisal against agreed pre-set targets with two-way discussion on how to improve performance.
- Additional training to increase efficiency, to stretch and challenge employees.
- Quality circles – small groups of workers are encouraged to take responsibility for identifying and suggesting solutions to work-related problems.
- Autonomous work groups where teams of workers are given multi-skill training and the opportunity to take responsibility for a complete section of work. Employees can take decisions on the best way for the team to achieve predetermined goals.
- Financial incentives linked to the profits of the business or an offer of a stake in the ownership of the company, such as employee share option schemes.
- Adopting a system of management by objectives (see the next section). Soft strategies to improve employee performance involve high costs of training and regular appraisal meetings. However, greater levels of motivation from these strategies should reduce absenteeism, improve punctuality and increase employees' determination to reduce waste and improve quality.

Management by objectives

Management by objectives (MBO) is a system designed to motivate and coordinate a workforce by dividing the company's overall aim into specific targets for each division, department and individual.

==Management by objectives (MBO):== establishing a management information system to compare actual performance and achievements against pre-set objectives for each department or employee.

Implementing MBO

The MBO process is best undertaken after discussion and agreement between managers and workers at each level of the organisation. This form of staff involvement is a key feature of job enrichment. It can be a very effective way of delegating authority and motivating people. This approach would be used by managers with a Theory Y approach to workers. If, however, the targets at each level were merely imposed by senior management (as with a Theory X style), then motivation would be likely to be low.

Individual targets for performance are established during the annual appraisal process. For maximum effect, these targets should be agreed with each worker and not without the employee's agreement.

For an MBO system to be effective, targets and objectives should be agreed and discussed with the managers and employees at departmental and individual levels. This form of employee participation is a key feature of job enrichment and should help provide a motivating force.

Figure 16.5: Management by objectives – how the corporate aim is divided at every level of the organisation Figure 16.5: Management by objectives – how the corporate aim is divided at every level of the organisation

Usefulness of MBO

The usefulness of MBO can be assessed by considering its benefits and limitations (see Table 16.11).

Benefits of MBO

Limitations of MBO

Each manager and subordinate will know exactly what they have to do. This will help them prioritise their time. It will also enable them to see the importance of what they do to the whole organisation and should lead to increased productivity.

By using the corporate aim and objectives as the key focus of all departmental and individual objectives, everyone should be working to the same overall target. This will avoid conflict and should ensure a consistent and well-coordinated approach.

Objectives act as a control device. By setting targets agreed with the people who have the authority to reach them, managers are able to monitor everyone's performance and measure success or failure.

The process of dividing the corporate aim and corporate objectives into divisional, departmental and individual targets can be very time-consuming, especially as this is best performed only after full consultation with those most affected.

Objectives can become outdated very quickly and fixing targets and monitoring progress against them can be less than useful if the economic or competitive environment has changed completely.

Setting targets does not guarantee success. Issues such as adequate resources and employee training must also be addressed if the original targets are to have any real meaning or act as true motivating goals.

Table 16.11: Benefits and limitations of MBO

16.2 The changing role of IT and AI in HRM

Some uses of IT in HRM are very common and have been in use for many years. They include:

- keeping employee records on databases
- recording flexible work schedules on planning software, so all workers have access to information on when they are expected at work
- holiday planning on similar software, so workers can enter their preferred annual holiday dates.

Recent IT applications in HRM

- Recruitment: web portals allow employers to post details of vacant positions and the qualifications and experience required of applicants. These portals make e-recruitment visual, allowing job applicants to post videos describing their main skills as well as showcasing their potential. Many workers are now recruited through social networks such as Facebook. When a business posts a job position on its Facebook page, any follower can apply if they qualify for that position.
- Training and development: Training programmes can be uploaded on IT, such as essential induction training programmes. They can be viewed by employees as many times as needed. Illustrations and demonstrations can be included to aid understanding. Assessment techniques can be incorporated, allowing employees to check their understanding and progress on the training course.

- Employee performance management: computerised performance management software allows regular recording and updating of employee performance. Managers can see easily how much work is being accomplished by each employee in a given time period. The software helps in the flow of information about employee performance across the business. This should be shared with employees and can help improve their performance.

  KEY CONCEPT LINK As with all innovations in business, it is important to consider the business context before managers decide to make the changes needed to introduce new technology.

The future of IT and AI in HRM

The IT opportunities appear to be almost limitless. The use of AI, which learns how to perform tasks that usually need human intelligence, is particularly likely to transform HRM within the next 20 years. Here are just a few ways in which IT and AI will impact on HRM in the years to come:

- Although AI is not currently extensively used to interview candidates, it can read hundreds of job applicants' details very rapidly. It can then evaluate these candidates without human bias or error. It can record and analyse thousands of possible replies to standard interview questions. These replies are then classified according to applicant type. Appropriate follow-up questions can then be asked, based on previous answers.
- Many companies are adding chatbots to their HRM systems to provide answers to employees' questions. Common questions related to pay, holiday entitlements, social benefits and employees' rights can be answered by computer software. Answering these questions in person can be both repetitive and time-consuming. Using a chatbot allows HR personnel to focus on responding to more complex and urgent employee issues.
- Virtual reality (VR) is breaking away from its computer gaming image and is being used to develop realistic and interactive training courses. The idea of building new worlds can be applied to training situations as well as gaming. For example, a VR simulation of an air emergency could be used to train airline cabin crew. The benefits of developing VR training programmes include the costs saved in trainers' time and the space needed for training.
- Biometric time clocks use biological markers to identify employees. Popular methods of biometric time-tracking include fingerprint scanning and facial recognition. They can identify which employees are present at work, what time they arrive and what time they leave. They prevent unauthorised people entering business premises, for example stopping employees from allowing friends or relatives to check in for work and claim wages on their behalf. Biometric technology can also automatically cut off employee access to computer systems once the employee has checked out and left

the workplace.

Evaluation of increased use of IT in HRM

- The use of IT frees up HRM time for more important strategic issues.
- It can reduce social and personal contact between HRM and employees and make the HR managers seem remote.
- The increased dependence on IT-based communication methods reduces the opportunity for two-way group discussions unless conferencing software is used.
- There is a risk of creating a sense of being watched and monitored at all times amongst employees.

  TIP At A Level you will not be asked detailed questions about IT software or AI applications. You should be aware of the potential these developments might have to HRM. In particular, you should be prepared to evaluate the benefits and limitations of these developments.

Image Image

17.1 Role of marketing

Most people think of marketing as being about the advertising and selling of products. This is a very limited view. Marketing is much more than just telling people about a product and selling it to them. There are thousands of definitions of marketing. One of the shortest and clearest is from the Chartered Institute of Marketing:

==marketing:== the management task of identifying and meeting the needs of customers profitably by getting the right product at the right price to the right place at the right time.

Another definition comes from Contemporary Marketing Wired, by Boone and Kurtz:

Marketing involves a number of related management functions, including:

- market research
- product design and packaging design
- pricing, advertising and distribution
- customer service. Marketing is a very important business activity. It links the business to the customer. It aims to identify the particular wants and needs of customers in a target market. Marketing managers then try to satisfy those customer needs more effectively than competitors. This

means that market research is needed to identify and analyse customer needs. With research results, strategic decisions can then be taken about product design, pricing, promotion and distribution.

Marketing objectives and corporate objectives

The 'McDonald's Marketing in Malaysia' case above provides an example of a clear marketing objective. Other examples of marketing objectives include a measurable increase in:

- the share of the market, perhaps to gain market leadership
- total sales (value or volume, or both)
- average number of items purchased per customer visit
- frequency of shopping by loyal customers
- percentage of customers who return (customer loyalty)
- number of new customers
- customer satisfaction
- brand identity. To be effective, marketing objectives should:
- be linked to corporate objectiveswell-defined and realistic goals that are set for the whole company. and be focused on helping the business achieve those overall targets
- be determined by senior management, because the key marketing objectives will impact on the markets and products a business trades in for years to come
- be realistic, motivating, achievable, measurable and clearly communicated to other departments. Why are marketing objectives important?
- They provide a sense of focused direction for the marketing department and help the business to achieve its overall corporate objectives.
- Business success can be measured against the targets set by the objectives.
- Marketing objectives can be broken down into regional and product sales targets.
- Marketing objectives form the basis of marketing strategya plan of action giving details of how a business intends to achieve its marketing objectives by creating competitive advantage.. Marketing objectives will impact on the marketing strategies adopted. It is necessary to have a clear vision of the business's objectives in order to discuss how marketing decisions can help to achieve them. Examples of marketing strategies include:

Coordination of marketing with other departments

Marketing objectives and marketing decisions cannot be set or taken in isolation from the rest of the business. There must be coordination between all departments. For example, if a marketing objective of increasing sales by 10% has been set, the marketing department will need to coordinate with the following departments:

Finance

- The finance department will use the sales forecasts of the marketing department to help construct cash flow forecasts and operational budgets.
- The finance department will have to ensure that the necessary capital is available to pay for the agreed marketing budget for promotional expenditure.

Human resources

- Sales forecasts will be used by human resources to help prepare a workforce plan. For example, additional workers will be needed in sales teams and production to increase sales.
- Human resources must ensure the recruitment and selection of qualified and experienced workers. There must be sufficient workers to produce and sell the increased number of products planned by the marketing department.

Operations

- Market research data will play a key role in new product development.
- The operations department will use sales forecasts to plan the capacity needed, the purchase of the machines that will be used and the raw material inventories required for the higher output level.

17.2 Demand and supply

Meeting consumer wants profitably means that marketing managers need to know how markets operate in determining prices. If the business can produce the product at a cost below this market price, it should be profitable. In free markets, the equilibrium price is determined when demand equals supply. Demand and supply analysis explains this relationship.

==equilibrium price:== the price level at which demand is equal to supply.

==Demand:== the quantity of a product that consumers are willing and able to buy at a given price in a specific time period.

==supply:== the quantity of a product that firms are prepared to supply at a given price in a specific time period.

Demand

1. Demand varies with price. For all normal goods, the quantity bought rises with a price fall and falls with a price increase. This is shown by a typical demand curve (see Figure 17.2).

Figure 17.2: The normal relationship between price and demand for a product
Figure 17.2: The normal relationship between price and demand for a product

2. Apart from price changes, the level of demand for a product can change as a result of a change in any of the following factors:
3. All of these changes can result in a new demand curve. For example, Figure 17.3 shows that the demand for holidays increases to D2 after an increase in consumer incomes.

Figure 17.3: Demand curve, D2, shows a demand increase for holidays after consumer incomes rise Figure 17.3: Demand curve, D2, shows a demand increase for holidays after consumer incomes rise

Supply

1. Supply varies with price. Businesses will be more willing to supply more of a product if the price rises and will supply fewer/less of a product as the price falls. This is shown by a typical supply curve (see Figure 17.4).

Figure 17.4: Supply increases when the price rises Figure 17.4: Supply increases when the price rises

2. Apart from changes in price, the level of supply of a product can vary due to a change in any of the following factors:
3. All of these changes can result in a new supply curve. For example, Figure 17.5 shows the supply of rice will fall to S2 after poor weather in the major growing areas.

Figure 17.5: Demand curve, S2, shows the supply of rice falls after a bad harvest
Figure 17.5: Demand curve, S2, shows the supply of rice falls after a bad harvest

Determining the equilibrium price

Demand and supply can be shown on the same diagram. The price level at which demand equals supply is called the equilibrium price (see Figure 17.6).

Figure 17.6: Equilibrium price is at the point where demand equals supply (the point at which the demand and supply curves intersect) Figure 17.6: Equilibrium price is at the point where demand equals supply (the point at which the demand and supply curves intersect)

If the price is higher than the equilibrium price, there will be unsold inventory – excess supply. Suppliers do not want unsold products. They will lower the price. If the price is lower than the equilibrium price, then inventories will run out, leaving excess demand. Suppliers could make a higher profit by raising the price to the equilibrium level.

17.3 Markets

Markets are where buyers and sellers meet to engage in exchange. The daily or weekly fruit and vegetable market is one example of this. Shopping centres and auctions are other examples of markets. Increasingly, a market does not have to be in a physical place in the sense of a geographical location. Online auctions now mean that a market can exist electronically with no physical meeting between buyer and seller.

The term 'market' also refers to the group of customers who are interested in a product and have the resources to purchase. This understanding of the term 'market' can be broken down into:

- The potential market for a product, which is the total population interested in the product.
- The target market, which is the market segmenta subgroup of a whole market in which consumers have similar characteristics. of the total available market that the business has decided to direct its product towards.

Industrial markets and consumer markets

An industrial market deals with products bought by businesses. These include specialist industrial machines, trucks and office supplies. A consumer market deals with products bought by the final users of the products. These include mobile phones, holidays and fashion clothing. The different approaches that might be needed to sell in industrial markets and consumer markets are examined in Section 17.4.

==industrial market:== the selling of products by businesses to other businesses, also known as business to business or B2B.

==consumer market:== the selling of products by businesses to the final end user, also known as business to consumer or B2C.

Local, national and international markets

Some businesses just sell in local areas to local customers. They only operate in the local market. Examples of such businesses include laundries, florist shops, hairdressers and car repair garages.

Some businesses expand their operations to the national market, selling their products to customers throughout the whole country. This gives greater potential to increase sales compared to local markets. Relatively few businesses, compared to the thousands that operate just in local markets, will expand to selling in the national market. Common examples include banks, supermarket chains and large clothing retailers.

Selling to the international market offers the greatest sales potential. The rapid rise of multinationals that operate and sell in many different national markets illustrates the sales potential from exploiting international markets. Expanding into foreign markets is a significant strategic decision. Many aspects of marketing will have to change in order to respond to the wide range of tastes, cultures and laws in different countries. (See more detail in Chapter 22.)

Customer (or market) orientation and product orientation

Important distinctions can be made between businesses which focus on customer orientation and those which focus on product orientation.

==customer orientation:== an outward-looking approach that bases product decisions on consumer demand, as established by market research.

==product orientation:== an inward-looking approach that focuses on making products that can be made – or have been made for a long time – and then trying to sell them.

Customer orientation requires market research and market analysis to measure present and future demand. Customers and their needs come first. The business will attempt to produce what consumers want to buy. This approach has important advantages, especially in fast-changing, volatile consumer markets. As consumers now have increasing awareness of competitors' products and prices, they must be offered products they really want to buy. The benefits of customer orientation are:

- The chances of newly developed products failing in the market are reduced. Effective market research helps to prevent product failures. With the huge cost of developing new products, such as cars or computers, most businesses use the customer-oriented approach to reduce the risk of failure.
- Products based on consumers' needs will have a longer lifespan and be more profitable than those that are sold using a product-led approach.
- Market research never ends. Constant feedback from customers will allow the product and the method of marketing it to be adapted to changing tastes before competitors get there first. Traditional product-oriented businesses, which assume there will always be a market for the products they make, are fast disappearing. However, product-led marketing still exists to a limited extent:

- Product-oriented businesses invent and develop products as they believe that they will find consumers to purchase them. Pure research into technical innovations without consumer research is rare but still exists. This is true in the pharmaceutical and electronic industries, for example. Dyson's investment in bagless vacuum cleaners is also a good example. There is still the belief that if a business produces an innovative product of a good enough quality, then it will be purchased.
- Product-oriented businesses concentrate their efforts on efficiently producing high-quality goods. They believe quality will be valued above market fashion. Such quality-driven firms do still exist, especially in product areas where quality or safety is of great importance, such as in the manufacture of advanced medical equipment or crash helmets.

Evaluating the difference between customer and product orientation

The trend is towards customer orientation, but there are limitations to this approach. Frequently updating market research can be expensive. Also, if a business tried to respond to every passing consumer trend or market fashion, then it may waste its resources and end up not doing anything particularly well. It is expensive for a business to offer sufficient choice and range to meet every consumer need. In contrast, product orientation, researching and developing a truly innovative product, can lead to high sales and profit, even if there has been no formal market research. Facebook is a good example.

Not all customer-oriented businesses will succeed. Market research and identifying consumer needs are not a guarantee of business success. The new products developed in this way may come to market too late or fail to match competing products. Success and survival in the competitive and globalised markets of the twenty-first century depend upon the whole marketing process not just market research.

Market share and market growth

The market size can be measured in two ways: by the quantity of sales (units sold) or by the value of products sold (revenue) by all businesses in the market over a given time period. Market size is important for three reasons:

==market size:== the total value (or quantity) of sales of all producers within a market in a given time period.

- It allows a marketing manager to assess whether a market is worth entering or not.
- It allows a business to calculate its own share of the market.
- The growth or decline of the market over time can be identified.

Market growth

Some markets are obviously growing faster than others and some are declining rapidly. Sales of desktop computers, for example, have fallen greatly in recent years. Is it better to be operating in a rapidly growing market? In most cases, yes, but not always. There might be many competitors entering the market at the same time, so market share and profit margins might be low.

The rate of market growth depends on several factors:

==market growth:== the percentage change in the total size of a market (volume or value) over a period of time.

- a country's rate of economic growth
- changes in consumer incomes
- development of new markets and products that reduce sales in existing markets and products
- changes in consumer tastes
- technological change, which can boost market sales following a new innovation
- whether the market is saturated because most consumers already own the product.

Implications of a change in market growth

There are several consequences to a business from a change in market growth. These are summarised in Table 17.1.

Increased market growth

Reduced market growth

• Sales will increase if the business's market share remains the same.

• It may be possible to increase prices and profit per unit.

• Increased sales could lead to cost savings (see Section 26.2).

• More businesses might be attracted to the market, increasing the level of competition.

• Sales will increase more slowly even if the business's market share remains the same.

• Competitors might reduce prices to increase sales in a slow-growing (or shrinking) market.

• Lower prices might result in lower profit per unit.

• Businesses might consider expanding into faster-growing markets (e.g. in other countries).

Table 17.1: Implications of changes in market growth

> TIP You may need to do some simple calculations to work out market growth and market share. It is a good idea to use a calculator to help you.

Market share

Market share, and increases in it, is an effective way to measure the relative success of one business's marketing strategy against those of its competitors. Market share is calculated by using the following formula:

market share=sales of the business in time periodtotal market sales in time period×100

If the market share of a business is increasing, then the marketing of its products has been more successful relative to most of its competitors. The product with the highest market share is called the brand leader.

==brand leader:== the brand with the highest share of the market.

Implications of an increase in market share

- Sales are rising faster than those of competing businesses in the same market and this could also lead to higher profits.
- Retailers will be keen to stock and promote the best-selling brands. These brands may be given the most prominent position in shops.
- The business producing the brand leader may be able to reduce the discount rate to retailers (for example, 10% instead of 15%), below that offered by the smaller, competing brands. The combination of this factor and the higher sales level should lead to higher profitability for the producer of the leading brand.
- The fact that an item or brand is the market leader can be used in advertising and other promotional material. Consumers are often keen to buy the most popular brands.

Implications of a fall in market share

- Sales are likely to fall unless there is rapid market growth.
- Retailers will be less keen to stock and promote the product.
- Larger discounts to retailers might have to be offered.
- The product may no longer be a brand leader, so promotions will not be able to state this. It is not always easy to measure market growth or

market share in an unambiguous way. Different results may be obtained depending on whether the growth and share rates are measured in volume or value terms. For example, if total sales in the market for jeans rose from 24 million pairs at an average price of $32 to 26 million pairs at an average price of $36, then market growth could be measured in two ways:

- By volume – the market rose from 24 to 26 million units, an increase of 8.33%.
- By value – the revenue rose from $768 million to $936 million, an increase of 21.88%. Which of these two methods (value or volume) should be used to calculate the changing market share for any one jeans manufacturer? Any manufacturer will use the measure that reflects best on their own position. It may, therefore, be difficult to compare changes in market share for different firms. A cosmetics company that specialises in selling low volumes of expensive products is likely to have a higher market share in value terms than when measured by volume.

  TIP You may need to make clear that the market share of a product can fall even though its sales are rising. This will happen if market growth is at a higher rate than sales growth of the business that sells the product.

17.4 Consumer marketing (B2C) and industrial marketing (B2B)

The differences between selling to consumers and selling to other businesses start with the type of products.

Classification of products

A general distinction can be made between goods and services produced for sale to individuals and households (consumer products) and those produced for industrial use (industrial products).

==consumer products:== goods or services sold to end users.

==industrial products:== goods or services sold to businesses.

Consumer products are often classified into:

- convenience products – purchased frequently, often bought on impulse and sold to a large target market (e.g. sweets, soft drinks)
- shopping products – usually require some planning and research by consumers before being purchased; consumers do not buy these frequently (e.g. washing machines)

- speciality products – bought infrequently, often expensive and with strong brand loyalty (e.g. cars and designer clothing). Industrial products are often classified into:
- materials and components – needed for production to take place (e.g. steel and electric motors for washing machines)
- capital items – equipment, machinery and vehicles (e.g. lathes, IT systems and industrial buildings)
- services and supplies – business services and utilities (e.g. power supplies and IT support/maintenance). The key differences between selling to businesses rather than consumers are:
- Most industrial products, such as equipment for power stations, are much more complex than many consumer products so specialist sales employees and support services will be more important with B2B selling.
- Industrial buyers often have much more market power and are better informed than the average consumer. They need to be sold products by well-trained and experienced sales employees.
- Industrial buyers will rarely buy on impulse. They will only purchase after long consideration and detailed analysis of alternative products. A business selling B2B needs to keep in regular contact with industrial customers.
- Traditional mass media advertising and sales promotion techniques are not used in most industrial markets. Selling can be via trade fairs or direct contact with industrial buyers, often, initially, via websites.
- Mass marketing in consumer markets is a common strategy but in most industrial markets there are relatively few buyers. Products may need to be adapted to meet the needs of a particular business buyer. An example of this would be a specialist elevator system for a very tall hotel building.

Figure 17.8: Marketing power station equipment is not the same as marketing chocolate bars Figure 17.8: Marketing power station equipment is not the same as marketing chocolate bars

17.5 Mass marketing and niche marketing

These are two different approaches to marketing strategy: mass marketing and niche marketing. The key distinguishing features of each type of market are outlined below.

==mass marketing:== selling standardised products or ranges of products in the same way to the whole market.

==niche marketing:== identifying and exploiting a small segment of a larger market by developing differentiated products to suit that segment.

Mass market

- This large market is made up of customers who are willing to purchase a standardised product (undifferentiated product).
- High sales levels allow for high levels of production.
- Low price is often a key element in selling the product. Mass marketing focuses on selling the same standardised product (or range of products) to the whole market. As consumer incomes rise and consumers develop more individual needs, mass marketing is becoming less frequently used. However, in the markets for cola drinks, toothpaste and washing-up liquid, for example, mass marketing can still be observed.

Niche market

- Customers want to buy differentiated products.
- Size of a niche market is often small.
- Market research is often necessary to establish customers' special needs. Niche marketing is often focused on a very small section of the total market. The niche might be one that has not yet been identified and filled by competitors. Examples of firms employing niche marketing include Versace designs and Clinique perfumes. Both these businesses sell only expensive, high-status products. Other niche markets exist for non-luxury products too, such as extreme sports clothing, and $-stretcher retail shops that sell only very cheap items, attracting a low-income segment of the market.

Advantages and disadvantages of mass and niche marketing

Both of these strategies have their advantages and disadvantages (see Tables 17.2 and 17.3).

Advantages of mass marketing

Disadvantages of mass marketing

• A mass-market strategy with high sales of a standard product can lead to lower average costs of production.

• Cost advantages can lead to lower prices to consumers which help to reinforce the position of the product in the market.

• Mass marketing can result in extensive publicity for the business and its product leading to clear brand identity.

• Lack of differentiated products and differentiated marketing does not appeal to many consumers.

• The focus on low prices does not help to establish a premium brand image for the product.

• Technological or other changes could lead to a fall in demand for the standardised product. Overdependence on this product is therefore a risky strategy.

Table 17.2: Advantages and disadvantages of mass marketing

Advantages of niche marketing

Disadvantages of niche marketing

• By using niche marketing, small businesses can survive and thrive in markets that are dominated by larger firms.

• An unexploited niche has no competitors. Selling to this niche offers the chance to sell at high prices and high profit margins until competitors react by entering too. Consumers will often pay more for an exclusive product.

• Niche market products and exclusive marketing can be used by large firms to create status and image. Their mass-market products may lack these qualities.

• Small market niches do not allow economies of scale to be achieved.

• There is limited scope for business growth if the niche market has few customers.

• The business is vulnerable to market changes if it only operates in one niche market. This makes it a risky strategy.

• If selling in a niche market is profitable, this is likely to attract competitors. This could lead to lower prices and profitability.

Table 17.3: Advantages and disadvantages of niche marketing

17.6 Market segmentation

Market segmentation is customer focused, so it is consistent with the concept of customer orientation. Sometimes segmentation is referred to as differentiated marketing. The aim is not to sell just one product to the whole market, but different products are targeted at different segments. For market segmentation to be successful, businesses must research the total market carefully. This allows them to identify the specific consumer groups that exist within the market.

==Market segmentation:== the identification of different groups of customers with common needs within a market and the marketing of different products or services to those customer groups.

Examples of market segmentation include:

- Hewlett-Packard and other computer manufacturers produce PCs for office and home use, including games, but also make laptop models for business people who travel.
- Coca-Cola makes the standard cola drink for the mass market but also Diet Coke for weight-conscious consumers and other flavoured drinks for consumers with different tastes.
- India's Tata Motors produces the Tata Ace, a mini-truck used by farmers. It markets the Buzzard car to middle-class consumers and the Yodha van to commercial customers. It offers a range of luxury Jaguar cars to the high-income segment. Tata creates the impression that there is something for everyone in its huge product range. Sometimes, firms only market their goods or services to one segment and do not aim to satisfy other segments. Abercrombie & Fitch is a clothing retailer that only targets the youth market, Nike targets sports and leisure use, and Coutts & Co. only offers banking services to the very wealthy. These businesses deliberately concentrate on only one segment and focus on developing an image and a brand that suit that segment.

Figure 17.9: Tata Motors offers different types of vehicle to various market segments Figure 17.9: Tata Motors offers different types of vehicle to various market segments

Methods of market segmentation

Successful segmentation requires a business to have a clear analysis of the consumers in its target market. The aim is to build a picture of the typical consumer and their key characteristics. This consumer profile helps with market research sampling, and designing, pricing and promoting the product. The main characteristics of consumers in a consumer profile are income levels, age, gender, social class and region.

==consumer profile:== a quantified picture of a business's consumers, showing data about their age groups, income levels, location, gender and social class.

Total markets may be segmented in a number of different ways. The three commonly used methods of segmentation are geographic, demographic and psychographic.

Geographic differences

Consumer tastes often vary between different geographic areas. These might result from cultural, social and climatic differences. Many businesses therefore offer different products and market them in location-specific ways. For example, a heating and refrigeration business will need to market different products to Malaysia compared with Finland.

A geographic segmentation approach is the opposite of adopting the same marketing strategy for the whole area or region. This is sometimes referred to, for example, as pan-Asian or pan-European marketing. It will be ineffective if there are great differences in consumer preferences in different geographical areas.

The way in which products are promoted may have to be adjusted for different geographic locations too. Competitions or lottery-type promotions are illegal in some countries. Advertising jeans or ice cream with pictures of models on a beach would not be tolerated in some communities. Even product names must be changed to suit the language of the country.

As in so many other aspects of marketing, accurate and detailed market research is essential before entering international markets.

Demographic differences

Demography is the study of population data and trends, and demographic factors, such as age, gender, income, family size, social class and ethnic background, can all be used to segment the market. For example, a construction business will use information on these factors to help identify the appropriate market segment for a new block of apartments. Should they build retirement flats with a resident caretaker? Should they build small studio flats for young single people? Should they offer interconnecting doors and walkways to attract extended families to the apartments? It is unlikely that the construction firm will attempt to attract all market segments but, having decided on the most appropriate one, it will need to adapt the price and promotion strategies towards this segment.

Income and social class are important demographic factors that identify socioeconomic groups and can be used to segment the market. An individual's occupation tends to determine their social class and will have an impact on their income level. The main socioeconomic groups that are commonly referred to are:

A – higher managerial, administrative and professional personnel, for example directors of big companies and successful lawyers

B – managerial staff, including professionals such as teachers

C1 – supervisory, clerical or junior managerial staff

C2 – skilled manual workers

D – semi-skilled and unskilled manual workers

E – casual, part-time workers and the unemployed.

The jobs people do are one of the main factors influencing their income levels. An individual's social class and income level may have a great impact on their spending patterns. High-income earners in professional jobs will have very different consumption patterns from low-income manual workers. Powerboating and golfing are just two activities that are associated with consumers in high-income, professional occupations.

Many marketing acronyms have been created to act as abbreviations for different demographic groups of consumers. Here are just a few:

- DINKY – double income no kids yet
- NILK – no income lots of kids
- WOOF – well-off older folk.

Psychographic factors

These factors are to do with differences between people's lifestyles, personalities, values and attitudes. Many are influenced by an individual's social class. For example, many middle-class families spend considerable sums of money on private education for their children. This might not be such a priority for other social classes or groups.

Attitudes towards ethical business practices, such as Fairtrade products, are very strong among some consumers. This explains the development of marketing towards these groups. Similarly, the increasing interest in organic foods shows how common values and opinions can also be used to group consumers in a useful way.

Lifestyle is a very broad term that often relates to people's opinions, interests and choice of leisure activities. Increasing concern amongst some consumer groups about health and fitness has led to significant increases in private gym membership.

Personality characteristics are difficult to measure or define, but they do influence consumption decisions. Many businesses, particularly in their advertising, attempt to appeal to consumers who share certain personality characteristics. Products such as activity holidays are aimed at outgoing people who wish to pursue relatively dangerous sports. These include mountain trekking, bungee jumping and whitewater rafting.

Advantages and disadvantages of market segmentation

Advantages of market segmentation

Disadvantages of market segmentation

• Businesses can define their target market precisely, and design and produce goods that are specifically aimed at these groups, leading to increased sales.

• It enables identification of gaps in the market and groups of consumers that are not currently being targeted, which might then be successfully exploited.

• Differentiated marketing strategies can be focused on different target markets. This avoids wasting money on trying to sell products to the whole market. Some consumer groups will have no intention of buying the product.

• Small firms that are unable to compete in the whole market are able to specialise in one or two market segments.

• Price discrimination between consumer groups can be used to increase revenue and profits (see Section 19.4).

• Research and development and production costs might be high as a result of needing to make and market different product variations.

• Promotional costs might be high as different advertisements and promotions might be needed for different segments. Marketing economies of scale may not be fully exploited.

• Production and inventory holding costs will be higher than for producing and selling just one undifferentiated product.

• By focusing on one or two limited market segments, excessive specialisation could lead to problems if consumers in those segments change their purchasing habits significantly.

• Extensive market research is needed to identify market segments and their needs.

Table 17.4: Advantages and disadvantages of market segmentation

17.7 Customer relationship marketing

The objective of customer relationship marketing (CRM) is to develop customer loyalty to ensure that customers buy from the business in the future. Studies have shown that it can cost between four and ten times as much to gain new customers (with expensive promotions) as it does to keep existing ones. CRM also makes sense for another reason. If a business can secure the loyalty of many customers, it means that there will be fewer customers buying products from competitors.

==customer relationship marketing (CRM):== using marketing activities to build and establish good customer relationships so that the loyalty of existing customers can be maintained.

At the heart of CRM is communication with the customer to gain information. The aim is to gain as much information as possible about each existing customer. This includes income, product preferences, buying habits and so on. Using this information, marketing tactics can then be adapted to meet the customer's needs. This is virtually segmenting each customer and is the complete opposite of mass marketing. Now that technology has made the collection of customer data so much easier and cheaper, CRM is becoming a widely adopted marketing strategy.

Developing effective long-term relationships can be achieved by:

- Targeted marketing – giving each customer the products and services they have indicated, from records of past purchases, that they most need.
- Customer service and support – after-sales service and effective call centres are good examples of the support essential to building customer loyalty.
- Communicate regularly with customers – to give frequent updates on new products / special offers / new features / new promotions and support services.
- Using social media – some CRM systems use social media sites to track and communicate with customers. Feedback management software platforms, such as Confirmit and Satmetrix, combine a company's internal survey data with trends identified through social media. This allows businesses to make more accurate decisions about which products to supply to satisfy customers' needs.

Costs and benefits of CRM

The costs and benefits of CRM need to be considered before a business adopts this strategy (see Table 17.5).

Costs of CRM

Benefits of CRM

• IT systems and software are needed and employees need to be trained to respond to customer feedback.

• Effective CRM campaigns may require the use of an external marketing consultancy at high cost.

• CRM needs an existing customer base to be established first before investing in CRM. If this is not done, the costs will not lead to higher sales.

• It may be costly to respond to each customer's feedback, especially if it contains special requests or requirements.

• For businesses with an existing customer base, CRM has proved to be cost-effective. Higher sales from effective CRM nearly always exceed its cost.

• It is a sustainable strategy creating long-term customers unlike 'special price offers' or similar promotions.

• Loyal customers often recommend the business to friends and family, providing additional marketing benefit at no cost.

• It costs less per customer than trying to attract new customers.

Table 17.5: Costs and benefits of CRM

> Innovation in CRM is proving to be a very effective marketing strategy for businesses such as Zara.

Image Image

18.1 Market research

Market research is a broad and far-reaching process. The data collected from this research impacts on most business decisions. Market research is not aimed at just finding out whether consumers will buy a particular product or not. It is also used to establish the characteristics of customers, what products they buy and why they buy them.

Market research can be used to measure customer reactions to:

- new products
- different price levels
- alternative forms of promotion
- new types of packaging
- online distribution.

The purposes of market research

Businesses undertake market research for a range of reasons, as outlined below.

Identify the main features of the market

Before entering a new market, a business will need to establish some of its key features:

- Overall size – is it worthwhile for the business to be entering this market?
- Growth – is the market becoming bigger or smaller in terms of sales?
- Competitors – how many other businesses sell in this market and how much market power do they have?

Reduce the risks of new product launches

Launching new products is risky and expensive. Failure to meet sales targets can prove damaging to a business. Researching potential demand for a new product allows a business to assess its likely chances of success. Although no research can be 100% accurate, testing the likely sales success of proposed new products is the most important purpose of market research. Table 18.1 explains how new product development (NPD) is supported by market research.

NPD process	Market research linked to it
identify consumer needs and tastes	primary and secondary research into consumer needs and competitors
product idea and packaging design	testing the product and packaging with consumer groups
brand positioning and testing of advertising	pre-testing the product image and advertisements
product launch and after-launch period	monitoring sales and consumer response

Table 18.1: Summary of how market research supports NPD

Identify consumer characteristics

It is important to establish who the consumers of a product are likely to be, their wants and needs. By being aware of the profile of potential consumers, products can be targeted at the appropriate market sector, based on factors such as age range, income level and social class.

Explain patterns in sales of existing products and market trends

Market research needs to be conducted for existing products as well as new ones. Sales at the fashion retailer Gap fell by 4% in 2019. This was despite global clothing sales increasing. Gap used market research to analyse the causes of this decline in sales. This data was used in the company's promotions to try to reverse the sales trend.

Predict future demand changes

Demand levels for existing products may change. Unless a business tries to forecast these changes with market research, it may overproduce or underproduce a product. For example, a travel firm will want to investigate social and income changes to see how these might affect the demand for holidays in the future.

Assess the most popular designs, promotions, styles and packaging for a product

Consumer testing of products, or the promotions used to sell them, is constantly undertaken by some businesses. Different versions of a product or potential new advertisements need to be consumer-tested before a final decision is made on them. Consumer responses can then be incorporated into the final product.

KEY CONCEPT LINK Market research is clearly an important element of developing a new marketing strategy in an existing business. New enterprises should also undertake market research as the data collected will form an important part of the business plan.

18.2 Primary research and secondary research

Selecting appropriate sources of market data and methods of data collection requires an understanding of the relative usefulness of primary research methods and secondary research methods.

==primary research:== the collection of first-hand data that is directly related to the needs of the business.

==secondary research:== the use of existing data that was originally collected for another purpose.

The differences between primary and secondary research

Primary research is the first-hand collection of data by an organisation for its own needs. In contrast, secondary research is the use and analysis of data that already exists. Secondary research data was originally collected by another organisation, often for a different purpose. The main sources of secondary data are outlined in Table 18.2.

Perhaps surprisingly, when a business is considering entering a new market or launching a new product, it will often undertake secondary research first, for these reasons:

- It is lower cost and obtainable more quickly than primary data.
- It can be used to assess the main features of a market. If this appears too small or has too many competitors, it might not be worthwhile proceeding with primary research. If the results of secondary research are positive, then a detailed programme of primary data collection is likely to be paid for. (See Activity 18.2.)

Activity 18.2 demonstrates that more detailed information about the food market in Trinidad and Tobago is needed before final decisions are taken by the food exporter. The secondary data has outlined the key features of the market and its structure. Other data collection methods will now have to be used.

Usefulness of secondary research data

Secondary research data can be very useful:

- It can provide information about the population, the economy, the market conditions that a business operates in or plans to operate in and major trends in that market.

- It can help identify the key areas of market information that primary research needs to focus on.
- It provides evidence that can be used as a baseline against which primary research data can be compared.
- Large samples are often used, which increases accuracy and reliability.
- Many of the sources of secondary data can be accessed via the internet.
- If time or finance is very limited, secondary research might be the only option.
- There is so much of this data, which opens up new business possibilities if it is analysed carefully. 'Big data' is a term used to describe the vast amounts of publicly available data on websites, social media posts, retail purchase records and healthcare records.
- There are many sources of secondary data, which allows information from one source to be checked against another for accuracy. (See Table 18.2.)

Main sources of secondary data

Details

Government (e.g. population censuses; vehicle registrations; social trends; family expenditure patterns).

• These are usually available for free on the internet.

• They may be several years out of date (e.g. population census is not annual).

Local government (e.g. number of local households; occupations; ethnic origins of local population).

• These are usually available for free on the internet.

• They may be several years out of date (e.g. population census is not annual).

Trade organisations often produce industry-specific publications, for example in the hotel and car retailing industries.

• These are not always available for free.

• Membership of the trade organisation may be needed to obtain detailed data.

Market research agencies (e.g. Mintel; Euromonitor) produce detailed market intelligence reports.

• These are often very expensive.

• They are not usually updated annually.

Internal company records are low cost and immediately available.

• Secondary data exists within any business. This can include customer sales records, feedback from customers, daily sales figures etc.

Company reports and accounts (e.g. competitors' end of year accounts).

• These allow analysis of competitor performance.

• Detailed, confidential information is not available from this source.

Table 18.2: Main sources of secondary research data

There are also limitations to the usefulness of secondary research data:

- Data may be out of date as not all sources update every year. This could lead to inaccurate conclusions based on old data.
- Data is unlikely to have been collected for the specific needs of the business. It might not be directly relevant or may not use the population samples that the business really wants.
- Not all secondary data is available to all potential users. Even if it is available, it can be expensive to obtain, for example, from market research agencies.
- Secondary data might indicate the potential for a new market, but primary research will be needed to gather specific information for potential consumer profiles and their product preferences.
- Big data is so vast that it is not easy to analyse and to make useful for an individual business. Data analysis businesses will do this, but at a high cost.

Usefulness of primary research data

Primary research data is most useful in the following situations:

- To find out about completely new markets, for example, for innovative products for which no secondary data exists.
- To collect data for the specific purposes of the business. The information gathered will provide direct answers to the questions the business is asking.
- To gather qualitative datanon-numerical data, which provides insight into the detailed motivations of consumers and helps to explain their buying behaviour or opinions. which supports and helps to explain quantitative datanumerical results from research that can be statistically analysed.. For example, if a business has falling sales in one market, it can question consumers about why they have changed their buying patterns.
- To focus research on market reaction to specific changes made by the business, such as lower prices or increased advertising.
- To gain information from a particular target group of consumers.
- When up-to-date data is essential, such as in rapidly changing markets.

- When data needs to be cross checked for accuracy – different methods of primary data collection allow for results to be verified and for different types of information to be gathered. (See Table 18.3.)

Figure 18.2: Focus groups provide useful feedback from consumers Figure 18.2: Focus groups provide useful feedback from consumers

Primary data collection method

Details

Questionnaire – postal, in-store, online, mobile (cell) phone

Questionnaires can include detailed, open questions which give qualitative and quantitative data.

Interview – face to face or mobile (cell) phone

Interviews allow personal contact with respondents. Follow-up questions can be asked.

Observation (e.g. in a large shop to see which displays and promotions attract shoppers)

If people know they are being observed, they could behave differently.

Test marketing – in a specific geographical area

The results might indicate whether the national launch of a new product will achieve sales targets.

Focus groups – discussions with potential or existing consumers, with the aim of gaining qualitative data

Focus groups encourage debate between consumers about a product or advertisement. Discussion is observed and recorded.

Table 18.3: Primary data collection methods

There are also limitations to the usefulness of primary research data:

- The selection of a sufficiently large and representative sample greatly influences the accuracy of data.
- Business start-ups may not be able to finance detailed primary research.
- Newly formed businesses have no customers yet to gain important data from.
- It can be time-consuming to collect and analyse primary research data.

Market research developments

Businesses are increasingly using electronic means to gather the data needed before deciding on their marketing strategies. Questionnaires can be sent out, answered and returned via tablets and mobile (cell) phones.

Businesses can also access the vast quantity of information that electronic data retrieval methods offer them. This is particularly true of retailers such as supermarkets that operate loyalty card schemes. By collecting data on the number and type of goods bought by each consumer, retailers can have a complete picture of what each consumer purchases, how often they buy, each consumer's age, gender and possibly their income (via the details initially provided to obtain the loyalty card). This allows retailers to target each consumer with advertisements and special offers about the goods they are most interested in. This form of targeted marketing is cost-effective. Money is not wasted on promoting products that consumers are not interested in.

Social media platforms are also transforming market research. Specially developed software makes use of social media, chat apps and behavioural data. It combines this data with software that learns to understand a respondent's thoughts, ideas and emotions. Inputs take the form of videos, images, text and sound, so that behavioural and emotional research reaches an advanced level.

Online marketing allows firms to conduct research projects for just a few thousand dollars, taking advantage of pre-prepared questionnaires, with the results coming in within a few days. Giving people the opportunity to respond conveniently by using their mobile (cell) phones increases the chance that they will respond to a survey request – especially if it is on a freephone number. A mobile (cell) phone survey can use pre-recorded messages and questions to which people respond by using numbers on the keypad or speaking the answers. These results are then automatically presented and analysed electronically.

Some forms of market research are becoming cheaper and more accessible to businesses of all sizes. However, questions still have to be asked: Is it worth the cost? Is it cost-effective? These can really only be fully answered after the research has been gathered, analysed and used in management decisions. The evidence is, however, that well-designed and focused market research pays for itself in higher sales and profits. International business managers think so too. In 2019, global spending on market research increased by over 5% to US$82 billion.

18.3 Sampling

Sampling is very commonly used in market research when collecting primary data.

==Sampling:== the process of selecting a group of respondents from a larger population.

The need for sampling

In nearly all market research situations, it is impossible to seek evidence from the total population – that is, the total potential target market. This is either because that market is so extensive that contacting everyone in it would be too expensive or time-consuming, or because it is impossible to identify everyone in that market. Therefore, a sample of the total potential market will need to be chosen. The larger the sample, the more representative of the total population it is likely to be. Greater confidence can then be placed in the final results.

==sample:== a group of people taking part in a market research survey selected to be representative of the overall target market.

Limitations of sampling

There are several limitations when sampling for market research.

Sample may be too small

To save on costs, a very small sample might be researched. This is likely to be too small to represent a true cross-section of the whole target population.

In researching consumer reaction to a new advertising campaign for a major brand of chocolate, a sample of ten people is unlikely to be sufficient. The first ten people chosen might show a positive reaction to the new advertisement. Yet another group of ten might show a majority with negative reactions. A sample of ten is too small to be confident about the result. Chance variations could easily occur because of the limited number of respondents chosen. A sample of 100 or even 1 000 will produce results that will reflect more accurately the preferences of the whole target population. There will be much less risk of pure chance distorting the results. A sample of 1 000 will give more accurate results than one of 100, especially if the questions are being focused on particular age or income groups. Once a sample of 100 has been broken down into, say, ten different age groups, then there will only be ten respondents from each age group. This could be too few.

What prevents all primary research from being based on a sample size of 1 000? Cost and time are the two major constraints. The cost of research increases greatly with the sample size, especially when a specialist firm of market research analysts is used. The results of a survey might be needed quickly to assist managers in making rapid decisions, but a sample size of 1 000 will take much longer to organise. Cost-effectiveness is an important consideration in market research.

Risk of sampling bias

The only really accurate method of primary research is to ask the entire target population, but this is expensive and time-consuming. Results from a sample may be different from those that would have been obtained if the whole target population had been questioned. This is called sampling bias. The less representative the sample, the greater the statistical bias that will exist. Therefore, no one can be 100% confident that sample results are ever really accurate. Statisticians often aim to achieve a 95% confidence level in their results, which means that the results can be relied upon in 19 cases out of 20. Generally, the larger the sample size, the greater the chance that this 95% confidence level will be met.

==sampling bias:== when a sample is not a good representation of the whole population, because it is chosen in ways which give some people a greater chance of being selected.

Researchers may not use the most appropriate methods of sampling

Researchers need to know the best and most statistically accurate methods of selecting samples. If only convenience sampling is used (i.e. asking those people who are most conveniently and easily contactable), the research results are most unlikely to be accurate.

18.4 Market research data

Once research has been completed, it needs to be analysed in ways that make it useful to business decision-makers. Three issues need to be considered: reliability of the data, analysis of the data and interpretation of the information.

Reliability of data collected

Unfortunately, primary data and secondary data can be unreliable and a poor basis for decisions. Secondary data can be unreliable because of the limitations already referred to: it may be out of date, not specific to the needs of the business, incomplete or unavailable.

There are three main reasons why primary data may be unreliable:

- Sampling bias: See Section 18.3.
- Questionnaire bias: This may occur when questions tend to lead respondents towards one particular answer. Because of this, the results are not a completely accurate reflection of how people act or of what they believe. An example of a leading question could be: 'Which of the following factors best explains why you prefer Chocko bars to other manufacturers' chocolate bars?' The question already assumes that the respondent prefers Chocko bars.
- Other forms of bias: These might include the respondent not answering in a very truthful way, perhaps because they do not want to admit to spending so much on music downloads or clothes.

Analysis of quantitative data

Interpreting and analysing quantitative or numerical data can start with an attempt to identify key features of the data. For example, Table 18.4 contains the results of two small market research surveys. These were conducted to find out more about the number of hours per week radio listeners tuned in to one particular radio station. One survey was taken last year and one this year.

This data is currently in its raw form. It has not been ordered, presented or analysed in any way to aid its interpretation by the user. In this raw form, the data makes little sense and is of no value. This section will show how numerical data might be analysed using basic statistical techniques. The data will then be in a form that will allow for further analysis, which can aid decision-making.

Number of hours per week

Last year

1, 5, 10, 15, 3, 6.5, 6, 4, 7.5, 16, 12, 4, 0, 2, 20, 18, 12, 10, 11, 10

This year

15, 12, 4, 5, 12, 6, 0, 2, 3, 10, 7, 8, 3, 12, 22, 18, 20, 14, 11, 8

Table 18.4: Number of hours per week respondents listened to the radio station

Averages

An average is a frequently used measure of a set of data. Averages tell us something about the central tendency of data. There are several different types of average that can be calculated from any set of data. The three most frequently used are:

- the arithmetic meanthe value calculated by totalling all the results and dividing by the number of results., often abbreviated to just 'the mean'
- the modethe value that occurs most frequently in a set of data.
- the medianthe value of the middle item when data has been ordered or ranked. It divides the data into two equal parts.. Arithmetic mean

The mean of the 'Last year' results in Table 18.4 is 173/20 = 8.65 hours, while the mean of the 'This year' results is 192/20 = 9.6 hours. The mean number of hours per week spent listening to the station increased from 8.65 to 9.6 hours. However, this was using a very small sample, which needs a word of caution. Any calculation from a set of data is only as accurate as the data gathered and, as was seen above, a small sample may give misleading results.

Mode

To identify the mode, the data should be put into ascending or descending order. Then values that recur will be immediately obvious. Table 18.5 shows the data from Table 18.4 put into ascending order.

Number of hours per week

Last year

0, 1, 2, 3, 4, 4, 5, 6, 6.5, 7.5, 10, 10, 10, 11, 12, 12, 15, 16, 18, 20

This year

0, 2, 3, 3, 4, 5, 6, 7, 8, 8, 10, 11, 12, 12, 12, 14, 15, 18, 20, 22

Table 18.5: Research data in ascending order

The mode in each case is clearly visible (see the bold type):

- 10 hours was the most frequently occurring length of listening time last year.
- 12 hours was the most frequently occurring response this year. The mode can be of limited value. It would be wrong to assume from the results above that the average listening time had increased by two hours. The mode is also meaningless where the data contains results that only occur once (that is, when there is no most frequently occurring item).

In other cases, when analysed together with the mean, the mode can help to give a clear picture of the overall central tendency, or average, of the results. It is of use in some instances. For example, where colour or size is the basis of choice, the frequency of occurrence is likely to influence inventory holding choices, as with clothing.

Median

The median is the middle item in a range of ordered data. The median item may be identified by using the following formula when the number of values is an odd number:

median=number of values + 12

If the number of values is 15, then 15 + 1 divided by 2 gives the eighth value as the median item.

When there is an even number of values, the mean of the middle two results will give the most accurate measure of the median.

In the ‘Last year’ data in Table 18.5, the median will be the mean of the 10th and 11th results, that is, 7.5 and 10. The median is the mean of these two results, which is 8.75 hours.

An evaluation of the three average measures is shown in Table 18.6.

Average measure

Uses

Advantages

Disadvantages

Mean

• Used as an indicator of likely sales levels per period of time. This could be used to help determine re-order levels.

• Used for making comparisons between sets of data such as attendance at football clubs.

• Includes all of the data in its calculation.

• The most well-known average; it is widely used and easily understood.

• Affected by one or two extreme results.

• Usually not a whole number. If the mean size of shoes sold by a shoe retailer is 6.38, is this useful for making inventory-holding decisions?

Mode

• Could be used for inventory ordering purposes (e.g. a shoe shop would order more pairs of size 7 shoes than any other size if this is the modal size).

• It is easily observed and no calculation is necessary.

• The result is a whole number and easily understood.

• It does not consider all of the data, therefore it cannot be used for further statistical analysis.

• There may be more than one modal result, which could cause confusion.

Median

• Could be used in wage negotiations (e.g. 'Half of union members earn less than $50 per week').

• Often used in advertising (e.g. 'our products are always in the best-performing 50% of all brands').

• It is less influenced by extreme results than the mean. So, it is more appropriate than the mean when there are a few very high or very low results.

• Calculation from grouped data is complicated.

• An even number of results means the value is approximated.

• It cannot be used for further statistical analysis.

Table 18.6: Evaluation of the three average measures

Measures of dispersion or spread of data

Two sets of examination results gave similar arithmetic mean results. Paper 1 had a mean of 52% and Paper 2 had a mean of 54%. Joe gained identical results, 45%, on both papers. Yet he was much more pleased with his result on Paper 1 than on Paper 2. Why might this be?

Consider the following distribution:

- Paper 1: top mark 83%, lowest mark 14%
- Paper 2: top mark 60%, lowest mark 43%. By knowing the spread of results, Joe was able to conclude that he had been much nearer to the lowest mark in Paper 2 than in Paper 1.

To see the significance of this we have to examine the spread (dispersion) of data. This can be done in a number of ways. The easiest to understand is called the range.

==range:== the difference between the highest and lowest value.

The range

The range is the easiest and most widely used measure of data dispersion. The formula used is:

In Paper 1, the range was 83% – 14% = 69%. In Paper 2, the range was 60% – 43% = 17%.

The main problem with this measure is that it can be distorted by extreme results. A particularly brilliant learner may have gained 83% on Paper 1, significantly higher than the other results, and this would give a much higher range than if that learner's results were not included. In ranges of this kind, it is sometimes useful to exclude the highest and the lowest result.

Analysis of qualitative data

Qualitative research aims to understand why consumers behave in a certain way or how consumers might react to the launch of a new product. The answers to qualitative research are based on opinions, attitudes and beliefs. For that reason, qualitative data cannot be analysed using statistical techniques.

Qualitative research can produce very useful insights into customer needs and wants. It can provide answers to questions such as:

- Why are consumers not buying this product?
- What features of this product do consumers find most appealing? The answers to these and other questions must be carefully recorded. They should be categorised into types of response and this process is called coding.

==coding:== the process of labelling and organising qualitative data to identify the main themes and the links between them.

This process assigns labels to key words or phrases used by consumers during the research process. These might include 'good value', 'branding' or 'low prices'. These responses can then be matched against other data such as consumers' ages or income levels to establish key relationships. Analysing these relationships, for example between 'branding' and high-income consumers, will help a business to plan marketing strategies.

Interpretation of information presented in tables, charts and graphs

New research data can be presented in various ways that make the information easier to understand for decision-makers. Research data might be presented in many forms, including:

- Tables: allow easy reference to the data and can be used to present a mass of data in a precise way.
- Pie graphs(or pie charts): are used where data needs to be presented so that the proportions of different sets of data in relation to the total are clearly shown (see Figure 18.4). Each section of the 'pie' shows how relatively significant that part of the data is compared to the whole. Pie graphs allow easy comparison between two sets of results to see if the proportions have changed. The size of each section is determined by the angle at the centre of the circle. This is calculated in the following way:
- Line graphs: are most commonly used for showing changes in a variable, such as sales, over time in time series graphs (see Figure 18.5). The line graph allows easy reference to trends in the data and shows up seasonal or other fluctuations clearly.
- Bar charts: use bands of equal width but of varying length or height to represent relative values (see Figure 18.3). They allow easy comparison over time or between different items.

  TIP You will not be asked to construct the above forms of data presentation, but you will be expected to understand data presented in these forms.

Image Image

19.1 The elements of the marketing mix

The marketing mix is a range of tactical decisions for marketing a product. Deciding on the appropriate marketing mix is a major factor in influencing whether a business can sell its products profitably. This is the most common aim of marketing departments.

==marketing mix:== the four key decisions on product, price, promotion and place that must be taken to enable the effective marketing of a product.

The marketing mix is made up of four interrelated decisions, often called the 4Ps. These are product design and performance, price, promotion (including advertising) and place (where and how a product will be sold to consumers).

- Product. Consumers require the right product. This might be an existing product, an update to an existing product or a newly developed one.
- Price. The right price is important too. If the price is set too low, then consumers might lose confidence in the product's quality. If the price is set too high, then many consumers will be unable or unwilling to afford it.
- Promotion must be effective, telling consumers about the product's availability and convincing them, if possible, that the brand is the one to choose.
- Place refers to how the product is distributed to the consumer through distribution channels. If the good or service is not available at the right time in the right place, even the best product in the world will not be bought in the quantities expected. Not all of the 4Ps have the same degree of significance in every case. It is vital that these elements fit together into a consistent integrated plan. The remainder of this chapter and Chapter 20 analyse the significance of each of these four marketing elements in detail and consider the options available to marketing managers.

Some analysts consider that there are more than four Ps. For example, it is argued that in marketing services rather than tangible goods, people (skilled and motivated staff) and process (the way in which the customer accesses the service) are just as important as the original 4Ps.

The key issue about the marketing mix, no matter how many Ps it might contain, is that the marketing decisions are interrelated. This means that they must be carefully coordinated to make sure that customers are not confused by conflicting messages about the good or service being sold.

19.2 Product: why is this a key part of the marketing mix?

It is sometimes said that, 'You can sell any product to consumers once, but to establish loyalty and good customer relationships, the product must be right.' Some products fail to meet customer expectations regarding quality, durability, performance and appearance. This means that no matter how low the price or how much is spent on advertising, the product will not sell successfully in the long term.

What is meant by the term 'product'?

The term 'product' includes consumer and industrial goods and services.

==goods:== products which have a physical existence, such as washing machines and chocolate bars.

==services:== products which have no physical existence, but satisfy consumer needs in other ways, such as hairdressing, car repairs, childminding and banking.

Tangible and intangible attributes of products

Why do consumers pay more for a well-known brand of aspirin than a generic, non-branded, cheaper alternative? What do advertisers mean when they state, 'This model of car is the most luxurious in its class'? Consumer decisions are not always easy to weigh up or explain, which makes market research less accurate. However, marketing managers should try to understand what intangible attributes (features) customers are looking for when making their purchasing decisions, as well as the tangible attributes, such as the colour of a car or the size of its engine. Meeting customers' intangible expectations for a product is most commonly achieved by effective branding.

==brand:== an identifying symbol, name, image or trademark that distinguishes a product from its competitors.

==intangible attributes:== the subjective opinions of customers about a product, which cannot be measured or compared easily.

==tangible attributes:== the measurable features of a product, which can be easily compared with other products.

The importance of product development

New product development (NPD) is crucial to the success of some businesses, for example, in the rapidly changing world of computer games. In other markets, it is possible to sell the same product for many years or to adjust and adapt it slightly to meet changing tastes and to enter new segments. One example of new product development is Pepsi NEXT, a new low-calorie soft drink from Pepsi.

==New product development (NPD):== the design, creation and marketing of new goods and services.

Why is new product development so important? There are seven possible reasons:

- Changing consumer tastes and preferences. For example, the trend towards home cinemas means that a TV manufacturer has to consider developing new products in this market segment to remain competitive.
- Increasing competition. Apple started the smartphone revolution, yet it cannot stand still as competition is greater than ever in this market. The iPhone 11 Pro had just been launched when this book was written. What is the latest version now?
- Technological advancement. It took Dyson 15 years, with thousands of failed attempts, to make a bagless vacuum cleaner operate successfully.

Now all vacuum manufacturers have adopted similar technology.

- New opportunities for growth. If the existing markets a business operates in are mature and no longer growing, then developing products for new markets is essential for further growth. IKEA now offers complete kitchen design and installation services. The demand for its traditional flatpack furniture is now only growing slowly.
- Risk diversification. Climate change pressure groups are succeeding in forcing governments to place limits on carbon emissions. Oil and gas companies are investing in new forms of renewable energies to create sources of revenue and profit to address the risk of falling demand for oil.
- Improved brand image. For example, by developing the Lexus brand of luxury cars, Toyota has taken the strategic move to improve the overall image of the company.
- Use of excess capacity. For example, hotels increasingly offer spa and beauty treatments to increase demand for empty hotel rooms (excess capacity). For a new product to succeed, it must:
- have desirable features that consumers are prepared to pay for
- be sufficiently different from other products to make it stand out and offer a unique selling point (USP)the special feature of a product that makes it different from competitors' products.
- be marketed effectively to consumers, who need to be informed about it. There are several general categories of new products. These include completely novel ideas that create new products (e.g. the original smartphones), some products that are new for the company launching them (e.g. Sony's decision to enter the games console market) and some that are new to a particular market (e.g. exporting IKEA furniture to Brunei for the first time).

Product differentiation and unique selling point (USP)

The most successful new products are those that are differentiated from competitors' products and offer something special. Product differentiation can be an effective way of distancing a business from its rivals and creating competitive advantage. Effective product differentiation creates a USP.

==Product differentiation:== the unique qualities of a product that lead to a difference between the product and competitors' products.

Examples of effective USPs include:

- Domino's pizza deliveries: 'It arrives in 30 minutes or it's free.'
- Dyson vacuum cleaners: '100% suction, 100% of the time from bagless technology.'

- Mast Brothers Chocolate: ‘Every bar of chocolate is handmade from purchasing the cacao beans directly from growers.’ The benefits of an effective USP include:
- promotion that focuses on the differentiating feature of the product or service
- opportunities to charge higher prices due to exclusive and unique features, design or customer service – higher prices should lead to higher profit margins
- free publicity from media reporting on the USP of the product
- higher sales compared to undifferentiated products
- customers being more willing to be identified with the brand because it is different.

Figure 19.2: Innovative new products give Dyson a competitive advantage Figure 19.2: Innovative new products give Dyson a competitive advantage

Products and brands

Mobile phones are an example of a product, but Huawei is an example of a brand. What is the difference? The product is the general term used to describe the nature of what is being sold. The brand is the distinguishing name or symbol that is used to differentiate one manufacturer’s products from another. Branding can have real influence on marketing. It can create a powerful image or perception in the minds of consumers – either negative or positive – and it can give the products a unique identity.

Extension: Positioning a new product

Before deciding on which product to develop and launch, businesses analyse how the new brand will relate to the other brands in the market, in the minds of consumers. This is called product positioning, and it is done using techniques such as market mapping.

==product positioning:== consumers’ view of a product or service as compared to its competitors.

The first stage of product positioning is to identify the features of this type of product that have been shown by research to be important to consumers. These key features might be price, quality of materials, perceived image, level of comfort offered (e.g. in hotels) and so on. They will be different for each product category.

Figures 19.3 and 19.4 illustrate the main cola products of the Coca-Cola Company and PepsiCo, and consumers’ perceptions of each brand. The estimated product positioning chart (Figure 19.4) uses the two criteria:

- male/female consumers
- sugar level/calories. It suggests that there might be a market gap for a soft drink with high calories aimed at female consumers. However, neither company is aiming new products at this sector. Can you suggest why not?

PepsiCo's new soft drink, Pepsi NEXT, is looking to break into the market made up of people who want to drink real-tasting cola but prefer mid-calories instead of zero-calories. Coca-Cola's C2 is operating in the same area, with half the carbohydrates, sugars and calories compared to standard Coke.

Figure 19.3: Coca-Cola and Pepsi brand comparison chart Figure 19.3: Coca-Cola and Pepsi brand comparison chart

Figure 19.4: Coca-Cola and Pepsi sugar/calories comparison chart Figure 19.4: Coca-Cola and Pepsi sugar/calories comparison chart

19.3 Product portfolio analysis

Knowing when to launch a new product or to update an existing one can give a business a crucial advantage. Product portfolio analysis helps when making these decisions. The two product portfolio analysis techniques to be considered are:

==Product portfolio analysis:== analysing the range of existing products of a business to help allocate resources effectively between them.

- product life cycle
- Boston Matrix analysis.

Product life cycle

Allowing existing models of cars or cell phones to remain in the market when other businesses are introducing attractive new or restyled ones is a classic business error that has led to many failures. An awareness of the product life cycle can assist greatly in dealing with this problem. The life cycle of a product records the sales of that product over time. It is one of the main forms of product portfolio analysis.

==product life cycle:== the pattern of sales for a product from launch to withdrawal from the market.

There are several stages in a product's life cycle, as shown in Figure 19.5.

Figure 19.5: Product life cycle – the length of each stage will vary from product to product Figure 19.5: Product life cycle – the length of each stage will vary from product to product

The significance of each stage in the product life cycle:

- Introduction: This is when the product has just been launched after development and testing. Sales are often quite low to begin with and may increase only quite slowly. But there are exceptions, such as a newly launched music download by a global rock star.
- Growth: If the product is effectively promoted and well received by customers, then sales should grow. This stage cannot last forever. Eventually, sales growth will begin to slow. The slowing down of sales growth may take days, weeks or even years. This leads the product into the next stage. The reasons for growth slowing or sales falling include increasing competition, technological changes making the product less appealing, changes in consumer tastes and saturation of the market.
- Maturity or saturation: At this stage, sales fail to grow, but they do not decline significantly either. This stage can last for years, as for example with Coca-Cola. The saturation of the consumer durablesa manufactured product that can be re-used and is expected to have a reasonably long life, such as a car or washing machine. market is caused by most consumers having already bought the particular product they want. The best recent example is mobile (cell) phones. Although the world market has grown phenomenally in recent years, sales growth has slowed dramatically and analysts forecast it will end altogether. This is explained by the high proportion of the world's consumers who already possess a mobile phone. It is only when their mobile phone breaks down or is replaced by newer technology that consumers will buy a new one. This is why all phone companies are working so hard on the next generation of mobile phones (5G and beyond) to make existing models obsolete.
- Decline: During this phase, sales will decline steadily. Either no extension strategya marketing plan to extend the maturity stage of the product before a completely new one is launched. has been tried or it has not worked, or else the product is so obsolete that the only option is replacement. Newer products from competitors are the most likely cause of declining sales and profits. When the product becomes unprofitable or when its replacement is ready for the market, it will be withdrawn.

Extension strategies

These strategies aim to lengthen the life of an existing product before the market demands a completely new product. Examples of extension strategies include selling in new markets (export markets, for example), repackaging and relaunching the product, or finding new uses for the product. For example, the VW Golf Mark 7 car was refreshed in 2017 with new colours and new interior trim. This extended the life of the model before it was replaced in 2020 with the Mark 8 (see Figure 19.6).

Figure 19.6: Product life cycle – showing the effect of extension strategies Figure 19.6: Product life cycle – showing the effect of extension strategies

Impact of the product life cycle on marketing decisions

The life cycle concept has two specific marketing uses: assisting with planning marketing-mix decisions and achieving a balanced product portfolio.

Assisting with marketing-mix decisions

- At which stage of the cycle would you advise a business to lower the price of its product?
- In which stage is advertising likely to be most important?
- When should variations be made to the product? Although there are no definite and unchanging answers to these questions, there are likely to be common links between the phases of the life cycle and marketing-mix decisions. Table 19.1 outlines these links. However, the final decisions about changing the 4Ps will also depend on competitors' actions, the state of the economy and the marketing objectives of the business.

Product life cycle stage

Price

Promotion

Place (distribution)

Product

Introduction

• May be high (skimming) or low (penetration) compared to competitors' prices.

• High levels of informative advertising are needed to make consumers aware of the product's arrival on the market.

• In restricted outlets, possibly high-class outlets if a skimming strategy is adopted.

• Basic model with few variations.

Growth

• If successful, an initial penetration pricing strategy could now lead to rising prices.

• Consumers need encouraging to make repeat purchases and branding will help win consumer loyalty.

• In growing numbers of outlets in areas indicated by the strength of consumer demand.

• Product improvements and developments to maintain consumer appeal.

Maturity

• As competitors enter the market, prices for the product need to stay at competitive levels.

• Brand imaging continues to stress the positive differences compared to competitors' products.

• Highest geographical spread possible, including new distribution channels.

• New models, colours, accessories as part of extension strategies.

Decline

• Lower prices may be needed to sell off inventory, but if the product has a small niche following, prices could even rise.

• Advertising is likely to be very limited and may just be used to inform of lower prices.

• Unprofitable outlets for the product are eliminated.

• Slowly withdraw product from certain markets and prepare to launch new products.

Table 19.1: The marketing mix and phases of the product life cycle

Identifying the need for a balanced product portfolio

Look at Figure 19.7. It shows an ideal position for a business to be in. As one product declines, so other products are being developed and introduced to take its place. Cash flow should be reasonably balanced, as there are products at every stage and the positive cash flows of the successful products can be used to finance the cash deficits of others. Factory capacity should be kept at roughly constant levels as declining output of some goods is replaced by increasing demand for the recently introduced products. This is known as a balanced portfolio.

Figure 19.7: A balanced portfolio of products Figure 19.7: A balanced portfolio of products

Limitations of using the product life cycle for marketing decisions

The product life cycle is based on past or current data and cannot be used to predict the future. Just because a product's sales grew over the past few months, does not mean that they will continue to grow until a long period of maturity is reached. Sales could crash very quickly, giving no chance to use an extension strategy. Think of all the fashions that died out – such as platform shoes or flared jeans – and then made a comeback. In contrast, sales of other products can, against all predictions, grow and grow.

The usefulness of the product life cycle analysis is increased if it is analysed together with the Boston Matrix, sales forecasts and management experience to assist with effective marketing decision-making.

==Boston Matrix:== a method of analysing the product portfolio of a business in terms of market share and market growth.

Figure 19.8: Changing fashions can explain declining sales: when do you think this photograph was taken? Figure 19.8: Changing fashions can explain declining sales: when do you think this photograph was taken?

Boston Matrix analysis

This method of analysing the market standing of a firm's products and the product portfolio of a business was developed by the Boston Consulting Group. It highlights the position of the products of a business when measured by market share and market growth (see Figure 19.9).

Figure 19.9: The Boston Matrix Figure 19.9: The Boston Matrix

The Boston Matrix allows an analysis, not only of the existing product portfolio, but also of what future marketing strategies the business could take next. The size of each circle on the matrix represents the total revenue earned by each product. The four sectors created by the matrix can be analysed in the following way:

Low market growth, high market share: product A: cash cow

This is a well-established product in a mature market. Typically, this type of product is profitable and creates a high positive cash flow. Sales are high relative to the market and promotional costs are likely to be low, as a result of high consumer awareness. The cash from this product can be 'milked' and injected into some of the other products in the portfolio. Hence, this product is often referred to as a cash cow. The business will want to maintain cash cows for as long as possible.

High market growth, high market share: product B: star

This is clearly a successful product as it is performing well in an expanding market. It is often referred to as a star. The business will be keen to maintain the market position of this product in what may be a fast-changing market. Therefore, promotion costs will be high to help differentiate the product and reinforce its brand image. Despite these costs, a star is likely to generate high amounts of income.

High market growth, low market share: product C: question mark

The question mark consumes resources but generates little return. If it is a newly launched product it is going to need heavy promotion costs to help become established. This finance could come from the cash cow. The future of the product may be uncertain, so quick decisions may need to be taken if sales do not improve. These could include revising the design, relaunching with a new brand image or even withdrawal from the market. It should, however, have potential as it is selling in a market sector that is growing fast.

Low market growth, low market share: product D: dog

The dog seems to offer little to the business in terms of either existing sales and cash flow or future prospects, because the market is not growing. It may need to be replaced shortly with a new product development. The business could decide to withdraw from this market sector altogether and position itself into faster-growing sectors.

Impact of Boston Matrix analysis on marketing decisions

This analytical tool has relevance when:

- analysing the performance and current position of existing product portfolios
- planning action to be taken with existing products
- planning the introduction of new products. By identifying the position of all products of the business, a full analysis of the portfolio is possible. This should help focus on which products need marketing support or which need corrective action. This action could include the following marketing decisions:
- Building – supporting question mark products with additional advertising or further distribution outlets. The finance for this could be obtained from the established cash cow products.
- Holding – continuing support for star products so that they maintain their good market position. Work may be needed to freshen the product in the eyes of the consumers so that high sales growth can be sustained.
- Milking – taking the positive cash flow from established products and investing it in other products in the portfolio.
- Divesting – identifying the worst-performing dogs and stopping the production and supply of these products. This strategic decision should not be taken lightly as it will involve other issues, such as the impact on the workforce and whether the spare capacity freed up by stopping production can be used profitably on another product. These strategies can only be undertaken if the business has a balanced portfolio of products. If there are too many dogs or question marks, then the overall shortage of cash may not allow the firm to take appropriate action.

Limitations of using the Boston Matrix for marketing decisions

No technique can guarantee business success. This will depend on the accuracy of the marketing managers' analysis and their skills in making marketing decisions. The Boston Matrix helps to establish the current situation of the firm's products, but it is of little use in predicting future success or failure.

- On its own, the Boston Matrix cannot tell a manager what will happen next with any product. Detailed and continuous market research will help. However, decision-makers must always be conscious of the potentially dramatic effects of competitors' decisions, technological changes and the fluctuating economic environment.
- The Boston Matrix is only a planning tool and it has been criticised for simplifying the complex set of factors that determine product success.
- The Boston Matrix assumes that higher rates of profit are directly related to high market shares. This is not necessarily the case when sales are being gained by reducing prices and profit margins.

  TIP If you are asked to discuss the usefulness of the Boston Matrix for marketing decisions, remember that it does not provide strategic choices for a business. Explain that it analyses a business's product portfolio and highlights those products that might need strategic action to be taken.

19.4 Price is a key part of the marketing mix

Price is the amount paid by customers for a product. Determining an appropriate price for a product (goods or services) is a vital component of the marketing mix. Price can have a great impact on the consumer demand for the product.

The price level set for a product will also:

- impact on the level of value added by the business to bought-in components
- affect the revenue and profit made by a business due to its impact on demand
- help establish the psychological brand image of a product. Pricing decisions are therefore some of the most significant issues that marketing managers are faced with.

The pricing decision: how do managers determine the appropriate price?

There are many determinants of the pricing decision for any product. Here are the main ones:

- Costs of production: If the business is to make a profit on the sale of a product, then, at least in the long term, the price must cover all of the costs of producing it and of bringing it to the market.

- Competitive conditions in the market: If the business is a monopolist, it is the only seller of a product. It is likely to have more freedom in price setting than if it is one of many businesses selling the same type of product.
- Competitors' prices: It may be difficult to set a price that is very different from that of the market leader, unless true product differentiation (see above) can be established.
- Business and marketing objectives: If the aim is to become market leader through mass marketing, this will require a different price level to that set by a business aiming for select niche marketing. If the marketing objective is to establish a premium-branded product, then this will not be achieved with very low prices.
- Price elasticity of demand: This measures the responsiveness of demand following a change in price. The significance of this is assessed in Section 21.1.
- Whether it is a new or an existing product: For a new product, a decision will have to be made as to whether a skimming strategy or a penetration strategy is to be adopted.

Pricing methods

There are several different pricing methods that can be used. These are broadly classified into cost-based methods and competition-based methods.

Cost-based methods of pricing

Companies will assess their costs of producing or supplying each unit, and then add an amount for profit to the calculated cost. There are a number of different methods of cost-based pricing that may be adopted, as outlined below. (See also Table 19.2.)

Mark-up pricing

Mark-up pricing is often used by retailers. They add a percentage mark-up to the unit cost of each item bought from the producer or wholesaler. The size of the mark-up usually depends on the strength of demand for the product, the number of competitors and the stage of the product's life cycle.

==Mark-up pricing:== adding a fixed mark-up for profit to the unit cost of buying in a product.

Example:

Total cost of bought-in product = $40

50% mark-up on cost = $20

Selling price = $60

Cost-plus pricing

Cost-plus pricing is often used by manufacturers. The business calculates or estimates the total cost per unit. The price is then this cost plus a fixed profit mark-up.

==Cost-plus pricing:== setting a price by calculating a total unit cost for the product and then adding a fixed profit mark-up.

Retailers know how much each of the products they buy in costs. However, it is less easy for a manufacturer to calculate the cost of each product. It is not always easy to allocate or divide all the costs of a manufacturing business and allocate them to each product. This is particularly the case if the business produces more than one product.

Example: A business makes industrial training films and the annual fixed costs are $10 000. The variable cost of producing each film is $5. The business is currently producing 5 000 units per year. The total costs of this product each year are:

The average or unit cost of making each film is:

The business will have to charge at least $7 for each film in order to break even.

If a 300% profit mark-up is added, then the total selling price becomes $28.

Contribution-cost (or marginal-cost) pricing

The contribution-cost pricing method does not try to allocate the fixed costs to specific products. Instead, the business calculates a variable cost per unit of the product. It then adds an extra amount, which is known as a contribution towards fixed costs and profit. If enough units are sold, the total contribution will be enough to cover the fixed costs and to return a profit.

==contribution-cost pricing:== setting prices based on the variable costs of making a product, in order to make a contribution towards fixed costs and profit.

Example: A business produces a single product that has variable costs of $2 per unit. The total fixed costs of the firm are $40 000 per year. The business wants each unit sold to make a contribution of $1. The selling price is therefore $3. Every unit sold makes a contribution towards the fixed costs of $1.

If the firm sells 40 000 units in the year, then the fixed costs will be covered. Every unit sold over 40 000 will mean the business makes a profit. If the firm sells 60 000 units, then the fixed costs will be covered and a $20 000 profit will be made.

Many businesses that have excess capacity use contribution-cost pricing to attract extra business that will absorb the excess capacity.

The advantage of contribution-cost pricing over cost-plus or mark-up pricing is that the level of competition can be considered when making the pricing decision. If competition is very high, a low contribution per unit can be added to the variable cost per unit. This will give a lower price than mark-up pricing as the fixed costs have not been included. If there is little competition, then a higher contribution can be added to the variable cost per unit.

Loss leaders

This is a common tactic used by retailers. It involves the setting of very low prices for some products, possibly even below variable costs (meaning a negative contribution). This low price is expected to attract consumers who will then, it is hoped, also buy other products that do make a positive contribution. The business hopes that the contribution earned by these other products will exceed the negative contribution made on the low-priced ones. Often, the purpose of loss leaders is to encourage the purchase of closely related complementary goods. For example, low-priced printers could lead to additional sales of high-priced printer ink.

Competition-based methods of pricing

There are two main reasons why a business might adopt competitive pricing and set the price of its products at the same or a very similar level to that of its competitors:

==competitive pricing:== making pricing decisions based on the price set by competitors.

- There is one dominant business in the market. This business often becomes the price leader. Once it sets its prices it would be very difficult for a smaller business to charge higher prices unless it sold a clearly differentiated product. It might be impossible to charge lower prices than the dominant business if the latter has the lowest costs of production per unit.
- Some markets have a number of businesses of the same size selling similar products. The prices are very similar in order to avoid a price war which would reduce profit for all the businesses. An example of this would be large petrol retail companies. Price discrimination

This pricing method is often used in markets where it is possible to charge different groups of consumers different prices for the same product. An example of price discrimination would be bus or train companies charging lower prices for the elderly than they do for other adults, for the same journey. Businesses can price discriminate profitably if there are different groups of consumers, where the business is able to avoid resale between the groups and when it does not cost too much to keep the consumer groups separate. There must also be different price elasticities of demand (see Section 21.1). Other examples of price discrimination include selling cinema or theatre tickets more cheaply to children or the elderly and setting different prices for products in different export markets.

==price discrimination:== charging different groups of consumers different prices for the same good or service.

Dynamic pricing

The dynamic pricing method involves setting constantly changing prices when selling products to different customers, especially online through e-commerce. E-commerce has become a hot spot for dynamic pricing models, due to the way consumers can be separated by and communicated with over the internet. Consumers cannot tell what other buyers are paying. Businesses can vary the price according to demand patterns or knowledge that they have about a particular consumer and their ability to pay. Airlines often use this method of pricing. On a typical flight it is rare to find any two passengers who have paid the same fare.

==dynamic pricing:== offering products at a price that changes according to the level of demand and the customer's ability to pay.

Methods

Advantages

Disadvantages

Cost-plus pricing

• The price set covers all costs of production.

• This is easy to calculate for single-product firms where there is no doubt about fixed cost allocation.

• It is suitable for businesses that are price-makers due to market dominance.

• It is inaccurate for businesses with several products where there is doubt over the allocation of fixed costs.

• It does not take market/competitive conditions into account.

• It tends to be inflexible (e.g. there might be opportunities to increase price even higher).

• If sales fall, average costs often rise and this could lead to the price being raised using this method.

Contribution-cost (marginal-cost) pricing

• All variable costs are covered by the price and a contribution is made to fixed costs.

• It is suitable for firms producing several products and fixed costs do not have to be allocated.

• It is flexible. The price can be adapted to suit market conditions or to accept special orders.

- Fixed costs may not be covered.
- If prices vary too much, due to the flexibility advantage, then regular customers might be annoyed.

Competitor pricing

- This is almost essential for firms with little market power – price-takers.
- It can be flexible to reflect market and competitive conditions.
- The price set may not cover all the costs of production.
- The price may have to vary frequently due to changing market and competitive conditions.

Price discrimination

- This uses price elasticity (the responsiveness of demand to price changes) to charge different prices to increase total revenue.
- There are administrative costs of having different pricing levels.
- Customers may switch to lower-priced markets.
- Consumers paying higher prices may object and look for alternatives.

Table 19.2: Summary of four pricing methods

Pricing methods for new products

These are normally split into two different approaches (penetration pricing and market skimming), depending on the marketing objectives of the business.

Figure 19.10: Market-skimming and penetration pricing strategies Figure 19.10: Market-skimming and penetration pricing strategies

Penetration pricing

Firms tend to adopt penetration pricing because they are attempting to use mass marketing and gain a large market share. If the product gains a large market share, then the price could slowly be increased during the growth stage of the product life cycle. This would increase the profit margin on the product (see the example of airline ticket pricing in Figure 19.11).

==penetration pricing:== setting a relatively low price to achieve a high volume of sales.

Market skimming

The aims of market skimming are to maximise short-run profits before competitors enter the market with a similar product. This pricing strategy also helps to create an exclusive image for the new product. If rivals do launch similar goods, it may be necessary for the price of the original product to be reduced over a period of time. This strategy is used by pharmaceutical firms, which are often given a legal monopoly for new drugs for a certain number of years. They are able to charge high prices in the initial years to recoup their considerable investments in research and to make high profits. However, it is common for them to lower their prices in the last year of their legal monopoly in order to hold their market share when other companies enter. This is a typical example of a market-skimming pricing strategy.

==market skimming:== setting a high price for a new product when a firm has a unique or highly differentiated product with low price elasticity of demand.

Psychological pricing

Psychological pricing has two possible applications. Firstly, it is very common for manufacturers and retailers to set prices just below key price levels in order to make the price appear much lower than it is. Therefore, $999 is often used instead of $1 001 and $1.99 instead of $2.01.

==Psychological pricing:== setting a price at a level which matches consumers' views about a product's perceived value.

Secondly, psychological pricing also refers to the use of market research to make sure that the price level meets consumer views about the perceived value of the product. Prices that consumers consider to be inappropriate for the style and quality of the product will not meet their expectations of value. A very low price for cosmetics or perfume, even though the costs of production may be low, will not create the status and exclusive image that the business is trying to portray. Potential consumers may be put off by the fact that too many people can now afford the product and by their belief that the quality may not be as high as they originally believed. Similarly, the price can be so high that it exceeds consumer perceptions of the quality and image of the product, so sales will be damaged as a result. The more prestigious the brand name, for example Rolex watches, the higher the perceived value, and so the higher the price that can be set.

> KEY CONCEPT LINK Charging the lowest price is rarely the best marketing strategy for management to adopt. For a newly launched innovative product, low prices could fail to cover the development costs.

Pricing decisions: an evaluation

- A business will not use the same pricing method for all of its products. This is because market conditions for the different products could vary greatly. It would, therefore, be important for the business to apply different methods to its portfolio of products, depending on the costs of production and competitive conditions within the market.
- The price level can have a powerful influence on consumer purchasing behaviour. Marketing managers should ensure that market research is

used to test the impact of different levels of price on potential demand.

- In the world of fast-moving consumer goods there is often surprisingly little to be gained from adopting a low-price strategy at all times, as consumers expect good value, not necessarily low prices. Good value means that all aspects of the marketing mix are combined and integrated together, so that consumers accept the overall position of the product and agree that its image justifies the price charged for it.
- When consumers assess whether a product offers good value, price is only one factor. The complete brand image or lifestyle offered by the product is increasingly important in a world where many consumers have so much choice and their incomes are rising. A low price for a prestige lifestyle product could easily destroy the image that the rest of the marketing mix is attempting to establish.

Image Image

20.1 Promotion methods

Promotion is about communicating with actual or potential customers. Effective promotion not only increases awareness of products, but also creates images and product personalities that consumers can identify with. Advertising is only one form of promotion – other techniques include direct promotion and sales promotion. The combination of all forms of promotion used by a business for any product is known as the promotion mix. The amount a business spends on promotion – the promotion budget – is a key decision. However, successful communication is not just about the total amount spent. It is also about how the budget is allocated between the competing forms of promotion available. The packaging of products is often considered as a separate 'P' in the marketing mix, but it is very closely tied to promotion and product imagery. This chapter also takes a closer look at the role of packaging in complementing promotional strategies.

==Promotion:== the use of advertising, sales promotion, personal selling, direct mail, trade fairs, sponsorship and public relations to inform consumers and persuade them to buy.

==Advertising:== paid-for communication to inform and persuade consumers, using media such as TV, newspapers and cinema.

==direct promotion:== a range of promotional activities aimed directly at target customers. It is also known as direct marketing.

==sales promotion:== incentives such as special offers or special deals directed at consumers or retailers to achieve short-term sales increases and repeat purchases by consumers.

==promotion mix:== the combination of promotional techniques that a firm uses to sell a product.

Promotion objectives

Businesses allocate resources to promotion to achieve certain objectives. The success of promotion campaigns can be measured against these objectives. They can include:

- Increasing sales by raising consumer awareness of a product, which is especially important for newly launched ones.
- Increasing consumer recall of an existing product and its distinctive qualities.
- Increasing purchases by existing consumers or attracting new consumers to the brand.
- Demonstrating the superior specification or qualities of a product compared with those of competitors, often used when the product has been updated or adapted in some way.
- Creating or reinforcing the brand image or personality of the product. This is becoming increasingly important in consumer markets where it is often claimed that all products look the same.
- Correcting misleading reports about the product or the business to reassure the public after a scare or an accident involving the product.
- Improving the public image of the business, rather than the product, through corporate advertising.
- Encouraging retailers to hold inventories of the product and actively promote products to the final consumer.

  TIP When writing about promotion of a product, try to consider the marketing objectives of the business. Is the promotion likely to help achieve these objectives?

The promotion mix

It is unlikely that just one method of promotion will be sufficient to achieve promotional objectives. There are several elements to the promotion mix. They include all of the marketing tools that can be used to communicate with consumers.

Advertising promotion

Advertising is communicating information about a product or business through the media, such as radio, TV and newspapers. These advertisements should be directed towards the appropriate target market by selecting the right media. Successful advertising campaigns have led to substantial increases in consumer awareness and sales. This effect can last for a considerable length of time if brand loyalty is established.

Advertisements are often classified into two types, but in practice this distinction is often quite blurred:

- Informative advertising – adverts that give information about a product to potential purchasers, rather than just trying to create a brand image. This information could include price, technical specifications, main features or places where the product can be purchased. This style of advertising is most effective when promoting a new product that consumers are unlikely to be aware of, or when communicating a substantial change in price, design or specification.

- Persuasive advertising – adverts trying to create a distinct image or brand identity for the product. They may not contain any details at all about the materials, ingredients used, prices, or places to buy the product. This form of advertising is very common, especially in markets where there might be little differentiation between products. Advertisements then try to create a perceived difference in the minds of consumers. Perhaps, in reality, there is little difference between these two styles of advertising: 'The more informative your advertising, the more persuasive it will be' (David Ogilvy, Confessions of an Advertising Man).

Not all advertising is aimed at the final consumer. Trade advertising is aimed at encouraging retailers to stock products and sell them to consumers and, if possible, to promote them in preference to rival products. This type of advertising is most likely to take place in trade journals and magazines which are not available to consumers.

Advertising agencies

These are specialists that advise businesses on the most effective way to promote products. Advertising agencies can offer a complete promotional strategy. This can be important to a business that does not have its own marketing experts or may be entering a new market. These agencies will – for substantial fees – undertake the following stages in devising a promotional plan:

- research the market, establish consumer tastes and preferences, and identify the typical consumer profile

- advise on the most cost-effective forms of advertising media to be used

- use their own creative designers to design adverts appropriate for each medium

- film or print the adverts to be used in the campaign

- monitor public reaction to the campaign and feed this data back to the client.

Advertising methods

The following seven advertising methods are the most frequently used:

Print advertising This includes advertising in newspapers, magazines and specialist publications.

- It can be directed at particular towns or regions, or consumers who read particular special interest magazines.
- It provides hard copy, which can be cut out and kept by the consumer for future reference. Print advertising has limitations:
- It is expensive to gain national coverage.
- Evidence suggests that it is now much less effective with younger consumers than digital communications.

Broadcast advertising This is advertising on TV and radio, and in cinemas.

- Adverts have visual appeal and can create a brand image through the actors used.
- National or even international coverage is possible.
- It can linger in the memory of consumers for a long time if visually dramatic. Broadcast advertising has limitations:
- It is expensive to buy media time.
- It is expensive to design and produce the adverts.
- There is no permanent hard copy.

Outdoor advertising This includes advertising on billboards and bus shelter posters.

- It is low cost compared to other media.
- It can be located in prime positions with many potential consumers passing by.
- It can be read/seen more than once. Outdoor advertising has limitations:
- The best locations are the most expensive.
- It can be damaged or vandalised.
- Many passers-by will not notice this type of advertising.

Product placement advertising Products are featured in TV shows and films.

- The chosen shows or films will be targeted at a particular type of consumer.
- This creates a desirable image if the product is associated with famous actors or shows.
- It is not explicit advertising. Some consumers assume the product is being used because it is desirable, not because a business has paid for the placement. Product placement advertising has limitations:
- The show, film or actors may become less popular.
- It is very expensive if the show or film is well known.

Guerrilla advertising Products are advertised at surprising and unconventional events to make the public take notice.

- It is low cost: graffiti paint on walls is low cost, but it is best to gain permission first!
- It can be creative, inventive and can appeal to young consumers.
- It encourages word-of-mouth communication between potential consumers.
- A staged event can receive free publicity from the media. Guerrilla advertising has limitations:
- The message may be misunderstood.
- It may be considered irresponsible and lead to a negative backlash.
- It may be remembered for the wrong reasons.

Sponsorship This involves payment by a business to become associated with an event, an individual or a sports team. It could lead to the business logo appearing on a team's shirts, for example. Advantages include:

- the good publicity of being associated with big sporting and other events
- global press and TV coverage of the largest events
- the success of the team or individual can lead to greatly increased interest in the brand. For example, it is estimated that for every $1 spent on sponsoring a team in the Tour de France cycle race, $5.4 of free publicity is received.

Sponsorship has limitations:

- It can be very expensive, for example, it costs up to $15m to sponsor a Tour de France team.

- Failure of the event, team or individual can reflect badly on the brand.

Figure 20.2: The cost of team sponsorship in the Tour de France is high but it can result in large sales increases Figure 20.2: The cost of team sponsorship in the Tour de France is high but it can result in large sales increases

Digital advertising This is a rapidly growing method of advertising and is evaluated in detail in the section below on methods of digital promotion.

Advertising methods: which one to use?

The bigger the advertising budget, the more choice there is. Limited finance will restrict advertising to the forms of communication that cost the least. However, the forms of communication that cost the most are not always the most effective. The advertising method chosen depends on:

- Cost: Marketing managers must compare the cost of each method, including the cost per target consumer. If one TV advert costs $1m and the number of potential consumers for a product who watch the programme is 5 million, then the cost per consumer is $0.20. In digital marketing, this measure is referred to as cost per click. Advertising material has to be written and produced. The use of celebrities in adverts greatly increases the total cost. In contrast, viral marketing through social media can be virtually cost-free.

- The consumer profile of the target audience – age, income levels, interests: Advertising decisions must consider the target market. There is little point in advertising a new children's toy after 10.00 p.m. at night. Using a mass-market, low-priced daily newspaper to advertise a new range of exclusive clothing would be aiming at the wrong target market. Younger consumers are likely to be most accessible via social media and digital marketing.

- The message and image to be communicated: Written forms of communication are likely to be most effective for giving detailed information about a product. This information can be referred to more than once by potential consumers. If an image-creating advert is planned for a new range of clothes or sports equipment, then a dynamic and colourful TV advert or YouTube video could be more effective.

- Other aspects of the marketing mix: The links and integration between the other parts of the marketing mix and the advertising method chosen could be crucial to success. The use of exclusive and glossy women's magazines to advertise a new budget range of ready-cooked meals could be counterproductive.

- Legal constraints: A widespread ban on tobacco advertising in Formula One grand prix racing forced many sponsors to use other media for presenting their cigarette advertising. In some countries, there are restrictions on the use of TV advertising aimed at children, claiming that it exercises too much influence over young minds.

KEY CONCEPT LINK Business context must be considered when deciding which advertising method to use. A small business can probably not afford a TV campaign, but it might instead use innovative ideas for relatively low-cost guerrilla advertising.

Sales promotion methods

Sales promotion generally aims to achieve short-term increases in sales, whereas advertising often aims to achieve returns in the long run through building customer awareness of and confidence in the product. A wide range of incentives and activities can be referred to as sales promotion. They include:

- price offers – temporary reductions in price, such as 10% reduction for one week only
- loyalty reward programmes – consumers collect points, air miles or credits for purchases and redeem them for rewards
- money-off coupons – redeemed when the consumer buys the product
- point-of-sale displays in shops
- BOGOF – buy one, get one free
- games and competitions on packaging. These examples suggest that sales promotion is an active approach to marketing – it is not just about informing consumers. In many cases, consumers already know about a product's existence, so any sales promotion campaign aims to stimulate consumers to try the product or buy more of it. Sales promotion can be directed either at:
- the final consumer, to encourage purchase (pull strategy), or
- the distribution channel, for example the retailer, to encourage stocking and display of the product (push strategy). The types and possible limitations of sales promotion methods are shown in Table 20.1.

Method

Possible limitations

Price offers

These are temporary reductions in price, also known as price discounting. The objective is to encourage existing customers to buy more and to attract new customers as the product now appears more competitive.

• Price reductions will reduce the gross profit on each item sold.

• There could be a negative impact on the brand's reputation from the discounted price.

Money-off coupons

These are a more versatile and better-focused way of offering a price discount. Coupons can appear on the back of receipts, in newspaper adverts or on an existing pack of the product.

• These could just encourage consumers to buy what they would have bought anyway.

• Retailers may be surprised by the increase in demand and not hold enough inventory, leading to consumer disappointment.

• The number of consumers using coupons might be low if the price reduction is small.

Customer loyalty schemes, such as air miles or customer loyalty cards

The aim is to encourage repeat purchases and discourage consumers from buying from competitors. Loyalty cards give the business much information about consumers' buying preferences, which helps in customer relationship marketing.

• The discount cuts the gross profit on each purchase.

• There are administration costs (e.g. informing consumers of loyalty points earned, and the costs may outweigh the benefits from increased consumer loyalty).

• Most consumers now have many loyalty cards from different retailers, so their loyalty impact is reduced.

Money refunds

These are offered when the receipt is returned to the manufacturer.

• These involve the consumer completing and posting a form, which might be a disincentive.

• The delay before a refund is received may act as a disincentive.

Buy one, get one free (BOGOF)

This encourages multiple purchases, which reduces the demand for competitors' products too.

• There could be substantial reduction in the gross profit margin.

• Consumers may conclude that the normal price is too high.

• Consumers may think goods are being sold off because they cannot be sold at normal prices, which may impact on reputation.

• Current sales might increase, but future sales could fall as consumers have stocked up on the product.

Point-of-sale displays

Maximum impact on consumer behaviour is achieved by attractive, informative and well-positioned displays in stores.

• The best display points are usually offered to the market leaders – products with high market share.

• New products may struggle for the best positions in stores unless big discounts are offered to retailers.

> TIP You should not confuse advertising promotion and sales promotion – they are both forms of promotion, but they are not the same.

Direct promotion methods

These methods do not use a paid-for medium, unlike advertising.

Direct mail

Direct mail is sent out by post.

- This is low cost and well-defined areas/regions can be targeted.
- It is easy to evaluate the success of a campaign by checking response rates (e.g. tear-off slips). Direct mail has limitations:
- Many potential consumers now prefer digital communication.
- The mailing may be viewed as junk mail and quickly thrown away.

Telemarketing

This includes all marketing activities conducted over the telephone (often from customer call centres), including selling, market researching and promoting products.

- Telemarketing can be outsourced to an agency. They may charge for the cost of the script to be used and then on an hourly basis, or might charge for each cold call that leads to an interested potential customer being contacted again.
- This is lower cost than personal selling.
- It is easy to monitor the response/rejection rate. Telemarketing has limitations:
- Many consumers object to cold-calling.
- It is very easy for consumers to reject a telemarketing message.

Personal selling

With this method, a salesperson is employed to sell to each individual customer.

- Sales success rates are often high with skilled direct-sales employees.
- It is often used for expensive industrial products. This is often one of the key differences between consumer marketing and business marketing.
- It is effective with expensive and complex products that require specialist knowledge. Personal selling has limitations:
- Customers may complain about being pressured into buying, especially if the sales employees are paid a high bonus for each sale made.
- Sales employees need to be well trained. They should avoid selling to a reluctant consumer who later regrets the decision.
- This is a high-cost method of promotion and selling.

Developments in digital promotion

Digital marketing methods and techniques are changing rapidly. This book analyses the most common methods being used at the time of publication, but by the time you read this, digital marketing will have moved on.

Digital promotion is the fastest-growing form of promotion. New opportunities for using it are constantly being created. The promotion mix of most businesses is being directed increasingly to digital promotion and away from traditional advertising.

==Digital promotion:== the promotion of products using digital technologies, mainly on the internet but also including mobile (cell) phones.

> TIP You are unlikely to be asked a question about a specific method of digital promotion but do try to keep up-to-date with the latest developments in the methods that businesses use to communicate with customers digitally.

Methods of digital promotion

These methods use the latest technology to get their messages to customers.

Social media marketing Social media is not just a marketing channel but also a way for people to keep in touch with friends and family, read the latest news or follow topics they are interested in. There are many social media platforms businesses can choose to use. Most businesses use more than one. Promotion managers need to consider Facebook, Twitter, Instagram and other platforms, and decide which are most relevant to the target group of consumers they are trying to communicate with.

Twitter and Facebook advertisements, hashtag campaigns and influencer marketing are among the most popular methods of social media marketing.

Email marketing Email marketing connects with customers within their own mailboxes. It is a well-established method of increasing brand loyalty and selling more products to existing customers.

There are many different ways businesses can reach out to customers through email marketing, including:

- newsletter campaigns
- purchase confirmation emails
- thank you emails
- email notifications about new products.

Online advertising Displaying pop-up banners or advertisements on other websites aiming at the same niche is the most common form of online advertising. Businesses can use online platforms such as Google AdSense that allows adverts to be automatically delivered to other content sites.

Smartphone marketing This is becoming one of the most important methods of digital promotion, especially to younger consumers. It is claimed that 94% of all emails are opened and – once open – the sender has the reader's attention. As well as sending text messages to subscribers, businesses can further appeal to potential consumers by providing them with free apps for all phone types. Apps can send real-time push messages to consumers' phones when new products are available on the company website.

Messaging platforms such as Messenger and Telegram also allow marketing teams to create marketing bots which are used to gain new customers.

Search engine optimisation (SEO) Businesses that use e-commerce (sell online) locate their websites on search engines such as Google, Bing, Yahoo and Baidu (China). They need to use SEO to make sure that their content appears among the first results of a search. Without SEO, it is very difficult indeed for a business trading online to remain competitive.

==e-commerce:== the buying and selling of goods and services by businesses and consumers through an electronic medium.

Several SEO methods can be used to ensure a high ranking on a search engine results page, such as optimising the content for specific keywords. Search engine algorithms are constantly changing and businesses need to update their SEO methods accordingly.

Viral marketing Viral marketing makes use of all types of digital marketing. The essence of viral marketing is to create a post, video, meme or similar short form of content that spreads across the web like a virus. To make a successful viral marketing campaign, businesses promote the same content across multiple channels such as Twitter, YouTube, blog posts and newsletters over a short period of time.

Marketing managers try to identify individuals with high social networking potential, called influencers. The managers create viral messages that appeal to the influencers. These have a high chance of being passed on to many people who may be impressed that the influencer has contacted them about the product.

Benefits of digital promotion

- Worldwide coverage – a website allows businesses to find new markets and trade globally, increasing potential market size.
- Relatively low cost – a well-planned and well-targeted digital marketing campaign can reach the right customers at a much lower cost than traditional forms of advertising.
- Easy to track and measure results – web analytics and other techniques of measuring response rates make it easy to establish how effective a promotion campaign has been. Detailed information about how customers use a website or respond to advertising is available, which helps to improve the effectiveness of future campaigns.
- Personalisation – this is a very important benefit of digital promotion. Each customer can be made to feel that only they are being sent a special offer. The business's customer database needs to be linked to the website, then whenever someone visits the site, the business can greet them with targeted offers.
- Social media communication builds customer loyalty – involvement with social media and quick responses to customers' messages can build customer loyalty and create a reputation for being easy to converse with.
- Content marketing – digital marketing allows a business to create engaging campaigns using content marketing. This means producing varied content such as images, videos and articles, which can help a business gain social currency, especially if it goes viral.
- Website convenience increases sales – the conversion rate of visits to websites (when customers buy something) is higher than with other forms of selling. It is more convenient too, unlike other forms of media which require people to get up and make a phone call or go to a shop.

Limitations of digital promotion

- Time-consuming – unless a digital promotion agency is used (which can be high cost), tasks such as optimising online advertising campaigns and creating marketing content can be time-consuming. The success of promotions needs to be judged against the cost of preparing them.
- Skills and training – employees must have up-to-date knowledge and expertise to carry out digital marketing with success. Tools, platforms and trends change rapidly. Employees may need training to keep their skills at the right level.
- Global competition – reaching a worldwide audience is easy but this means competitors can do so too! Standing out clearly against a large number of competitors can be difficult and costly. Search engine optimisation is one way of trying to do this.
- Complaints and feedback – unhappy customers can quickly send out negative messages about a business or its products. Any negative feedback or criticism of a brand can be visible to the target audience through social media and review websites. It is essential for a business to respond quickly and effectively to such criticism.

Extension: Measuring success of promotions

It is vital that marketing managers gather as much evidence as possible about the success (or failure) of existing promotion campaigns to allow them to take better decisions in the future. The best ways of assessing the success of promotions are:

- Sales performance before and after the promotion campaign: By comparing the sales of the product before the campaign was launched, with the daily and weekly sales during and after the campaign.
- Consumer awareness data: Each week, market research agencies publish results of consumer recall or awareness tests, based on answers to a series of questions concerning the advertisements they have seen and responded to. This gives businesses rapid feedback on the progress of a promotion campaign.
- Consumer panels: These are useful for giving qualitative feedback on the impact of promotions and the effectiveness of advertisements.
- Response rates to advertisements: Newspaper and magazine adverts often have tear-off slips for consumers to request more details. Even TV adverts can ask for consumers to ring in, perhaps with the chance of winning a competition. Websites can record the number of hits and video-sharing sites can record the number of times an uploaded advert has been viewed.
- Social media feedback: The rapid response rate of social media users to

new products or new promotions is perhaps now the most widely used measure of marketing success or failure.

The role of packaging in promotion

The quality, design and colour of materials used in packaging can have an important supportive role to play in the promotion of a product. Packaging can perform the following functions:

- protect and contain the product, both during transportation and in stores
- give information – depending on the product – to consumers about the contents, ingredients, cooking instructions, assembly instructions and so on
- support the brand image of the product created by promotional campaigns
- make the product attractive and help the consumer to recognise it. Cheap and unattractive packaging of goods such as clothes or chocolates will destroy any quality and status image that the firm is attempting to establish. Distinctive packaging can help to form the basis of a promotional theme, which will endure as long as the product. The bright red of Coca-Cola cans is a feature of advertisements for the product, while Pepsi is instantly recognisable by its blue cans.

In contrast, expensive and wasteful packaging may add unnecessarily to costs, which could reduce a product's competitiveness. In addition, with increasing environmental pressures, packaging that is seen to be too ostentatious or cannot be recycled may result in a negative consumer reaction. For this reason, the use of recycled and recyclable materials in packaging is increasing and this helps to support the image of sustainable brands.

Some packaging advances can revolutionise the sale and promotion of products. Fresh food is often sold in airless packaging that reduces contact with the environment to increase shelf life. Tetra Brik (a registered trademark) boxes have given milk and fruit juice manufacturers many new marketing and sales opportunities. As with all other aspects of marketing, packaging decisions need to be blended with the overall objectives of the business for its product.

The role of branding in promotion

A brand is the name given by a firm to a product or a range of products. The aims of branding products include:

- aiding consumer recognition
- making the product distinctive from competitors
- giving the product an identity or personality that consumers can relate to. The choice of brand name is an important part of the overall marketing

strategy and there are specialist agencies that will advise firms on name suitability. These agencies check that the proposed name has not been registered by another company and that it does not have an unfortunate translation in other languages. They will survey consumers to gauge their reaction to the proposed brand name. The benefits of effective branding include:

- It increases the chances of brand recall by consumers, for example, when several similar products are available.
- It clearly differentiates the product from others, including reinforcing the difference by promotion.
- It allows for the establishment of a family of closely associated products with the same brand name.
- It reduces the responsiveness of consumer demand to a price increase. Consumers often have preferences for well-known brands and are prepared to pay a high price for them. This gives the business a high profit margin.
- It increases consumer loyalty to brands, which is a major marketing benefit. A recent development has been the growth of own-label brands. These are product ranges launched by retailers under their own store name. It is rare for the retailers to actually produce the goods. They purchase them from producers who add on the retailers' labels and brand names. Often, the goods are made by leading manufacturers that have their own well-known brands that compete with the own-label brands. This has the disadvantage of creating a more competitive environment for the well-known brands, but it can also make use of spare manufacturing capacity. For the retail stores, this strategy gives them a reasonable quality product, bought with bulk discounts, over which they have full marketing control.

20.2 Place: an important part of the marketing mix

Place is the final 'P' in the marketing mix. Place decisions are about how products should pass from manufacturer to the final customer. This process is known as distribution. Getting the right product to the right consumer at the right time in a way that is most convenient to the consumer is a good definition of distribution.

Any business, whether it produces goods or provides services, needs to establish a distribution strategy. This explains how a product will move from the point of creation to points of consumption in an efficient and low-cost manner so that it is convenient for the consumer to buy.

Several different channels of distribution are available.

==channels of distribution:== the chain of intermediaries a product passes through from producer to final consumer.

> TIP A common mistake is to confuse place or distribution decisions with transportation methods. Remember that place is about how and where the product is sold to consumers. Transportation is about how the product is physically delivered.

Channels of distribution

The most commonly used channels of distribution are outlined below. Their advantages and disadvantages are summarised in Table 20.2.

- Direct selling: this direct route from manufacturer to consumer is shown in Figure 20.6. There are no intermediaries, so this is also referred to as the zero-intermediary channel. The growth of the internet has led to a rapid rise in the use of this channel of distribution (see below for more detail). When the manufacturer wishes to keep complete control over the marketing mix, then direct routes are more likely to be used. Direct routes are also more likely to be used when the goods are bought infrequently but in large quantity, when they are bulky and expensive to transport, or when they have been purpose-built for a particular customer. Products and services that use this channel of distribution include mail order from manufacturers, airline tickets, hotel accommodation sold online by suppliers, and farmers' markets that sell produce directly to consumers.

Figure 20.6: Direct selling to consumer Figure 20.6: Direct selling to consumer

- Single-intermediary channel: With the increasing size of many modern retailers, the single-intermediary channel shown in Figure 20.7 is becoming more common. These big retailers have great purchasing power. They are able to arrange their own systems for storage and distribution to individual stores. This channel of distribution is usually used for consumer goods and where goods can easily be transported to the whole country but could also be used by an agent selling industrial products to businesses. Other examples include holidays sold via travel agents, and large supermarkets that hold their own inventories instead of using wholesalers.

Figure 20.7: Single-intermediary channel Figure 20.7: Single-intermediary channel

- Two-intermediaries channel: Until recent developments in retailing and e-commerce, the traditional two-intermediaries channel was the most common of all channels of distribution (see Figure 20.8). It is still used when wholesalers buy from producers and sell to retailers.

Figure 20.8: Two-intermediaries channel Figure 20.8: Two-intermediaries channel

Online marketing (e-commerce)

This is one of the fastest-growing ways of selling and distributing to customers. See Table 20.3 for the benefits and limitations.

Channel of distribution

Advantages

Disadvantages

Direct selling

(including e-commerce. See Table 20.3)

- No mark-up or profit margin is taken by intermediaries.
- The producer has complete control over the marketing mix.
- It is quicker than other channels so may lead to fresher food products.
- Direct contact with consumers offers useful market research.
- All storage and inventory costs have to be paid by the producer.
- There are no retail outlets so consumers cannot see and try before they buy.
- It may not be convenient for consumers.
- No after-sales service is offered by shops.
- It is expensive to deliver each item to consumers.

Single-intermediary channel

- Retailers incur the cost of holding inventories.
- Retailers display the products and offer after-sales service.
- Retailers should be in locations that are convenient to consumers.
- Producers focus on production, not on selling the products to consumers.
- The intermediary takes a profit mark-up, making the product more expensive to consumers.
- Producers lose control over the marketing mix.
- The outlet is not exclusive as retailers sell competitors' products too.
- Producers pass on delivery costs to retailers.

Two-intermediary channel

- Wholesalers hold the goods and buy in bulk from producers.
- It reduces producers' inventory costs.
- Wholesalers pay for the costs of transport to retailers.

• Wholesalers buy in large quantities and sell in small quantities.

• Another intermediary takes a profit mark-up, making the product more expensive to consumers.

• Producers lose further control over the marketing mix.

• It slows down the distribution chain.

Table 20.2: Advantages and disadvantages of frequently used channels of distribution

Benefits

Limitations

• It is relatively inexpensive if the cost is compared to the number of consumers reached.

• Companies can reach a worldwide audience for a small proportion of traditional promotion budgets.

• Consumers interact with the websites and make purchases and leave important data about themselves.

• The internet is convenient for consumers to use if they have access to a computer.

• Businesses can keep accurate records on the number of clicks or visitors, and quickly measure the success rate of different web promotions.

• Computer and smartphone ownership is increasing in all countries of the world.

• Selling products on the internet involves lower fixed costs than traditional retail stores.

• Dynamic pricing – charging different prices to different consumers – is easier.

• Some countries have low-speed internet connections and, in poorer countries, computer ownership is not widespread.

• Consumers cannot touch, smell, feel or try on tangible goods before buying, which may limit their willingness to buy certain products online.

• Product returns may increase if consumers are dissatisfied with their purchases once they have been received.

• The cost and unreliability of postal services in some countries may reduce the cost advantage of internet selling.

• Websites must be kept up-to-date and user-friendly, and good websites can be expensive to develop.

• Worries about internet security (e.g. consumers may wonder who will use information about them or their credit card details) may reduce future growth potential.

Table 20.3: Benefits and limitations of e-commerce

Factors influencing the choice of distribution channel

In deciding on an appropriate channel, a business must answer questions such as:

- Should the product be sold directly to customers or through retailers? Many industrial products, which are sold in small numbers and are very complex, are sold directly.
- How long should the channel be (i.e. how many intermediaries should there be)? If the market is very widely dispersed geographically, having more than one intermediary can be an advantage.
- In which locations should the product be made available? Market research will be needed before this decision can be made.
- Should the internet (online selling) be the main channel? See Table 20.3 for the main advantages and disadvantages of this.
- How much will it cost to keep the product inventory on store shelves and in warehouses? If inventory costs are high, then direct selling might be the preferred option.
- How much control does the business want to have over the marketing mix? Direct selling gives much more control over pricing, for example.
- How will the distribution channel integrate with other marketing-mix components? The overall marketing image needs to be supported by the channel of distribution used. The channel strategy must be integrated with the marketing objectives of the business. For example, if the aim is to secure a niche market for branded cosmetics with a high-quality image product, then selling through street vendors will not achieve this objective. If the marketing aim is to achieve maximum sales and distribution coverage for sweets, then selling through a few carefully selected and exclusive food retailers will not be successful.

The choice of distribution channel is important because:

- Consumers can benefit from easy access to products. This allows them to see and try products before they buy, makes purchasing easy and allows, if necessary, for the return of goods.
- Manufacturers need outlets for their products that give a wide geographical market coverage. However, they also want the desired image of the product to be promoted effectively.
- Retailers, which sell goods to the final consumer, add on a mark-up to cover their costs and make a profit. If price is very important to consumers,

using few or no intermediaries is an advantage as the manufacturer should be able to charge a lower price.

Digital and physical distribution

Products that can be converted into digital format are now being widely distributed to consumers by digital means over the internet rather than in a physical form. Digital distribution bypasses the traditional physical distribution formats, such as paper, optical discs and film cassettes.

==Digital distribution:== the delivery or distribution of digital media content such as audio, video, TV programmes, films, software and video games.

==physical distribution:== the activities that combine to achieve the efficient movement of finished products from the end of the production operation to the consumer.

The processes involved in digital distribution include streaming and downloading of content. The key difference is that a streaming file is simply played as it becomes available, while a download is stored onto a computer's memory. Both processes involve the act of downloading, but only a download leaves the consumer with a copy that can be accessed at any time from the device without having to download the data again.

The promoters of this form of distribution claim that music writers or music performers of the content can:

- get their music output distributed globally on platforms such as iTunes, Spotify and Google Play
- avoid the high costs of traditional physical distribution such as transport and inventory holding costs
- expand a global fan base
- keep 100% of the revenue earned
- achieve a low carbon footprint method of distribution (e.g. no transport and no packaging). Analysts are predicting that, by 2025, over 50% of global music revenue will be derived from streaming and 30% of total book revenue.

An integrated marketing mix

- If an expensive, well-known brand of perfume was for sale on a market stall, would you be suspicious?
- If the most exclusive shop in your town sold expensive gifts and wrapped them in newspaper, would you be surprised?

- If a cheap range of children's clothing was advertised in a glossy colour magazine aimed at professional women, would this advert lead to many sales?
- If the messages we are receiving about a product appear to be confused or lacking in focus, then we often fail to identify the true identity or personality of the product.
- If the product looks cheap but is highly priced, are we being overcharged or is the product's quality higher than that suggested by its appearances?
- If the product looks expensive but is priced cheaply, are we about to buy the bargain of a lifetime or are appearances deceptive and is the product actually of very low quality? These are all examples of a poorly integrated marketing mix. The part of the marketing mix in italics stands out as being inappropriate and lacks integration with the rest of the marketing mix. Why does this matter? The impact a product has on consumers is explained by human psychology – as complex beings we are influenced by a range of different messages before we decide on taking an action, such as buying a product.

==integrated marketing mix:== the key marketing decisions complement each other and work together to give customers a consistent message about the product.

Consumers will avoid buying products with a confusing and inconsistent marketing mix. This results in low long-term sales. Far better to have a clear and unambiguous message about the product, relayed through all elements of the marketing mix.

The best-prepared marketing plans can be destroyed by just one part of the marketing mix not being consistent with the rest. The most effective marketing-mix decisions will, therefore, be:

- based on marketing objectives and affordable within the marketing budget
- integrated and consistent with each other and targeted at the appropriate consumers.

  TIP You may be asked to recommend and evaluate the marketing mix for a product. The best answers will include suggestions for a fully integrated marketing mix, clearly aimed at achieving a marketing objective.

Image Image

21.1 Elasticity of demand

Marketing decisions about prices, products, promotions and distribution should be based on as much up-to-date and relevant information as possible. For example, how useful would it be for marketing managers to know:

- How much will demand change if we raise prices by 10%?
- How much will sales increase if we raise promotion spending by $1m a year?
- How much will demand for our products be affected by changes in consumer incomes? Marketing departments try hard to assess the impact on demand of these three variables: the price of the product, promotional spending, and consumer income levels. A form of measurement has been developed to help in this assessment. It is called elasticity of demand.

Price elasticity of demand

Look at the two demand curves in Figures 21.2 and 21.3. D2–D2 has a steeper gradient than D1–D1. What impact does the slope or gradient of the curves have on the demand levels for these two products when prices are changed? You will notice that when the price of both products is increased by the same amount, the reduction in demand is greater for product B than it is for product A. This could be very important information for the marketing manager because the total revenue for product A has actually increased, but for product B it has fallen, as can be seen by the size of the shaded areas.

Figure 21.2: Demand curve for product A Figure 21.2: Demand curve for product A

Figure 21.3: Demand curve for product B Figure 21.3: Demand curve for product B

This relationship between price changes and the size of the resulting change in demand is known as price elasticity of demand (PED).

==price elasticity of demand (PED):== a measure of the responsiveness of demand for a product following a change in its price.

This concept can be demonstrated on demand curves as shown above. Product A's demand is less elastic, or less responsive, to a price change than product B's. This idea can also be measured mathematically.

The formula for PED is:

Interpreting price elasticity results

PED results need to be interpreted carefully, as summarised in Table 21.1.

Value of PED (ignoring minus sign)

Classification

Explanation

Zero

Perfectly inelastic demand

The same amount is demanded, no matter what the price. In reality, there is no product that would have this PED.

Between 0 and 1

Inelastic demand

The percentage change in demand is less than the percentage change in price. If a product has this elasticity of demand, a price increase will lead to a smaller proportionate change in demand and revenue will rise. However, as the price continues to rise, demand will become more elastic.

Unitary

Unit elasticity

The percentage change in demand is equal and opposite to the percentage change in price, so any price change will lead to an equal change in demand and the total revenue will remain constant. When PED = 1, sales revenue will be maximised.

Between 1 and infinity (∞)

Elastic demand

The percentage change in demand is greater than the percentage change in price. If a product has this elasticity of demand, if price is reduced, there will be a bigger proportionate increase in demand and revenue will increase.

Infinity (∞)

Perfectly elastic demand

An infinitely large amount is demanded at one price and then demand falls to zero if the price is raised, even by the smallest amount. In reality, there is no product that would have this PED.

Table 21.1: Interpretation of PED results and their impact on revenue (negative signs are not shown)

The value of PED is normally negative because a fall in price (–ve) usually results in a rise in demand (+ve). Similarly, a rise in price (+ve) results in a fall in demand (–ve). This is called an inverse relationship. It is quite common to ignore the negative sign of the PED result, as it is the numerical value of the result that is important.

Example: In Figure 21.2, the price increased from \$4 to \$5 and demand fell from 300 units per week to 270 units. What is the PED?

Step 1: Calculate the percentage change in price.

Step 2: Calculate the percentage change in demand.

Step 3: Use the PED formula:

It is now important to explain this result. A PED of 0.4 (overlooking the minus sign) means that demand changes by 0.4% for every 1.0% change in price. As this is less than one, it is described as being inelastic. Consumers do not respond greatly to a change in the price of this product. An increase in price will raise a firm's revenue, while a price reduction – because demand will change little – will reduce revenue.

Factors that determine price elasticity of demand

There are a number of factors that will determine the PED of a product:

- How necessary the product is: The more necessary consumers consider a product to be, the less they will react to price changes. This will tend to make the demand inelastic as is the case with salt and cooking oil.
- Number of close competitors: If there are many competitors, then there are a large number of substitutes. Consumers will quickly switch to another brand if the price of one manufacturer's product increases (e.g. fruit being sold by one seller in a large street market). Any reduction in the number of competing products will probably make demand for a product less elastic.
- Consumer loyalty: If a business has established a strong brand identity, such as Coca-Cola, consumers will often continue to purchase the product following a price rise. Another example is designer clothes, which have consistent demand from high-income consumers, even when prices rise. All businesses attempt to increase brand loyalty with influential advertising and promotional campaigns, and by making their products more distinct. This is called product differentiation.
- Price of the product as a proportion of consumers' incomes: A cheap product that takes up a small proportion of consumers' incomes, such as matches or batteries, is likely to have inelastic demand, as consumers will not be much affected by a 10% or 15% price increase.

Impact of price elasticity of demand on business decisions

There are two main ways PED could impact on business decisions:

- Pricing decisions: If a bus service operator is considering changing its prices, then knowing the PED on different routes will help. It could raise prices on routes with low PED (inelastic demand) and reduce them on routes with high PED (elastic demand). These decisions will increase the total revenue of the bus operator. This kind of analysis also underpins the pricing strategy known as price discrimination (see Section 19.4).
- Wage increase decisions: If the PED for the products of a business is low (inelastic), then a demand for wage increases from employees is more

likely to be accepted than if PED was high. This is because, if the business increases wages, costs will rise but the marketing manager could increase product prices with little impact on demand. If PED was high (elastic), then a wage increase could not easily be passed on in the form of higher prices.

Income elasticity of demand

The same elasticity principle can be applied to changes in variables other than price. When consumer incomes change, for example, the demand for most products will increase. But by how much? This is the question that income elasticity of demand attempts to answer.

==income elasticity of demand:== a measure of the responsiveness of demand for a product following a change in consumer incomes.

Income elasticity is measured by:

income elasticity = % change in demand for the product% change in consumer incomes

Example: Following a reduction in consumer incomes of 5%, the demand for a supermarket's own-label breakfast cereal increased by 10%. The demand for an expensive well-known branded cereal fell by 10%. The demand for salt hardly changed: just a small reduction of 1%. Check these income elasticity results for yourself (see Table 21.2).

Own-label cereal

Branded cereal

Salt

Income elasticity of demand

−2

2

0.2

Table 21.2: Income elasticity of demand

Interpreting income elasticity results

- The own-label cereal in the example above is called an inferior gooda product that experiences an increase in demand when consumer incomes fall.. It has a superior branded alternative. Quantity of demand for inferior goods rises as income falls, and falls when incomes rise. For products like these, income elasticity is negative and the negative sign should always be shown.

- The expensive branded product has positive income elasticity. It is referred to as a normal good. We would expect that the demand for most products would fall if consumers had less income to spend, and would rise if incomes increased. If income elasticity is above 1, demand is income elastic. This suggests the product is a luxury good which has inferior substitutes. Demand changes by a higher proportion than any change in income.
- Salt is a necessity and has very low positive income elasticity. Demand is income inelastic. Most consumers will continue to buy almost the same quantity of salt even if incomes rise. If incomes fall, as salt is a necessity, almost the same quantity will be demanded.

Impact of income elasticity on business decisions

There are two main ways income elasticity results could influence business decisions:

- During a period of economic growth and rising consumer incomes, businesses are likely to focus on increasing output of income-elastic products such as luxury goods. New product launches should be for products that are likely to have a high income elasticity of demand.
- During an economic recession when incomes for most consumers fall, the reverse will be the case. Businesses will focus on producing more basic versions of their products, which can be sold at a lower price. Businesses that sell inferior goods may have to increase output to cope with the expected increase in demand. New product launches should focus on affordable products rather than those with an exclusive image and expensive features.

Promotional elasticity of demand

Promotional elasticity of demand is measured by:

==Promotional elasticity of demand:== a measure of the responsiveness of demand for a product following a change in the amount spent on promoting it.

promotional elasticity of demand = % change in demand for the product% change in promotional spending

If the result is greater than 1, then the demand for the product is responsive or elastic following a change in promotional spending. If the result is less than 1, then demand is inelastic following a change in promotional spending. There might be little point in increasing promotional expenditure when promotional elasticity of demand is low.

Example: A business increases its advertising spending on two of its products by 10%. Product A has a 2% increase in sales, but product B's sales record a 12% increase. The promotional elasticities of demand are:

Interpreting promotional elasticity of demand

Increased promotion spending nearly always results in increased demand for the product. This means the result of promotional elasticity of demand is positive. If the result is above 1 (as with product B above), then demand increases by a higher proportion than the increase in promotional spending. Demand is elastic following increased promotion.

If the result is below 1 (product A above), then demand is inelastic following increased promotion. Promotional elasticity of demand could be negative, although this would be very rare. If the campaign uses images or slogans that cause great offence to many people, then demand could fall following these promotions.

Impact of promotional elasticity on business decisions

Generally, it would be more effective for a business to increase spending on those products with a high promotional elasticity of demand and to cut back promotional spending on those with a low elasticity.

However, promotional elasticity of demand depends greatly on the effectiveness of a promotional campaign. A promotion that costs $2m and yields only a low increase in sales might have been poorly designed and focused on an inappropriate group of consumers. This does not mean that all promotion for that product should end. Perhaps a more effective promotional campaign would increase sales by a larger amount? This means that the reason for a low promotional elasticity of demand needs to be investigated first, before final decisions can be made about how much to spend on promoting each product.

Limitations of the measures of elasticity

The results gained from price elasticity must be used with caution. The concept has three main limitations:

- PED assumes that nothing else has changed. If Business A reduces the price for a product by 10%, it will expect sales to rise because of this. However, if, at about the same time, a competitor leaves the industry and consumer incomes rise, the resulting increase in sales of Business A's product may be very substantial, but not just because of the price reduction. Calculating PED accurately in these, and similar, situations, where other changes occur is almost impossible.
- A PED calculation, even when nothing but price changes, quickly becomes outdated. It may need to be recalculated often, because consumer tastes change over time and new competitors will introduce new products. Last year's PED calculation may be very different to the one calculated today, if market conditions have changed in the meantime.

- It is not always easy or possible to calculate PED. The data needed for working it out might have come from past sales results following previous price changes. This data could be quite old and market conditions might have changed. In the case of new products, market research will have to be relied upon to estimate PED. This is done by trying to identify the quantities that a sample of potential customers would purchase at different prices. This will be subject to the same kind of inaccuracy as other forms of market research. Income elasticity of demand also has limitations, because the results can be affected by other variables changing at the same time as consumer incomes rise or fall. For example, an increase in consumers' incomes might not lead to an expected increase in demand for a brand of mobile (cell) phone if, during the same period, a competitor launches a superior product.

Promotional elasticity results will not be entirely reliable, as changes in sales may have been due to other factors that might have changed. These could have influenced sales during the same period as a new promotion campaign. This is a weakness of the elasticity concept.

If, for example, competitors launch a more effective promotion or if any of the external economic constraints change, the results of sales comparisons with data before the campaign might be misleading. It is possible that an increase in sales after a campaign would have occurred anyway due to favourable economic conditions. However, especially if a similar elasticity result is obtained on more than one occasion, the marketing manager should have some useful data on which to base future promotional spending decisions.

> TIP When commenting on an elasticity calculation, you should never assume that the result will be accurate and relevant for future changes in price, income or promotion spending. It would be unwise to base major marketing decisions on elasticity results alone.

21.2 New product development

In many fast-changing markets, there is a constant need to develop new products. If this is not successfully undertaken, then a business will find itself trying to market products that are perceived as being out-of-date, based on technology that has been overtaken by products marketed by other businesses. This is particularly true for the consumer electronics market, cars and cameras. New product development is also very important in the pharmaceutical industry, where the opportunities to make huge profits from new medicines are considerable. In industrial product markets such as machinery, where robots and microchips have revolutionised production methods and machinery, new product development is equally vital for a business to maintain its competitiveness.

==New product development:== the design, creation and marketing of new goods and services.

For a new product to succeed it must:

- have desirable features that consumers are prepared to pay for
- be sufficiently different from other products to make it stand out and to offer a unique selling point
- be marketed effectively to consumers – they need to be informed about it.

The process of new product development

There are seven stages in the process of NPD:

1 Generating new ideas: sources of new ideas for product development

All new product innovations must start with an initial idea. Ideas for new products can come from a variety of sources:

- Company's own research and development department: This is a very expensive process and not all businesses will have a research and development (R&D)the scientific research and technical development of new products and processes. department. The significance of R&D is discussed below.
- Adaptation of competitors' ideas: It is important to be careful not to infringe copyright and patent laws. In addition, if a product is developed that appears too similar to existing products, consumers may prefer the original one.
- Market research, such as focus groups: These can be used to stimulate discussion about new products that consumers would like to see on the market.
- Employees: Encouraging employees to participate in generating new product ideas gives businesses two benefits. Firstly, employees often have contact with the existing products and customers. This can lead to excellent ideas for new developments. Secondly, employee participation can lead to increased motivation.
- Sales employees: They have close contact with the final consumers and may suggest improvements to existing products, or even come up with completely new ones.
- Brainstorming in groups: This generates new ideas by members of the group proposing and developing ideas beyond the level achieved by individuals working separately.

2 Idea screening

The purpose of this stage is to eliminate those ideas that stand the least chance of being commercially successful. It can be very expensive to develop and market new products, so care should be taken to try to ensure that only those ideas with a reasonable chance of success are proceeded with. Those doing the screening should ask:

- How will the consumers in our target markets benefit from this product?
- Is it technically feasible to manufacture this product?
- Will the product be profitable enough at the price we are likely to be able to charge the customer for it?

3 Concept development and testing

This stage takes the product idea a step further by asking key questions about what features the product should have, the likely cost of these to manufacture and who the consumers are likely to be. These questions need to be asked against the background of how much the final consumer is likely to be prepared to pay for the product. So, the following points should be discussed:

- Who are the most likely consumers of the product?
- What product features should be incorporated?
- What specific benefits will this product provide?
- How will consumers react to it? This might be tested by using market research and asking a sample of prospective customers what they think of the product idea, or whether they would be likely to buy it as a replacement for their current brand.
- What are the most cost-effective methods of manufacture?
- What will it cost to produce?

4 Business analysis

This stage considers the likely impact of the new product on the company's costs, sales and profits. An estimated price is set for the product based on customer feedback from concept testing and competitors' data. The expected sales volume and market share can be estimated, as can the expected break-even level of production. Other issues to be researched include:

- Is finance available to develop the product?
- Can it be patented? This would offer legal protection against the product being copied by competitors for a number of years.
- Will it fit in with the existing product mix?
- How will changes in the economic environment be likely to affect sales in the future?

5 Product testing

This is concerned with the technical performance of the product and whether it is likely to meet consumers' expectations. Product testing should include:

- developing a prototype of the product, or working model of it
- testing the product in typical-use conditions (e.g. a car will be tested in hot and cold countries to test performance under different conditions)
- using focus groups to gather opinions about the product
- adapting the product as required after testing or focus group feedback. The final version should take into account the views of potential customers at this stage.

6 Test marketing

A small test market needs to be identified. It should be as representative as possible of the main market in terms of consumer profiles. Test marketing has certain benefits over a full-scale launch to the entire market:

==Test marketing:== the launch of the product on a small-scale market to test consumers' reactions to it.

- Actual consumer behaviour can be observed and measured.
- Feedback from consumers will enable a final decision to be made about investing capital in a full-scale launch.
- The risks associated with a product failing after a full-scale launch are reduced and the associated poor publicity avoided.
- Any weaknesses in the product identified by consumer feedback can be addressed in the final version of the product. There are some limitations to test marketing. It can be expensive. Also, competitors are able to observe a firm's intentions and react accordingly, perhaps rushing out a copy, before a full-scale launch of the original product can be put into effect.

Some new products are withdrawn at this stage if the sales results of the test market are disappointing. There are cheaper alternatives to test marketing, such as a free-sample strategy, where small numbers of free samples are distributed to potential consumers who agree to be questioned later about their thoughts on the product.

Figure 21.4: The NPD process filters out products that will not succeed so only a few new products reach the commercialisation stage Figure 21.4: The NPD process filters out products that will not succeed so only a few new products reach the commercialisation stage

7 Commercialisation

This stage is the full-scale launch of the product. This is the introduction phase of the product life cycle. A promotional strategy will be put into place with advertisements to inform the market of the new product's arrival. The distribution channel will be filled up with stocks of the product to make sure it is available when consumers want to buy it. This will be the most crucial few weeks or months in the life of the new product. Marketing managers will await the newest sales data with keen interest.

Research and development

Effective R&D is essential in some industries if a business is to keep at the forefront of its market and is to retain or recapture a competitive advantage. Examples of firms that have improved their performance with R&D include Apple, Samsung, Toyota and Honda.

The importance of R&D

Inventions generate new product possibilities. Some of these are converted into successful and profitable product innovations. New product innovations allow businesses to survive and grow in rapidly changing marketplaces.

Innovative products may give a considerable unique selling point over rivals so that the business can charge premium prices, thus earning higher profit margins. Expenditure on R&D can be a risky investment, as the success of such scientific enquiry can never be foreseen with great accuracy. The cost of R&D programmes can run into millions of pounds and success cannot be guaranteed. For example, between them the top three UK-based pharmaceutical companies were forecast to spend more than $12 billion on R&D in 2020. Much of this was spent on research into new drugs that might not be ready for sale to the public for another ten years.

Some businesses, as a consequence, deliberately adopt the strategy of no R&D. They are then forced to license other businesses' new ideas or to make very similar 'lookalike' products to follow the market leaders. This may be a safer strategy to adopt, but one that can lead to legal battles if the copy is too close to the original concept. It will, generally, fail to capture consumers' imaginations and allows the market leaders to continue to dominate the market. This strategy is often referred to as a follow-the-leader strategy.

Other business strategies regarding R&D include offensive and defensive approaches. An offensive R&D strategy is to lead the rest of the industry with innovative products. The aim of these businesses is to gain market share and, possibly, market dominance. Success can lead to further successes as the profits made on a lucrative new product can be re-invested into further R&D. Apple provides us with a classic example of an offensive strategy towards R&D.

In contrast, a defensive strategy is to attempt to learn from the initial innovators' mistakes and weaknesses. This approach does not lead the field, but it suggests that the business does not want to be left behind. A defensive strategy aims to improve on the original products or develop slightly different types of goods, which might appeal to other market segments.

R&D: an evaluation

Not all R&D leads to scientific or engineering breakthroughs. For example, despite spending billions of dollars, the drugs industry has failed to come up with a remedy for the common cold.

Also, not all inventions become innovative products that can be marketed successfully. New ideas often fail to reach the market because of defects in design or manufacture, competitors' products leaping ahead in terms of technology and higher than expected costs.

Even when they are launched, products may still fail. Here are some of the reasons why a fully researched and developed product may reach the commercialisation stage and still fail:

- inaccurate market research
- poor marketing support or inappropriate pricing
- changes in technology make the product outdated
- competitors release a product that consumers prefer. Despite these risks, many businesses continue to invest in R&D. They take a long-term view. They believe that the costs and inevitable short-term failures will be compensated for by the occasional outstanding success. Much depends on whether the business is driven by short-termism. The perceived need to satisfy shareholders with high dividends in the short term will make R&D spending less likely.

  KEY CONCEPT LINK Successful R&D will lead to innovation in both new products and new processes for making products. Not all businesses will find R&D useful as it will depend on the industrial context in which it operates.

  TIP When evaluating the impact of R&D, you should not assume that a business's success will be guaranteed by spending more and more on it. Some inventions will simply not be commercially successful.

Factors that influence the level of R&D expenditure by a business

- The nature of the industry: Rapidly changing technologies and consumer expectations in pharmaceutical products, defence, computer and software products, and motor vehicles lead to the need for substantial investment in R&D by leading businesses.

- Level of R&D spending by competitors: In many markets, it is essential to spend as much as, or more than, competitors if market share and technical leadership are to be maintained.
- Business expectations: If business managers are optimistic about the future state of the economy, economic growth and consumer demand, then they are more likely to agree to substantial budgets for R&D.
- The risk profile or culture of the business: Management's willingness to take risks, and to invest for the long term, affects the R&D expenditure of a business. A short-term objective of maximising profits will discourage managers from investing in R&D.
- Government policy towards grants to businesses and universities for R&D: Government support programmes, and the range and scope of tax allowances for such expenditure, will influence decisions by businesses.

21.3 Sales forecasting

If marketing managers were able to predict the future accurately, the risks of business operations would be much reduced. If a precise forecast of monthly sales over the next two years could be made (sales forecasting), the benefits to the whole organisation would be immense:

==sales forecasting:== predicting future sales levels and sales trends.

- The operations department would know how many units to produce, how many materials to order and would hold the correct level of inventories.
- The marketing department would be aware of how many products they would need to sell and distribute.
- The human resources workforce plan would be more accurate, leading to the appropriate number of employees with the right skills.
- Cash flow forecasting would be much more accurate. In reality, 100% accuracy in forecasting is impossible to achieve. There are many external factors that can impact on future sales. Consider, for example, the difficulties in forecasting the sales for one brand of tablet computers. Apart from changes in consumer incomes caused by economic factors (demand is likely to be income elastic) and new developments by competitors, changes in pricing and any promotional offers will also have a significant effect on future sales levels. Despite these problems, most businesses make sales forecasts in order to reduce the unforeseen nature of future demand changes to an acceptable minimum.

The need to forecast sales

- Sales forecasts form an essential part of the market planning process (see Section 22.1).
- Sales forecasts are a key part of the screening process before new products are launched onto the market.
- Planning future workforce needs of a business is partly based on sales forecasts.
- Preparing other resources needed by the business, such as supplies of materials and capital equipment levels, requires sales forecasts.
- Sales forecasts can predict maximum capacity working or excess capacity so important operations decisions require forecasted data.
- Decisions about price changes and promotion partly depend on sales forecasts. If demand is predicted to decline, then it might be decided to reduce prices or finance a new promotion campaign.

Time series analysis

This method of sales forecasting is based entirely on past sales data. Sales records are kept over time and, when they are presented in date order, they are referred to as a time series.

Extrapolation

The most basic method of predicting sales based on past results is termed extrapolation. It means basing future predictions on past results. When actual results are plotted on a time series graph, the line can be extended (or extrapolated) into the future along the trend of the past data (see Figure 21.6). This simple method assumes that sales patterns are stable and will remain so in the future. It is ineffective when this condition does not hold true.

Figure 21.6: Extrapolating a trend Figure 21.6: Extrapolating a trend

Moving averages

This method is more complex than simple graphical extrapolation. It allows the identification of underlying factors that are expected to influence future sales. These are:

- the trendthe underlying movement in a series of data over time.
- seasonal fluctuationsthe regular and repeated variations that occur in sales data within a period of 12 months.
- cyclical fluctuationsvariations in sales over periods of time of much more than a year which are due to the business cycle.

- random fluctuationsvariations that occur at any time and cause unusual and unpredictable sales figures, due to events such as exceptionally poor weather or negative public image.. Most of the questions that you will encounter on this topic will be concerned with the identification of the trend and seasonal fluctuations. The moving average method is used in Table 21.4 to analyse these factors in relation to ice cream sales. Once they have been identified, then short-term sales forecasts can be made.

Points to note:

- The moving average method involves calculating moving totals from a number of sales figures. Each total in column 4 of Table 21.5 is made up of four quarters' results. This is why the total is called a four-quarter moving total. A four-quarter moving total was used because the data clearly varied consistently over this length of time. For example, sales of ice cream are always highest in the summer quarter. If other data were to be used, perhaps daily sales figures, then a seven-period total might have been used, because the regular variation in sales would have been over seven days. Monthly sales data may require the use of a twelve-period moving total.
- If this four-quarter moving total was divided by 4 in order to calculate the average, this result would not lie alongside any one quarter. It would not make sense to have a result which does not belong to any one time period (see Table 21.4). The problem is overcome by centring the average so that it lies alongside one actual quarter. This is done by adding two four-quarter moving totals together. This gives an eight-quarter moving total (column 5 in Table 21.5). This is divided by 8 to give the quarterly moving average (column 6 in Table 21.5).
- The quarterly moving average is known as the trend of the data. The underlying movement of the data has been identified by averaging out the regular seasonal fluctuations.
- The difference between the actual sales and this trend must have been largely due to seasonal fluctuations. These can then be calculated as shown in Table 21.5. Seasonal variation (column 7) = actual result (sales revenue, column 3) – moving average trend (column 6)

Make sure you obtain the correct plus or minus sign for your results. If the result is negative, it means that sales in that quarter are usually below the trend, or average, for seasonal reasons.

- The average seasonal variation (ASV) is calculated by adding up all of the seasonal variations for each separate quarter and then dividing by the number of results. For example, for quarter 3, the seasonal variations are:

Quarter

Sales

Four-quarter total

Four-quarter average

1

20

2

30

27.5

3

50

4

10

110/4

Table 21.4: Four-period moving total and average

Table 21.5: Moving averages for ice cream sales ($000) Table 21.5: Moving averages for ice cream sales ($000)

Forecasting using the moving average method

The results from Table 21.5 can now be used for short-term forecasting. You will need to:

1Plot the trend (moving average) results on a time series graph (see Figure 21.7).

2Extrapolate this into the future. Short-term extrapolations are likely to be the most accurate.

3Read off the forecast trend result from the graph for the period under review (e.g. quarter 2 in year 2022).

4Adjust this by the average seasonal variation for quarter 2. Thus, for quarter 2 in the year 2022, the actual forecast will be the extrapolated trend forecast for this quarter plus the average seasonal variation:

Figure 21.7: Forecasting future trend sales figures Figure 21.7: Forecasting future trend sales figures

An evaluation of the moving average method

The benefits are:

- This method is useful for identifying the seasonal variation and applying it to predictions.

- It can be reasonably accurate for short-term forecasts in reasonably stable economic conditions.
- It identifies the average seasonal variations for each time period and this can assist in planning for each quarter in future. The limitations are:
- Forecasts further into the future become less accurate as the projections made are entirely based on past data. External environmental factors can change so that past results become an unreliable indicator of the future.
- The moving average method does not take qualitative factors into account. Forecasting for the longer term may require the use of more qualitative methods that are less dependent on past results.

Qualitative sales forecasting methods

There are several methods of qualitative sales forecasting.

==qualitative sales forecasting:== predictions about future sales which use expert judgement instead of numerical analysis.

Sales force composite

Sales force representatives have the task of keeping in contact with customers. These are usually not the final consumers, but the retail businesses that purchase and stock the product for sale to consumers. Frequent contact with customers means sales representatives are able to develop a real insight into market trends and potential future demand. An overall sales forecast can be obtained by asking all sales staff for their individual estimates of future sales to their customers and then adding these estimates together.

The sales force composite method has the advantage of being quick and cheap to administer. However, sales representatives may not be aware of macroeconomic developments or competitors' actions, which could have a substantial impact on future sales. Customers may overestimate the number of products that they hope to sell in the future in the hope of gaining a more favourable arrangement with the supplying business.

==sales force composite:== a method of sales forecasting that adds together the individual predictions of future sales from all the sales representatives working for a business.

Delphi method

With the Delphi method, a facilitator collects opinions from a panel of experts who are sent detailed questionnaires asking for their judgement about possible future events, such as demand levels or technology changes that could affect consumer taste and demand levels. The experts do not meet and they are anonymous to each other. After each round of questionnaire results have been collected, they are summarised and sent back to all the experts on the panel. A further questionnaire is then sent out to see if the experts have changed their minds after reading the results of the first round of questionnaires.

==Delphi method:== a long-range qualitative forecasting technique that obtains forecasts from a panel of experts.

In this way, any extreme responses from the experts are often amended and moderated so that, eventually, a consensus is reached that represents the most accurate forecast. This may take several rounds of questionnaires to achieve. Tests have proven that the Delphi method (named after the all-knowing Oracle of Delphi) is more accurate than an unstructured group of experts giving their opinions and forecasts.

Jury of experts

The Delphi method uses experts not directly employed by the business. The jury of experts uses senior managers within the business, who meet and develop forecasts based on their knowledge of their specific areas of responsibility. This is quicker and cheaper than the Delphi method, but it lacks the external view of market conditions and consumer trends that the Delphi method offers. It is sometimes referred to as the jury of executive opinion.

==jury of experts:== a method that uses the specialists within a business to make forecasts for the future.

The impact of sales forecasting on business decisions

The main purpose of sales forecasting is to enable a business to make better-informed business decisions and plans for growth. Decisions within all major functional areas can be improved by detailed sales forecasts. For example, assume sales forecasts are showing a downturn or downward trend in sales. The following decisions could be based on this prediction:

- Marketing – reduce price, increase promotional spending, widen and extend channels of distribution, new product development, or undertake market development in countries with more positive sales forecasts.
- Operations – reduce the risk of excess capacity by rationalisation, keep inventory levels low, or aim for flexible operations to switch to other products.
- Finance – seek short-term financing if net cash flows become negative, reduce cash outflows where possible, or seek long-term finance to develop new products.
- Human resources – make plans for flexible employment contracts, plan for redundancies or cut back on recruitment for vacant posts. The limitations of sales forecasting methods mean that the predicted data should

not be the only factor that determines these decisions. However, when sales forecasts indicate a sharp increase or decline in sales, the benefits of operating a flexible and adaptable organisation, which is able to make speedy decisions, become clear.

Image Image

22.1 Planning the marketing strategy

Chapters 19 and 20 stress the importance of developing an integrated marketing mix. The four elements of the marketing mix (4Ps: product design and performance; price; promotion; place) must be coordinated with each other. They should be focused on achieving the marketing objectives and all marketing activities must be within budget. The process of developing an appropriate marketing strategy is called marketing planning.

Contents of a marketing plan

The key contents of a typical marketing plan are:

==marketing plan:== a detailed and fully researched written report on the marketing objectives and the marketing strategy to be used to achieve them.

- purpose of the plan and mission of the business
- situational analysis – where the business is now, which includes market research
- marketing objectives – the strategy must be focused on achieving these
- marketing strategy – the overall plan of action to be taken to achieve the objectives
- marketing mix – the combination of the 4Ps that is to be used
- marketing budget – the resources available
- executive summary and time frame for implementing the plan.

Purpose and mission

This section of the plan gives information about the plan's purpose. For example, is it part of a proposal for a new business or to prepare a business for the launch of a new product?

The mission statement and other background information about the business help users of the report to understand where the marketing plan fits in with the existing business.

Situational analysis and market research

Where is the business now? This is an important question to answer in the marketing plan. To develop effective new marketing strategies, it is essential to know about the following:

- the current product portfolio
- market research into the target market (e.g. typical consumer profiles)
- competitor analysis – how many there are and their marketing mix
- the economic and political environment – a PEST analysis
- SWOT analysis.

Marketing objectives

The next question a marketing plan should provide an answer to is: Where do we want to be? All marketing strategies need clear marketing objectives to focus on. These objectives should be SMART so that progress towards achieving them can be monitored at regular intervals. Marketing objectives can be expressed in terms of:

- sales level (units or monetary value) to be reached by a given date
- market share target
- rate of sales growth
- profit margin targets for the new product.

Marketing strategy

This section of the plan analyses how the business intends to achieve its marketing objectives. Marketing strategies could include:

- mass or niche marketing
- selling to the existing markets and consumers
- selling to a new market segment
- developing new markets (e.g. in other countries).

Marketing mix

The marketing plan gives details of the specific marketing tactics that will be used as part of the coordinated strategy. These tactics are the 4Ps of the marketing mix and details in the marketing plan will include:

- product – the USP and main differentiating factor
- price – whether skimming or penetration pricing

- promotion – the methods to be used
- place – the main distribution channels to be used. The marketing plan should explain how the 4Ps are linked and coordinated with each other, and how they should work together to achieve the marketing objectives.

Marketing budget

The financial resources available to the marketing team responsible for the plan must be considered. There is little point in proposing a strategy that the business cannot afford. The plan should make clear the amount to be spent on each promotion method with a clear month-by-month timetable. The total sum to be spent should not exceed the allocated budget for the launch of the new product.

Executive summary and timescale

This final section of the report gives a short overall summary of the plan and the timescale over which it will be introduced.

Reviewing the marketing plan

How successful was the marketing plan? This will be a crucial test of the marketing plan's effectiveness. Have the marketing objectives been reached? If not, by how much did actual performance fall short of the objectives? Changes to the overall plan for the next time period might need to be made.

At the end of the planning period under review, overall success must be assessed and this information used to help develop the marketing strategy for the next time period. Preparing and reviewing marketing plans is not a static exercise – it must be done continuously. This process is known as the strategic planning cycle (see Figure 22.2).

Figure 22.2: The strategic planning cycle Figure 22.2: The strategic planning cycle

Benefits and limitations of marketing planning

Marketing planning benefits include the following:

- The marketing plan is an essential part of the overall business plan of existing businesses or proposed new start-ups. The plan should demonstrate that a market exists for the product; that it would be profitable to exploit this market; and that the marketing-mix tactics are appropriate for the market.
- Marketing planning reduces the risk of failure of strategies that are very different to those the business has followed before. By following the stages of a plan, major potential risks are much reduced because clear objectives

are set, market research is undertaken, a coordinated strategy is used and promotion spending is kept within budget.

- Planning marketing activities helps to give clear direction to other departments within the business: finance prepares the cash resources needed, operations ensures sufficient output is produced and human resources recruits and trains the workforce needed. Marketing planning limitations:
- Marketing plans take up much management time and a small business may not have the skilled management expertise to produce an effective and professional plan.
- Any plan can be affected by events and, in a fast-changing market, a complex and inflexible plan could be a disadvantage. When facing changes, such as the entry of a new competitor, only a flexible marketing plan is likely to be successful.
- A plan that is not based on adequate research of the market and customers' preferences can result in inappropriate marketing strategies being adopted.

22.2 Approaches to marketing strategy

There are important issues that marketing managers should consider when developing an effective marketing strategy:

Consistency

A marketing strategy must be consistent in the quality, quantity and message the marketing activities portray. In particular a new marketing strategy should be consistent with:

- The business – the image of the business and its brands' identities must be reflected in its marketing strategies. If the strategy is completely different to customers' existing perceptions, then the message will be confused and misleading.
- The product – the nature and planned image of the product should be clearly supported by the promotional methods and messages used in the marketing strategy.
- The market – The marketing strategy should reflect the nature of the target market. For example, an industrial market will need a different marketing strategy to a consumer market, whilst a niche market approach will require a different strategy to a mass-marketing approach.

Coordination

The marketing strategy must be completely coordinated. All marketing activities in the strategy need to be tied together so that a consistent message is communicated to customers and potential customers. Examples of the need for linking parts of the strategy together include:

- The marketing mix must be coordinated with the marketing objectives.
- Promotion tactics need to be coordinated with the marketing budget.
- Marketing-mix decisions need to be coordinated together so that the 4Ps are aligned with each other.

Focused

The importance of measurable marketing objectives to the overall marketing plan cannot be overstressed. Marketing strategies must be focused on achieving specific marketing objectives.

Different marketing objectives will require different strategies. For example, a breakfast cereal producer could set very different marketing objectives for one of its major brands. Each objective will require different marketing strategies, as explained in Table 22.1.

Marketing objective

Marketing strategy

Main marketing-mix tactics

Increase market share of existing national market by 30% in 2 years

Use an integrated strategy to penetrate the market

- lower the price
- increase promotions
- increase incentives to retailers to sell the brand

Increase total sales by 50% in 3 years

Market the product in foreign markets by selling through agents in those countries

- change product taste for different consumer preferences
- use different language on the packaging
- match promotions to local culture

Increase profit margins on this cereal brand

Use an integrated strategy to increase added value and establish a premium brand image

- focus promotions on quality and healthy ingredients
- raise the price

- change the product recipe to appeal to health-conscious higher-income groups

Table 22.1: Different marketing objectives require different marketing strategies

The changing role of IT and AI in marketing

Marketing has changed fundamentally as a consequence of the use of IT. The rate of change is being accelerated by the increasingly numerous ways AI can be used to make marketing decisions.

> TIP You will not need to know specific applications of IT or AI. Instead, you may be expected to understand the general impact of IT and AI on the role of the marketing department and on marketing decisions, especially in manipulating and analysing marketing data.

IT applications in marketing

The following are widely used IT applications in marketing:

- Internet: websites are now business necessities for the marketing of products. The internet allows the communication and sharing of product details, reviews, photos and videos that can attract potential customers. Announcements often go out through online services and media stories, while blog posts can drive traffic to a website. Businesses use the internet to promote products and to sell them directly to customers all over the world.
- Email: Most businesses have created opt-in email lists which give them a large base of customers who are already interested in their products. Email marketing can be an effective way to announce new products, give out coupons or discounts, and share information about products. This is affordable and can be an engaging way to market a product and generate sales.
- Mobile: mobile marketing reaches customers on mobile (cell) phones and other mobile devices through text messaging and applications. Text messages can send special coupons or deals to consumers on marketing lists. For example, a business may maintain a profile on a social media smartphone application that offers users a 20% discount if they buy a new product.
- In store: digital signage allows businesses to capture the attention of customers and market specific products to them. This can help restaurants and other businesses that need to respond to changes in inventory or introduce new products on a regular basis. Advanced point-of-sale systems can give employees immediate information on what products are on the shelves or help them track a customer's preferences.
- Social media: this is both a major opportunity and a great challenge for businesses when it comes to product marketing. It can be a quick

and easy way to communicate information on new products to a large group. However, businesses need to use it regularly and effectively to attract customers. Social media communication is equivalent to the old marketing technique of word of mouth. The aim is to create an appealing social media experience, to communicate regularly with customers and to encourage them to share information and reviews about products with others.

Potential AI applications in marketing

The ability of AI to analyse and draw conclusions from vast amounts of data is at the root of what machine learning can do for marketing managers. AI will assume even greater importance to marketing in years to come, but here are four examples of what AI can achieve:

- Gain a more complete understanding of consumers by monitoring what they are buying, reading, watching and commenting on via social media. This data analysis allows marketing managers to quickly modify a message or special offer to meet consumer preferences.
- Optimise the effectiveness of digital advertising campaigns by analysing consumer word searches, social profiles and other online data. Once this has been done, more effective digital promotions can be directed at consumers.
- Create detailed consumer profiles so that the right message can be sent to each individual at the right time, using the right media. This type of personalisation of the media message about a product is one of the great advances in AI analysis of consumer-related data.
- AI's analysis of huge blocks of data and its ability to identify trends allow brand marketing to interact with consumers exactly when they are making purchasing decisions. This real-time interaction through an online conversation at the precise moment of purchase or decision-making can directly influence which product is bought. There are also possible limitations to using AI in marketing:
- Consumer resistance to data being collected and used may lead to pressure-group activity against businesses dependent on big data.
- Management supervision and control is still required.
- It needs significant investments in data collection, IT expertise and computing power.
- At present, AI computing systems lack human creativity and imagination.

22.3 Strategies for international marketing

There is a debate between business analysts about the degree to which the strategies for international marketing should differ from those for national marketing. However, all business managers would accept that there are implications for marketing of increased international trade.

Globalisation and international cooperation: implications for marketing

Globalisation is not a new process but it has accelerated in recent years with the growth of multinational companies and the expansion of economic collaboration between countries. Much of this collaboration has been with the aim of creating free-trade agreements. These reduce or eliminate tariffs and quotas on imports.

==economic collaboration:== countries working together to achieve common aims, such as free international trade.

==free-trade agreements:== agreements made between countries (or trading blocs of countries) to reduce or eliminate trade barriers between them such as import tariffs and quotas.

The key features of globalisation that have an impact on business strategy are:

- increased international trade, as barriers to trade are reduced
- growth of multinational businesses in all countries, as there is greater freedom for capital to be invested from one country into another
- freer movement of workers between countries. World trade (international trade between countries) has grown in recent years. This has been a sign of increased globalisation, resulting from:
- the World Trade Organization (WTO) and free-trade agreements it has negotiated between member countries
- the growth of regional free-trade areas (or blocs) that remove trade barriers between member states, such as the Association of Southeast Asian Nations (ASEAN) and the EU. Since 2001, Asian economies, led by China and India, have contributed 40% of total world trade expansion. China's membership of the WTO is one of the major factors behind this rapid growth. By 2020, exports accounted for around 20% of China's GDP.

The rate of world trade growth averaged 7% per year in the decade 1997–2007. However, the rate fell considerably after 2008 as a consequence of the global financial crisis. It was only 2.5% in 2013. This rose to 3.9% in 2018. The threat of trade protectionism will limit world trade growth in the next few years.

The biggest recent increases in imports and exports of goods (merchandise trade) have been from less economically developed countries (see Figure 22.3).

Figure 22.3: Global trade in goods by level of economic development Figure 22.3: Global trade in goods by level of economic development

Globalisation and increased economic collaboration have positive and negative implications for marketing:

Positive implications

- Greater opportunity for selling goods in other countries without tariffs and quotas. The national markets may be saturated. Moving internationally gives the chance of higher sales, economies of scale and improved profitability.
- One global marketing strategy can be used to create a global brand identity. This saves on the costs of 'different products for different markets'.
- By sourcing and importing materials and supplies from low-cost countries, with no tariffs or quotas, businesses should be able to reduce prices and become more competitive.
- More opportunities to arrange mergers, takeovers and joint ventures with businesses in other countries which could make marketing in other countries easier.

Negative implications

- Businesses from other countries now have freer access to the domestic market. This increases competition. Wider consumer choice means that if national businesses are uncompetitive, sales will fall.
- Increased competition from multinational businesses will force national businesses to reduce prices and profits may fall.
- Using the same marketing strategy across the world does not consider the cultural and taste differences between consumers of different nations. Businesses may need to 'think global but act local'.
- Activity from anti-globalisation pressure groups may result in bad publicity for multinationals in particular. There is growing concern about the cultural and environmental impact of globalisation and pressure-group activity could lead to consumer boycotts and a fall in demand.

Importance of international marketing for a business

For many firms, international marketing is now an opportunity to profitably expand their sales. For many businesses, it is no longer an option to remain based in just one country if they aim to achieve growth. The rapid development of major developing countries (BRICS) is also leading to huge marketing opportunities for businesses prepared to sell their products and services in these international markets.

==international marketing:== selling products in markets other than the original domestic market.

==BRICS:== the acronym for five rapidly developing economies with great market opportunities: Brazil, Russia, India, China and South Africa.

An increasing number of businesses market their products internationally. Why is international marketing so important to so many businesses?

- Saturated home markets: one country can have only so many fast-food restaurants, for example. When the market stops growing and competition is severe, a move to another country, with few large competitors, can offer rapid sales increases.
- Profit opportunities: rapid sales growth may be combined with low costs of operation and create high profitability. If a business produces in a country with low labour and property costs and low tax levels, it can gain higher profit margins by selling at high prices in high-income countries. The great wealth of some nations, such as the Arab oil states, provides some luxury goods producers with the opportunity to sell at higher prices than in their domestic markets.
- Spreading risks: international marketing means that the sales and profits of a business are much less dependent on economic and legal constraints in the home country.
- Poor trading conditions in the home market: for example, in 2019, sales of luxury products in Greece fell due to the economic austerity crisis, but sales of luxury goods in China continued to increase.
- Legal differences creating opportunities abroad: for example, strict legal controls on the selling and advertising of tobacco products in the USA and EU have encouraged most large cigarette manufacturers to target their selling to emerging market economies with fewer restrictions. Profitable, yes, but how ethical is this?

International markets: identification, selection and entry

Moving into international marketing is a major strategic decision for a business. It should not be taken quickly or without adequate research. There are four stages in the decision-making process to select which foreign country to sell products in and how to sell them in this new market:

- Identify potential suitable markets. This might be done by researching GDP growth, GDP per head (standard of living), languages spoken, main cultural influences and geographical location.
- Screen potential markets. Once the potential markets have been identified, they must be carefully screened and the features of them fully researched.

This means considering a wide range of issues such as political stability, currency stability, the size of the potential market, the number and strength of competitors, the cost of transportation, the location in each country and the distribution channels available.

- Select the market to enter. A shortlist of the most suitable markets is drawn up. The marketing manager should visit each one, meet with potential retailers or distributors and analyse other foreign companies' rates of success in each country. A final decision is made based on all the data gathered and analysed.
- Enter the new market. The business needs to decide on the best marketing strategies to sell the product successfully in the new market.

International marketing strategies

One feature of globalisation is that national and regional differences in tastes, culture, fashion and wants are becoming less obvious. According to some analysts (e.g. Theodore Levitt), the world is becoming more standardised in the goods and services it is demanding. If this is true, then there are great opportunities for companies to use technology to gain massive economies of scale by selling the same product worldwide. Other writers (e.g. Susan Douglas and Yoram Wind) suggest that substantial differences still exist in consumer needs in different countries' markets. Standardisation is only one option for entering these markets, and this will sometimes fail. The alternative is for businesses to adapt a global marketing mix to suit local needs and conditions. This is called localisation and aims to maintain local differences in the marketing of products.

Figure 22.4: Biscuits in a Singapore shop. Would these food products and the marketing of them have to change to sell well in your country? Figure 22.4: Biscuits in a Singapore shop. Would these food products and the marketing of them have to change to sell well in your country?

There are, then, two broad approaches to selling goods and services internationally. These are known as pan-global marketing and global localisation.

==pan-global marketing:== marketing a standardised product across the globe, as if the entire world were a single market, selling the same product in the same way everywhere.

==global localisation:== adapting the marketing mix, including differentiated products and adjusting for national and regional tastes and cultures, in order to maintain local differences.

Pan-global marketing strategies

Truly global corporations can operate at relatively low costs by treating the entire world, or major parts of it, as if it were a single country.

A pan-global marketing strategy is one that adopts standard products, brand messages and promotional campaigns across the whole world (see Figure 22.4). More limited developments of this concept include pan-European or pan-Asian strategies, where the geographical area for such common approaches is more restricted.

Figure 22.5: Global marketing (compare with Figure 22.6) Figure 22.5: Global marketing (compare with Figure 22.6)

Advantages of pan-global marketing

Disadvantages of pan-global marketing

• A standard identity for the product can be established. This aids consumer recognition, especially in a world of increasing international travel and the widespread use of satellite-TV channels with international advertising.

• Cost reductions can be substantial. The same product can be produced for all markets, allowing substantial economies of scale. This is particularly important for firms that must spend huge sums on developing new products that may have only a short product life cycle. The same marketing mix can be used. This means that just one marketing agency and one advertising strategy can be used for the whole world or region rather than different ones for each country.

• It recognises that differences between consumers in different countries are reducing. It is often said that teenagers in different countries have more in common with each other than they have with their parents, so a pan-global strategy for a product aimed at teenagers could be successful.

• Despite growing similarity between consumer tastes in different countries, it might still be necessary to develop different products to suit cultural or religious variations. Market opportunities could be lost by trying to sell the same product everywhere.

• Legal restrictions can vary substantially between countries and this does not apply just to product restrictions. It is illegal to use promotions involving games or gambling in certain countries, and restrictions on what can be shown in advertisements vary too.

• Brand names do not always translate effectively into other languages. If a brand name that is to be used in all markets is not chosen with care, it might cause offence to potential consumers or embarrassment for the company.

• Setting the same price in all countries will fail to take into account different average income levels.

Table 22.2: Advantages and disadvantages of a pan-global marketing strategy

There is growing concern about cultural imperialism from US and European businesses, and an expanding anti-globalisation movement. There is also increasing scope for businesses to benefit from adapting and selling products that are geared directly towards the particular cultural, religious and consumer requirements of each country.

The political and cultural backlash experienced in some countries by multinational giants like McDonald's, Coca-Cola and Starbucks indicates the danger of trying to use a policy of one marketing strategy suits all. Slowly, these and other multinationals are realising the importance of developing slightly different strategies and products to suit diverse communities around the world, even if this adds to total costs. The more changes that are made to a marketing mix to reflect local and regional differences, then the closer this comes to global localisation.

Pan-global marketing may continue to be important for two groups of products in particular. The first is upmarket brands with international appeal for their exclusivity, such as Rolex watches, Rolls-Royce cars and Versace dresses. The opportunity to buy the same product as famous pop stars and film actors is the key promise made by these brands. Consumers do not want them adapted to suit their local markets. The second is mass-appeal brands such as Levi's, Apple and Nike, which have substantial opportunities for global campaigns and standardised products, and the economies of scale that result from these.

Global localisation strategies

This approach to international marketing is sometimes summed up as 'Thinking global – acting local' (see Figure 22.6).

Figure 22.6: Should Häagen Dazs sell the same ice cream flavours in all countries? Figure 22.6: Should Häagen Dazs sell the same ice cream flavours in all countries?

Figure 22.7: Localised marketing (compare with Figure 22.4) Figure 22.7: Localised marketing (compare with Figure 22.4)

Yum!, the world's largest fast-food organisation, with top brands such as KFC and Pizza Hut, has adopted this approach to great success. It offers all its global franchisees and branches the benefits and security of a giant multinational corporation. However, it differentiates most aspects of its marketing mix between different countries and markets. For example:

- In China, it sells products that are not available in other countries to suit local consumers' tastes. So, although it was the first company to introduce the Chinese to pizzas, its best-selling lines today include 'KFC Dragon Twister'. It has recently introduced crayfish burgers, lotus leaf-wrapped rice and chicken burgers topped with kimchi – but only in China.
- Price levels are varied between different countries to reflect different average incomes.
- Advertisements always contain local people. Yum!'s distribution and place decisions are being tested for local markets too. In China, it has tried out

new Chinese quick-service restaurants offering authentic Chinese food in surroundings designed in a local style.

Although it has many benefits, global localisation also has limitations (see Table 22.3).

Benefits of global localisation

Limitations of global localisation

Local needs, tastes and cultures are reflected in the marketing mix of the business and this could lead to higher sales and profits.

There is no attempt to impose foreign brands, products or advertisements on regional markets.

The products are more likely to meet local national legal requirements than if they are standardised products.

There will be less local political and pressure-group opposition to this type of multinational business activity.

The scope for economies of scale is reduced.

The international brand could lose its power and identity if locally adapted products become more popular than the international product.

There will be additional costs of adapting products, adverts, store layouts etc. to specific local needs. These costs might lead to higher prices than for a global marketing strategy.

Table 22.3: Benefits and limitations of global localisation

Choosing the strategy to develop a global market

The choice of strategy will be influenced by the differences between the existing national market and the target global markets. The greater these differences are, the greater the need for a localised strategy and not a pan-global strategy. These are the main differences between international markets:

Economic and social differences

Average living standards vary greatly across the globe. According to the International Monetary Fund in 2018, the country with the highest GDP per head of population was Qatar ($130 475) and the lowest was Central African Republic ($712). Decisions about international marketing activities need to take the cost of living into account as well as differences in tax rates, interest rates and the age structure of the population.

Social differences, such as the role of women and the importance of marriage in society, vary substantially too. These social factors may have a considerable impact on the choice of products to sell in foreign markets and the marketing strategies used to sell them.

Legal differences

There are many differences in laws around the world and they will impact on international marketing strategies in key ways. For example:

- Some products have a different legal status in different countries. For example, goods such as guns can be sold legally in the USA but are illegal in other countries.
- Many countries have advertising restrictions. For instance, it is illegal to advertise directly to children below the age of 12 on Swedish TV.
- Product safety and product labelling controls are much stricter in certain countries (e.g. they are tighter in the EU than in some African states).

Cultural differences

Cultural differences are a key factor to consider in international marketing, yet they are often difficult to define and measure. They can exercise a powerful impact on people's behaviour. Failure to recognise cultural differences, including language differences, can have a disastrous effect on a firm's marketing strategy. For example, some words have unfortunate meanings when translated into another language. The use of male and female models together in advertisements is not acceptable in some countries with strong religious traditions. Colours can have different significances too: in the Far East, white is associated with mourning, whereas black is associated with mourning in the West.

Differences in business practices

Accounting standards and rules can vary in different parts of the world. The business may be planning on using direct marketing by setting up a local company to manage the distribution and selling. The ease and cost of setting up a limited company vary widely between countries. It can take a few days in the UK, yet the formalities and form-filling can take more than a year in Sierra Leone, for example.

> TIP You need to keep up-to-date with business practices and legal changes in your own country. You may be asked to evaluate a business strategy used by a business operating in your country. Specific references to differences between your country and others could also be useful.

Selecting the method of entry into international markets

Once a business has decided to adopt international marketing, it must choose which method of entry into (method of selling into) this market it should adopt.

There are various options, as follows:

Exporting products

Exporting can be undertaken by selling the product directly to a foreign customer. This happens with online e-commerce sales. Direct exporting is also commonly used for large and expensive items of capital equipment, such as aircraft, sold to business customers. Alternatively, the exporting business could set up its own marketing division in each target country.

Exporting can also be done indirectly through international trade agents or trading companies. These intermediaries specialise in managing the sale of products from businesses that may not know the target country well. The benefits and limitations of exporting directly and indirectly are shown in Tables 22.4 and 22.5.

Benefits of exporting directly

Limitations of exporting directly

• The business has complete control over the international marketing of its product.

• Agents and traders may represent several other companies exporting goods, so may not give priority to a new exporting business and its products.

• No commission is taken by intermediaries, so profit margins are not reduced.

• The business will need dedicated sales personnel dealing with foreign buyers. Management may have to travel abroad to meet customers if the size of contracts justifies this.

• The business does not have a local agent or trader supporting them, so may lack important local knowledge (e.g. about import controls).

• The exporting business has to handle the logistics of transporting and storing the product and dealing with all paperwork.

Table 22.4: Benefits and limitations of exporting directly

Benefits of exporting indirectly

Limitations of exporting indirectly

• The overseas agent or trading company has local market knowledge and contacts with potential customers, which should aid the marketing of the product.

• Transport and administrative procedures become the responsibility of the agent.

• It may be cheaper for the exporting firm as fewer employees are involved in selling abroad and fewer visits from senior managers will be needed.

• Commission or payment will have to be paid to the agent or trading company, reducing the exporting firm's profit margin.

• The intermediary will have other products, perhaps from competitors, to sell as well. How much focus and effort will be given to selling products from just one business?

Table 22.5: Benefits and limitations of exporting indirectly

International franchising

Franchising was explained in Section 2.2. International franchising means that foreign franchisees are used to operate a firm's activities abroad. This can take the form of one foreign company being used as a franchisee for all the branches in their own country. McDonald's uses just one franchisee business to operate all its branches in Argentina, for example. Another option is for individual franchisees to be appointed to operate each outlet.

The benefits and limitations of appointing franchisees are the same as explained in Table 2.7 with the additional benefit that the foreign franchisee(s) will have important local market knowledge.

Joint ventures

Joint ventures, and their benefits and limitations, are analysed in Section 2.2. An example of using this method to enter an international market is the 50–50 joint venture between McDonald's and two Indian restaurant chains, Hardcastle Restaurants and Connaught Plaza restaurants.

Licensing

Licensing allows another business in the foreign country to produce the branded goods or patented products under licence. This will involve strictly controlled terms over quality. Licensing means that goods do not have to be physically exported, saving on time and transport costs – and making food products fresher too. The business selling the licence avoids the capital cost of setting up its own operating bases abroad.

The limitations of this approach could include:

- possible lapses in quality
- unethical production methods used by the licensee to cut costs, reflecting badly on the main business
- business failure of the licensee, cutting production and sales of the product and reducing income to the business selling the licence.

Direct investment in foreign subsidiaries

Taking over or merging with local companies in other countries can result in major problems. The differences in business culture, organisational structure and technology between the original company and the locally acquired business can create significant obstacles.

An alternative is to set up wholly owned subsidiaries. Studies have shown that these can achieve more success than takeovers or mergers. The subsidiaries can be factories set up in foreign countries (e.g. Toyota in the EU and South America) or retailing operations (e.g. Tesco in Thailand and China). They may be almost completely decentralised, where local managers take most key decisions, or organised with centralised control from head office in the home country.

Table 22.6 shows the benefits and limitations of direct investment in foreign subsidiaries.

Benefits of foreign subsidiaries

Limitations of foreign subsidiaries

- Head office has control of operations and may decide to decentralise this control to allow local managers to take decisions that reflect local conditions. There is no agent or joint venture partner to consult with or take joint decisions with.

- All profits after tax belong to the company. No commission is paid, and no profit has to be shared with a partner business.

- Foreign governments may be willing to offer some financial support to encourage such inward investment.

- It is expensive to set up operations in foreign countries. Senior staff need to visit and may need to be based in the country. Much higher capital costs are required than exporting directly or indirectly.

- Foreign operations may be subject to changes in government policy (e.g. nationalisation of assets) or be asked to leave (e.g. Coca-Cola from certain states in India).

- Decentralised foreign subsidiaries might take decisions that could damage the reputation of the whole business, such as using unethical labour practices.

Table 22.6: Benefits and limitations of foreign subsidiaries

Image Image

23.1 The production (transformational) process

Operations or operations management is concerned with the use of resources called inputs (factors of production) – land, labour and capital – to provide outputs in the form of goods and services.

Factors of production

All business operations require resources or factors of production – these are the production inputs.

- Land: All businesses need somewhere to operate from, even if it is the bedroom of a sole trader operating an internet-based website design service. Some businesses, of course, require large sites for the extraction of minerals or the manufacture of finished products.
- Labour: All business activity requires some labour input. This can be the manual labour of a gardener or the mental skills of a research scientist. The quality of the labour input will have a significant impact on the operational success of a business. The effectiveness of labour can usually be improved by training in specific skills, although trained workers will become sought after by other businesses and may leave.

Figure 23.2: The transformational process Figure 23.2: The transformational process

- Capital: This refers to the tools, machinery, computers and other equipment that businesses use to produce the goods and services they sell. Intellectual capitalthe intangible capital of a business that includes human capital (well-trained and skilled employees), structural capital (databases and information systems) and relational capital (good links with suppliers and customers). is becoming increasingly important too in knowledge-based economies. Efficient operations often depend on capital equipment and, in competitive markets, the more productive and advanced the capital, the greater the chance of business success.
- Enterprise: As explained in Section 1.2, the decision-making skills and risk-taking qualities of entrepreneurs are essential for new business formation.

The stages of the transformational process

The way businesses change factors of production into finished goods is called the transformational process. The starting points of this process are the factors of production or inputs. These are converted, by an operations department, into outputs. This process can be simply illustrated (see Figure 23.2).

==transformational process:== an activity or group of activities that transforms one or more inputs, adds value to them, and produces outputs for customers.

This process applies to both manufacturing and service industries. By production, we mean the making of tangible goods, such as computers, and the provision of intangible services, such as banking. The aim, in all cases, is to achieve added value. This means selling the finished products for a higher value than the cost of the inputs. This concept was covered in Section 1.1, but it is important to revisit it here.

Contribution of operations to added value

Operations managers can increase added value by effectively managing:

- efficiency of production: keeping costs as low as possible will help to give competitive advantage
- quality: the goods or services must be suitable for the purpose intended
- flexibility and innovation: the need to develop and adapt to new processes and new products is increasingly important in today's dynamic business environment. Operations managers aim to produce goods and services of the required quality, in the required quantity, at the time needed, in the most cost-effective way.

The amount of value added to the inputs will depend on a number of factors. Not all of these factors are operations management issues:

- The design of the product: Does this allow for economic manufacture, while appearing to have quality features that will enable a high price to be charged?
- The efficiency of operations: By reducing waste, the operations department will increase the value added by the production process. Increasing productivity will reduce costs per unit and this will increase added value if customer prices remain unchanged.
- Branding to encourage consumers to pay more for the product than the cost of the inputs: A good example is the market for luxury ice creams. Effective branding leads consumers to pay prices much greater than the input costs. Operations makes a considerable contribution to adding value by:
- reducing production costs through increased efficiency
- producing quality goods that meet customer expectations
- ensuring production is flexible so that changing consumer tastes can be satisfied.

TIP You are advised to show your understanding of the importance of operational management to service businesses as well as manufacturers. Businesses providing services, such as banks and web designers, need to plan to use resources productively and effectively.

23.2 Efficiency, effectiveness, productivity and sustainability

Operations management aims to convert inputs into outputs. The resources needed are costly and their use can result in undesirable consequences, such as pollution. Operations managers must constantly consider how to make the best use of the resources at their disposal and how to minimise the impact of the transformational process on future generations.

The importance of productivity

Productivity is not the same as the level of production and the two should not be confused. Production converts inputs into outputs. The level of production is an absolute measure of the quantity of output that a firm produces in a given period of time. Productivity is a relative measure and is concerned with how efficiently inputs are converted into outputs.

==Productivity:== the ratio of outputs to inputs during production (e.g. output per worker per time period).

==level of production:== the number of units produced during a time period.

==Production:== the process that transforms inputs into outputs.

Productivity is important because it is one of the main factors that determine the competitiveness of a business. Raising the level of productivity will reduce the average cost of making each unit of output. This lower cost might allow the business to reduce prices to customers. It is important to be able to measure productivity levels.

Measuring labour productivity

The most frequently used measure of productivity is:

The following example illustrates the importance of productivity to average labour costs.

Example: Companies A and B produce kitchen cupboards. Table 23.1 shows the annual output and employment levels in both companies.

Annual output

Number of workers

Labour productivity = output/workers

Annual pay per worker

Average labour cost = annual pay/labour productivity

A

5 000

10

500

$2 000

$4.00

B

12 000

20

600

$2 000

$3.33

Table 23.1: Labour productivity impacts on average labour costs

Raising productivity

There are four main ways in which productivity could be increased:

- Improve the training of employees to raise skill levels: Employees with higher skill levels and more flexible skills should be more productive. However, training can be expensive and time-consuming, and highly qualified workers could leave to join another business.
- Improve worker motivation: Using appropriate financial and non-financial methods of motivation should encourage employees to work more efficiently. Non-financial methods in particular could be used as they will not increase labour costs. Therefore, any resulting increase in labour productivity will lead to lower average costs of production.
- Purchase technologically advanced equipment: Modern machinery – from office computers to robot-controlled production machines – should allow increased output with fewer workers. High-cost investment will only be worthwhile if high output levels can be maintained. In addition, workers may need to be retrained and there may be genuine fear about lost jobs and reduced security of employment.
- More effective management: Ineffective management can reduce the overall productivity of a business. Failure to purchase the correct materials, poor maintenance schedules for machines or demotivating methods of employee management are just some examples of this. More efficient operations and people management could go a long way towards improving productivity levels.

TIP You are encouraged to show understanding of labour productivity as a relative measure. It is possible for a business to achieve an increase in labour productivity but for total output to fall. If demand for the product falls, the size of the workforce could be cut by more than the decline in output.

Raising productivity does not guarantee success

- If the product is unpopular with consumers, it may not sell profitably no matter how efficiently it is made.
- Greater effort from workers to increase productivity could lead to demands for higher wages. This will lead to higher costs, which may cancel out the impact of productivity gains.
- Workers may resist measures to raise productivity. A 20% increase in labour productivity may lead to job losses if sales do not increase too. There could be industrial disputes.
- The quality of the management determines the success of a policy to increase productivity. If the culture of management is to involve the workforce and seek their views, then productivity improvements are likely to be greater and accepted by workers.
- There is a difference between efficiency, as measured by productivity, and effectiveness.

The importance of efficiency and effectiveness

A distinction needs to be made between these two terms. Efficiency is measured by productivity, but effectiveness is rather different. Effectiveness is achieved only if the customer's needs are met.

==Efficiency:== producing output at the highest ratio of output to input.

==effectiveness:== meeting the objectives of the business by using inputs productively to meet customers' needs.

Example: A business has recently achieved its highest ever level of productivity in making an old design of bicycle it has been producing for 25 years. Unfortunately, sales of this model are falling and inventories of unsold bicycles are increasing. Would you describe the operations of this business as being effective?

Hopefully not! Effectiveness means meeting objectives other than just being efficient in operations. It means meeting customers' needs profitably – and being efficient in production is only one part of this. For the long-term future of any business, satisfying customers' needs profitably is much more important than just producing at the lowest possible unit cost. Effectiveness is about not wasting inputs and putting them to productive use to achieve the objectives of the business.

Efficiency is important because it determines the average cost of production. Effectiveness is important because it means customers' needs are being met.

The importance of sustainability of operations

Sustainability is one of the key business issues of the twenty-first century. Growing global concern about pollution and climate change has put pressure on businesses to clean up their operations. Businesses are becoming increasingly focused on achieving sustainability of operations.

==sustainability of operations:== business operations that can be maintained in the long term, for example, by protecting the environment and not damaging the quality of life for future generations.

They can do this in a number of ways, by:

- reducing energy use and carbon emissions
- reducing the use of plastic and other non-biodegradable materials
- using recycled materials
- manufacturing products that are recyclable
- reducing waste from operations
- buying from suppliers who use sustainable materials and processes. Why are businesses making operations more sustainable?
- Businesses must comply with stricter laws on environmental issues.
- Pressure-group activity exposes the most environmentally damaging businesses and operations.
- Businesses need to fulfil senior managers' commitments on corporate responsibility.
- Sustainable operations gain positive publicity, which is good for public relations.
- More sales are likely as consumers prefer greener and more sustainable products.

Impact on a business of measures to improve the sustainability of operations

The key issue here is whether any costs incurred by making operations more sustainable will be justified by benefits to the business. Table 23.4 outlines the impact on businesses of measures to increase sustainability.

Benefits of increasing sustainability

Limitations and costs of increasing sustainability

Reducing energy use can reduce energy costs.

Increasing sustainability might require capital investment (e.g. in solar panels).

Reducing use of plastic and non-biodegradable materials will attract more demand from green consumers.

More environmentally friendly materials could cost more and may not protect and preserve goods as effectively as plastic.

Using recycled materials reduces demand for newly produced raw materials. This may reduce the price of them.

Recycled materials might need to be cleaned or processed before use.

Making recyclable products reduces the cost of waste disposal.

Development of recyclable products can be expensive and time-consuming.

Reducing waste from operations will also reduce production costs.

Increasing sustainability might need investment in worker training and more accurate equipment.

Buying from sustainable suppliers helps to ensure that operations are sustainable and minimises the risk of bad publicity.

Supplies from sustainable sources might be more expensive than from unsustainable sources so costs might rise – is low cost or reputation more important?

Table 23.4: Impact on businesses of measures to increase sustainability

23.3 Labour intensive and capital intensive operations

Operations managers must decide what combination of factors of production they will use. There are two main approaches. Firms can be described as being either labour intensive or capital intensive.

==labour intensive:== involving a high level of labour input compared with capital equipment.

==capital intensive:== involving a high quantity of capital equipment compared with labour input.

Figure 23.3: Example of a capital intensive production process Figure 23.3: Example of a capital intensive production process

Figure 23.4: Example of a labour intensive production process Figure 23.4: Example of a labour intensive production process

Labour intensive production is still commonly used in small businesses that produce specialist, customised products to meet particular customers, needs. The advantages include:

- interesting and varied work
- low machine costs
- one-off designs meet customer requirements such as exclusive furniture. However, the limitations of labour intensive production include:
- low output levels
- skilled, high-paid workers required
- product quality depends greatly on the skill and experience of each worker. Many industries that supply mass-produced goods are capital intensive. This is because of the nature of the production process involved. Electricity generation or aluminium smelting can only be economically undertaken by using large and expensive capital intensive plants. Other businesses decide to be capital intensive even though labour intensive production is still possible. There are still many craft bread bakers who bake bread in traditional ways, using simple and low-cost capital tools. However, on a large scale, it is possible to bake thousands of loaves a day in highly automated factories with very few workers. The advantages of capital-intensive production are:
- economies of scale
- consistent quality
- low unit costs of production
- the ability to supply the mass market. Capital intensity brings its own limitations, including:
- high fixed costs
- cost of financing the equipment
- high maintenance costs and the need for skilled workers to do repairs
- the quick pace of technological change, which can make the latest production equipment and computer systems obsolete and relatively inefficient. These limitations of capital intensive production are unlikely to slow the trend towards this approach. However, for as long as consumers are prepared to pay for traditional craft-made goods that create a sense of distinction, then labour intensive methods will remain profitable for businesses in certain industries.

In conclusion, which approach is chosen depends on:

- the nature of the product and its brand image

- the relative cost of labour and capital
- business size and access to finance.

23.4 Operations (production) methods

Operations methods are usually classified as follows:

- job productionthe production of a one-off item specially designed for the customer.
- batch productionthe production of a limited number of identical products – each item in the batch passes through one stage of production before passing on to the next stage.
- flow productionthe production of items in a continually moving process.
- mass customisationthe use of flexible computeraided technology on production lines to make products that meet individual customers' requirements for customised products..

Job production

This is normally used for the production of single, one-off products. These products may be small or large and are often unique. Examples of job production would be a specially designed wedding ring, made-to-measure suits or the Yangtze Dam in China. In order to be called job production, each individual product has to be completed before the next product is started. Thus, at any one time, there is only one product being made. Job production enables specialised products to be made and tends to be motivating for workers, because they produce the whole product and can take pride in it.

Job production is often expensive. It can take a long time to complete each unit. It is usually labour intensive. The labour force also needs to be highly skilled and this is not always easy to achieve. An Aston Martin is an example of a very expensive car that is individually produced for the needs of each customer. Each engine is hand-built and carries a plate with the engineer's name on it. Job production can be slow but rewarding for the workers involved.

Image Image

Batch production

Batch production involves the production of identical products in groups. The products in the batch go through the whole production process together. The production process involves a number of stages. An important feature of batch production is that every unit in the batch goes through each production stage before the whole batch moves on to the next stage.

Figure 23.6: Batch production of identical bread rolls Figure 23.6: Batch production of identical bread rolls

An example of this form of production is a baker making batches of rolls. First, the dough is mixed and kneaded. Then the dough is separated into individual amounts, the right size for rolls. The rolls are then baked together and left to cool. When they have cooled, they are put on display in the shop while another batch is prepared. All the rolls in the batch have undergone each production stage before going on to the next stage.

Batch production allows firms to use division of labour. It enables some economies of scale if the batch is large enough. It is usually employed in industries where demand is for batches of identical products, such as 500 school uniforms for the learners of one school. It allows each individual batch to be specifically matched to the demand. The design and composition of batches can often be easily altered.

However, batch production tends to have high levels of work-in-progress inventory at each stage of the production process. The work may well be boring and demotivating for the workers. If batches are small, then unit costs are likely to remain high. There is often a need to clean and adjust machinery after each batch has passed through.

Flow production

With this method individual products move from stage to stage of the production process without waiting for any other products. Flow production systems are capable of producing large quantities of output in a relatively short time. It suits industries where the demand for the product is high and consistent. It also suits the production of large numbers of a standardised item. This is why it is often referred to as mass production.

Figure 23.7: Flow production at a Coca-Cola plant in Ho Chi Minh City, Vietnam Figure 23.7: Flow production at a Coca-Cola plant in Ho Chi Minh City, Vietnam

Coca-Cola's production plant, like the one in Ho Chi Minh City, uses flow production. Here, the product is standardised in that it is a can of soft drink of a standard size. The cans move through the various stages independently. However, the company can make changes to the contents of the cans and the labelling on them without having to alter the flow production system. It is capable of producing Coke, Sprite and Schweppes Soda Water on the same production line. It is essential that the flow production process is carefully planned, so that there are no disruptions in the system. In a perfect system, the production process would be broken down so that all of the stages were of equal duration and producing equal output levels.

Flow production has advantages. Labour costs are low because much of the process is mechanised. There is little physical handling of the products. The constant output rate should make the planning of inputs relatively simple. This makes inventory control easier and minimises inventory levels. Quality tends to be consistent and high. It is easy to check the quality of products at various points throughout the process.

The main disadvantage of flow production is the high initial set-up cost of high-technology production line equipment. This cost cannot be justified if demand is low. In addition, the work involved tends to be boring, demotivating and repetitive.

> TIP It is important to weigh up the advantages and disadvantages of each production method if a question asks you to suggest an appropriate production method.

Mass customisation

This is now the most important production method in industries where customers demand competitive prices and product variations or customisation. The process combines advanced flexible computer-controlled technology and multi-skilled workers. It uses production lines to make a range of products with variations at high volume. This allows the business to move away from the mass-marketing approach with high output of identical products. Instead, focused or differentiated marketing can be used, which allows for higher added value. Dell computers are able to make a customised computer to suit a customer's specific needs in a matter of hours. Mini cars, by BMW, claim that over 1 000 specification and colour options are available, all produced on the same production line. By changing just a few of the key components – but keeping the rest the same – low unit costs are maintained with greater product choice.

Mass customisation requires:

- advanced and flexible capital equipment
- skilled and well-trained workers to operate this machinery
- product designs that have many standardised parts but some interchangeable ones
- suppliers able to supply variations on parts and components.

Choosing between operations methods

The following factors influence which production method is used:

- Size of market: If the market is very small (e.g. designer clothes), job production is likely to be used. Flow production is most efficient when the market for similar or identical products is large and consistent throughout the year. If mass production is used in this way, then mass-marketing methods have to be adopted to sell the high output levels. Even in a market for mass-produced items, such as cars, there are market niches.

These allow smaller manufacturers to survive by making one-off products. If the market demands a large number of units, but at different times of the year (for example, textbooks at the start of the academic year), then batch production might be most appropriate.

- The capital available: A purpose-built flow production line is difficult and expensive to construct. Small firms are unlikely to be able to afford this type of investment and are more likely to use job or batch production.
- Other resources: Large-scale flow production often requires a supply of relatively unskilled workers and a large, flat area of land. Job production needs skilled craftspeople. If any of these resources are unavailable, or limited in supply, then the production method may have to be adapted to suit the available resources, depending on market size.
- Customers demand products adapted to specific requirements: If firms want the cost advantages of high volumes combined with the ability to make slightly different products for different markets, then mass customisation is most appropriate. Technology gives businesses the flexibility to produce a variety of models from one basic design and production process. See Table 23.5 for a comparison of the different operations methods.

Job production

Batch production

Flow production

Mass customisation

Main feature

• single one-off items

• a group of identical products pass through each stage together

• mass production of standardised products

• flow production of products with many standardised components but also customised differences

Requirements

• highly skilled workforce

• labour and machines must be flexible to switch to making batches of other designs

• specialised, expensive capital equipment

• high steady demand for standardised products

• many common components

• flexible and multi-skilled workers

• flexible equipment allows variations in the product

Advantages

• allows for specialist projects or jobs, often with high added value

• high levels of worker motivation

• some economies of scale

• faster production with lower unit costs than job production

• some flexibility in design of product in each batch

• low unit costs due to constant working of machines

• high labour productivity and economies of scale

• combines low unit costs with flexibility to meet customers' individual requirements

Disadvantages

• high unit production costs

• time-consuming

• wide range of tools and equipment needed

• high levels of inventory at each production stage

• unit costs likely to be higher than with flow production

• inflexible – it is often very difficult and time-consuming to switch from one type of product to another

• expensive to set up flow-line machinery

• expensive product re-design may be needed to allow key components to be switched to allow variety

• expensive flexible capital equipment needed

Table 23.5: Summary of main operations methods

Problems of changing operations methods

Businesses may need to change the method used to produce goods and services. This might be because of increasing demand, leading to a need to increase output. It could also result from an increase in labour costs for skilled job production employees, making a switch to a more capital-intensive flow production method more economic.

The problems that result from changing from job to batch production include:

- The cost of equipment needed to handle large numbers in each batch may be too high.

- Additional working capital is needed to finance work-in-progress inventory.
- There is a risk of worker demotivation as there is less need for an individual's craft skills. The problems that result from changing from job or batch to flow production include:
- The cost of capital equipment needed for flow production may be too high.
- Employee training needs to be flexible and multi-skilled. If this approach is not adopted, then workers may end up on one boring repetitive task and become demotivated.
- Accurate estimates of future demand are needed to ensure that output matches demand.

Evaluation of operations methods

The traditional differences between these operations methods are becoming much less obvious. Many complex products, such as computers and industrial engines, can be adapted to meet different consumers' wide range of requirements. The flexibility offered by technology to large businesses could put at risk the survival of small firms that exploit small market niches with hand-built or specialised products. However, there is always likely to be a demand from increasingly wealthy consumers for original and specialist products. So, small firms with non-mass-production methods will still thrive in these market segments.

> KEY CONCEPT LINK Context must be considered when evaluating the suitability of an operations method. Different businesses have very different production requirements. What might be a suitable operations strategy in one business situation might not be appropriate in another one.

Image Image

24.1 Managing inventory

Operations efficiency can be improved if a business manages inventory well by balancing the holding cost against the cost of running out of essential supplies.

Reasons for holding inventory

All businesses hold inventories of some kind. Banks and insurance companies hold supplies of stationery and retailers have goods on display and in their warehouses. Manufacturing businesses hold inventories in three distinct forms:

- Raw materials and components: These will have been purchased from outside suppliers. They will be held in storage until they are used in the production process. These inventories can be sent to the production line quickly. The business can meet increases in demand by increasing the rate of production quickly.

- Work in progress: At any one time, the production process will be converting raw materials and components into finished goods. During this process there will be work in progress and for some businesses, such as building and construction businesses, this will be the main form of inventories held. The value of work in progress depends on the length of time needed to complete production and on the method of production. Batch production tends to have high work-in-progress levels.
- Finished goods: Having been through the complete production process, goods may then be held in storage until sold and dispatched to the customer. These inventories can be displayed to potential customers and increase the chances of sales. They are also held to cope with sudden unpredicted increases in demand, so that customers can be satisfied without delay. Firms will also stockpile completed goods to meet anticipated increases in demand, for example seasonal goods or products such as toys or fireworks at festival times.

  TIP Apply your answer to the business in the case study when writing about inventories and inventory handling systems. For example, if the business sells toys, it may hold high inventories of toys at festival times.

Inventory management

Why do inventories need to be managed effectively? Without effective inventory management serious problems can arise:

==inventory management:== the process of ordering, storing and using a company's inventory.

- There might be insufficient inventories to meet unforeseen changes in demand.
- Out-of-date or obsolete inventories might be held if an effective rotation system is not used, for example, for fresh foods or for fast-changing technological products.
- Inventory wastage might occur due to mishandling or incorrect storage conditions.
- High inventory levels have high storage costs and a high opportunity cost.
- Poor management of the supply purchasing function can result in late deliveries, low discounts from suppliers or a delivery too large for the warehouse to cope with.

Costs of holding inventory

- Opportunity cost: Working capital tied up in goods in storage could be put to other uses. It might be used to pay off loans, buy new equipment or pay suppliers early to gain an early payment discount. The capital could be left in the bank to earn interest. The most favourable alternative use of the capital tied up in inventories is called its opportunity cost. The higher the value of inventories held and the more capital used to finance them, then the greater will be this opportunity cost. During periods of high interest rates, the opportunity cost of inventory holding increases.
- Storage costs: Inventories have to be held in secure warehouses. They often require special conditions, such as refrigeration. Employees will be needed to guard and transport the goods. Insurance of inventories is recommended in case they are stolen or damaged by fire or flood. If finance has to be borrowed to buy the goods held in storage, then this will incur interest charges.
- Risk of wastage and obsolescence: If inventories are not used or sold as rapidly as expected, then there is a danger of goods deteriorating or becoming outdated. This will lower the value of such inventories. Goods often become damaged while held in storage or when moved. They can then only be sold for a much lower price.

Benefits of holding inventory

There are real risks and costs of holding very low inventory levels and these risks may have financial impacts for the firm. These costs are often called inventory-out costs. On the other hand, the benefits of holding inventory are:

- Reduces risk of lost sales: If a business cannot supply customers from goods held in storage, then sales could be lost to businesses with higher inventory levels. This is a form of poor customer service. Holding high inventories not only gives customers more choice but reduces the risk of losing sales because no products are available.
- Allows for continuous production: If inventories of raw materials and components run out, then production will have to stop. This will leave expensive equipment idle and labour with nothing to do. The costs of lost output and wasted resources could be considerable and can be avoided by holding inventories.
- Avoids the need for special orders from suppliers: If a business runs out of inventory, an urgent order may have to be given to a supplier to deliver additional materials. This incurs extra costs because of the administration of the order and possibly also special delivery charges.
- Large orders of new supplies reduce costs: To keep inventory levels low, goods and supplies may be ordered in small quantities. The larger the size

of each delivery, the higher will be the average level of inventories held. By ordering in large quantities and keeping inventory levels high, a business may gain from bulk discounts while transport costs could be lower since fewer deliveries have to be made. The optimum inventory level will be at the lowest point of total costs on the total inventory cost graph (see Figure 24.2).

Optimum order size

Purchasing the right level of inventories is not easy. The purchasing manager must ensure that supplies of the right quality are delivered at the right time and in sufficient quantities to allow continuous production.

The temptation might be to order huge quantities to gain economies of scale and to ensure that there is never zero inventory. Ordering and administration costs will be low, as few orders will need to be placed. Continuous production should be ensured and special order costs for out-of-stock materials should be unnecessary.

Figure 24.2: Total inventory-holding costs Figure 24.2: Total inventory-holding costs

However, this policy also incurs costs. Inventory-holding costs will be higher as the large orders will have to be stored until needed. Opportunity costs will be high due to more capital being tied up. The danger of goods held in storage becoming obsolete and out-of-date is increased. What, then, is the optimum order size? It will differ for every business and every kind of inventory. The economic order quantity (EOQ) can be calculated for each product. At AS/A Level it is sufficient just to know the factors that influence the magnitude of this optimum order size (see Figure 24.3).

==economic order quantity:== the optimum or leastcost quantity of stock to re-order taking into account delivery costs and stock-holding costs.

> TIP You will not be asked to calculate the optimum order size, but do remember to consider the costs of holding inventories and the costs of running out of them, and apply these to the business in the question.

Figure 24.3: Factors influencing the economic order quantity Figure 24.3: Factors influencing the economic order quantity

Inventory control charts

Inventory control charts or graphs are widely used to monitor a firm's inventory position. These charts record, over time, the numbers of goods held, inventory deliveries, buffer levels and maximum inventory. They help an inventory manager to determine the appropriate order time and order quantity. They also allow an analysis of what would happen to inventory levels if an unusual event occurred, such as a competitor operating a very successful promotion campaign.

A typical inventory control chart has certain key features (see also Figure 24.4):

- Buffer inventoriesminimum inventory level that should be held to ensure that continuous production is possible should delivery delays occur or output increase.: The greater the degree of uncertainty about delivery times or production levels, then the higher this buffer level will have to be. Also, the greater the cost involved in shutting production down and restarting, the greater the potential cost savings from holding high buffer levels of inventories.
- Maximum inventory level: This may be limited by space or by the financial costs of holding even higher inventories. One way to calculate this maximum level is to add the economic order quantity of each component to the buffer level for that item.
- Re-order quantitynumber of units ordered each time.: This will be influenced by the economic order quantity.
- Lead timethe time between ordering new supplies and their delivery.: The longer this period of time, the higher will be the re-order inventory level. If suppliers are unreliable and the lead time is long, the buffer inventory level will have to be relatively high.
- Re-order levelthe level of inventory that triggers a new order to be sent to suppliers.: This depends on how long it takes suppliers to deliver new supplies and the rate of usage of inventories. Most businesses use computers to keep a record of every sale and every delivery of stock. The re-order quantity and re-order stock level can be programmed into the computer. It can then re-order automatically from the supplier when inventories fall to the re-order level. The inventory control chart can also be computerised.

Figure 24.4: A typical inventory control chart Figure 24.4: A typical inventory control chart

Figure 24.5 shows the stock level of Popsquash soft drinks held by one retailer over a ten-week period. The inventory level does not follow the regular and consistent pattern of the previous chart. Sales were affected by demand changes, shown by the two very steeply sloping lines. This is a more realistic situation and helps to illustrate the usefulness of this type of chart for future decision-making about inventories.

Figure 24.5: Inventory control chart for Popsquash soft drinks Figure 24.5: Inventory control chart for Popsquash soft drinks

Importance of supply chain management

Operational efficiency can be improved by managing the supply chain with the aim of minimising costs and improving customer service. Supply chain management is a management function of growing importance in nearly all businesses.

==supply chain:== the network of all the businesses and activities involved in creating a product for sale, starting with the delivery of raw materials and finishing with the delivery of the finished product.

==Supply chain management:== handling the entire production flow of a product (from raw materials to finished product) to minimise costs but improve customer service.

Businesses of any size will benefit from reducing the time it takes to convert raw materials into completed products available for sale. Supply chain management aims to reduce this time period by:

- establishing excellent communications with supplier companies, which helps to ensure the right number of goods of the right quality are received exactly when needed
- cutting the time taken to deliver all materials required for production by improving transport systems
- speeding up the new product development process to improve the competitiveness of the business
- speeding up the production process with technology and flexible workforces
- minimising waste at all production stages to cut costs.

Benefits of effective supply chain management

- Improves customer service: Customers expect products to be delivered quickly and on time. Good supply chain management ensures that customers receive products more quickly and of the appropriate quality. This increases customer satisfaction.
- Reduces operating costs: Effective supply chain management allows a business to reduce costs. In particular, purchasing costs and inventory costs should fall. Also, production costs are cut as time is saved in converting raw materials into finished products.
- Improves profitability: By reducing wasted time, improving inventory management and creating a low-cost but efficient supply chain, business profits should increase.

24.2 Just-in-time (JIT) inventory management

Just-in-time (JIT) inventory management aims to achieve zero buffer inventories. Components and other supplies arrive just as they are needed on the production line. Finished goods are delivered to customers as soon as they are completed.

==Just-in-time (JIT) inventory management:== aims to avoid holding inventories by requiring supplies to arrive just as they are needed in production and completed products are produced to order.

Comparing JIT with just-in-case inventory management

JIT contrasts with the traditional method of managing inventory, which focuses on never running out of inventory by holding high buffer inventory levels. This method is referred to as just-in-case (JIC) inventory management. This means holding more inventory than is usually required 'just in case' there is a hold-up in supplies or an unforeseen increase in demand.

==just-in-case (JIC) inventory management:== aims to reduce the risk of running out of inventory to the minimum by holding high buffer inventory levels.

The business world is constantly seeking ways to reduce costs and increase efficiency, so JIT is now much more common than JIC in industries in all economic sectors. This shift towards 'no buffer inventories' led to major supply chain problems for many secondary-sector industries in Europe in 2020. The supplies of a huge range of components from Asia were halted as a result of the COVID-19 epidemic. The relative advantages and disadvantages of these two inventory management systems are outlined in Tables 24.1 and 24.2.

The impact on business of adopting a JIT approach

There are advantages and disadvantages to a business of using a JIT approach, as shown in Table 24.1.

Advantages

Disadvantages

• Capital invested in inventory is reduced and the opportunity cost of inventory holding is reduced.

• Costs of storage and inventory holding are reduced. Space released from holding inventories can be used for a more productive purpose.

• There is much less chance of inventories becoming outdated or obsolete. Fewer goods held in storage also reduces the risk of damage or wastage.

• The greater flexibility needed for JIT leads to quicker response times to changes in consumer demand or tastes.

• The multi-skilled and adaptable staff required for JIT to work may gain improved motivation.

• Any failure to receive supplies of materials or components in time, caused by, for example, a strike at the supplier's factory, transport problems or IT failure, will lead to expensive production delays.

• Delivery costs will increase as frequent small deliveries are an essential feature of JIT.

• Order administration costs may rise because so many small orders need to be processed.

• There could be a reduction in the bulk discounts offered by suppliers because each order is likely to be very small.

• The reputation of the business depends significantly on outside factors such as the reliability of suppliers and traffic delays.

Table 24.1: The advantages and disadvantages of JIT inventory management

The impact of using a JIT approach can be compared with the impact of a JIC approach. Table 24.2 explains the advantages and disadvantages to a business of a JIC inventory management system.

Advantages

Disadvantages

• There is very little chance of running out of inventory. Production levels can be maintained even if there are major delays in the supply of materials/components.

• There is much less need for accurate sales forecasting than with JIT.

• Economies of scale from very large orders of supplies/components are possible.

• High capital cost of finance invested in inventories.

• High storage, insurance and other costs are associated with inventory holdings.

• Inventories could lose value if fashion or technology changes while they are being held.

Table 24.2: The advantages and disadvantages of JIC inventory management

Conditions for JIT to operate successfully

The principle of JIT is easy to understand but less easy to put into practice. For JIT to be introduced successfully, there are certain important requirements that a business must meet:

- Excellent supplier relationships: Suppliers must be prepared and able to deliver additional supplies at very short notice (i.e. on a short lead time).

Suppliers have to see that being reliable and consistent is of great long-term benefit to them as well as to the business adopting JIT. This often means that a business might have only one supplier for each component, so that a relationship of mutual benefit can be built up.

- Production employees must be multi-skilled and flexible: It is wasteful for a worker to produce the same item all the time if this leads to inventories building up. Workers must be able to switch to making different items at very short notice so that no excess supplies of any one product are made. For example, if a worker in a clothing factory usually makes men's denim jeans, but demand is falling, then the worker should be able to switch to making other garments that are still in demand.
- Equipment and machinery must be flexible: Old-fashioned manufacturing equipment was designed to produce products which were very similar. It often took days to adapt the equipment to making other types of products. The machinery would have to produce large batches of one type of product before being converted to making another. Large inventories of each product would be needed to meet demand while equipment was producing other products. This equipment would be most unsuitable for JIT. Modern, computer-controlled equipment is more flexible. It is able to quickly switch to making another type of product with no more than a different software program. Very small batches of each item can be produced, which keeps inventory levels to an absolute minimum. However, such equipment is expensive, so JIT may not be appropriate for small or under-financed firms.
- Accurate demand forecasts: If it is difficult for a firm to predict likely future sales levels, then keeping zero inventories of materials, parts and finished goods could be a risky strategy. Demand forecasts can be converted into production schedules that allow calculation of the number of components of each type needed over a certain time period.
- IT equipment is needed for JIT: Accurate data-based records of sales, sales trends, re-order levels and lead times will allow very low or zero inventories to be held. Communication with suppliers should use the latest electronic data exchanges. Automatic and immediate ordering can take place when it is recorded that more components will shortly be required.
- Excellent employee–employer relationships: Any industrial relations problem could lead to a break in supplies and the entire production system could grind to a halt. It is no coincidence that many of the businesses that have adopted JIT in Japan and in Europe have a no-strike deal with the major trade unions.
- Quality must be everyone's priority: As there are no spare inventories to fall back on, it is essential that each component and product must be right first time. Any poor-quality goods that cannot be used will mean that a customer will not receive goods on time.

TIP If you are asked to discuss how appropriate JIT is in different businesses, remember to consider the potential drawbacks of JIT as well as its benefits.

JIT evaluation

JIT requires a very different organisational culture to that of JIC. It means not accepting waste or poorly used resources, which can be of great benefit to a business. It requires employees to be more accountable for their performance and suppliers to be very reliable. Any failure to meet targets will lead to production stopping. There is no surplus or buffer in the JIT system to cover up for inefficient workers, inflexible people and equipment, unreliable suppliers or poor production planning.

JIT is an important aspect of the move towards lean production (see Section 28.4). It is a principle that has been so widely adopted that most of the world's manufacturing industry will never return to the old ways of inventory management.

JIT may not, however, be suitable for all businesses at all times:

- There may be limits to the use of JIT, if the costs resulting from production being halted when supplies are delayed, far exceed the costs of holding buffer inventories of key components.
- Small businesses may not be able to finance the expensive IT systems needed to operate JIT.
- Global inflation could make holding inventories of raw materials more beneficial. It may be cheaper to buy a large quantity now, rather than smaller quantities in the future when prices have risen. High oil prices will make the transport of frequent and small deliveries of materials and components more expensive.
- Tertiary-sector businesses, such as hotels and hairdressers, may decide to hold buffer inventories to avoid running out. Zero inventories mean they cannot meet customer service expectations, which will damage their reputation.

  KEY CONCEPT LINK Changing to a JIT strategy from a JIC inventory management system will require a different approach to supply chain management. For example, communication with suppliers must be quick and accurate as many small orders will need to be delivered on time.

Image Image

25.1 Measurement and significance of capacity utilisation

The maximum capacity means the total possible level of sustained output a business can achieve in a given time period. Capacity utilisation measures the proportion of that capacity that is currently being used.

==maximum capacity:== the highest level of sustained output that can be achieved.

Capacity utilisation is calculated by the formula:

$$\text{rate of capacity utilisation} = \frac{\text{current output level}}{\text{maximum output level}} \times 100$$

Capacity utilisation is a major factor in determining the operational efficiency of a business. Maximum capacity for a hotel will be the number of room nights available during a period. For a factory, it will be the total level of output that all of the existing resources – land, capital equipment and labour – can produce. If a business is working at full capacity, it is achieving 100% capacity utilisation. There is no spare capacity.

Capacity utilisation rates are used by analysts to compare how one business or factory is performing compared to the average, or how capacity utilisation differs from previous periods.

Capacity utilisation: the impact on average fixed costs

When capacity utilisation is at a high rate, the fixed costs of rent and machinery depreciation are spread over a large number of units. Average or unit fixed costs will be relatively low. When capacity utilisation is low, fixed costs will have to be borne by fewer units and average fixed costs will rise (see Table 25.1).

100-bed hotel	All bedrooms occupied (100% capacity)	50 bedrooms occupied (50% capacity)
Hotel fixed costs per day (e.g. rent, salaries)	$2 500	$2 500
Average fixed costs per room per day	$25	$50

Table 25.1: How unit fixed costs vary with capacity utilisation

Do all firms aim to produce at 100% capacity at all times? Unit fixed costs will be at their lowest possible level and this should help to increase profits. The business will be able to claim how successful it is, as it has no spare capacity. For example, hotels will put up 'No vacancy' signs and airlines will have no unsold seats. Employees feel their jobs are secure and may have a sense of pride that the products they produce are so popular.

However, there are potential drawbacks to working at full capacity for a considerable period of time:

- Employees may feel under pressure due to the workload and this could raise stress levels. Operations managers cannot afford to make any production scheduling mistakes, as there is no slack time to make up for lost output.
- Regular customers who wish to increase their orders will have to be turned away or kept waiting for long periods. This could encourage them to use other suppliers, with the danger that they might be lost as long-term clients.
- Machinery will be working continuously and there may be insufficient time for maintenance and repairs. This lack of servicing may store up trouble in the form of increased unreliability in the future. Therefore, most businesses attempt to maintain a high level of capacity utilisation, while also keeping some spare capacity for the unforeseen events that can always occur.

Operating at over maximum capacity

The definition of maximum capacity contains an important term: 'sustained'. This suggests that it is the highest output level that can be maintained over a reasonable period of time. It might be possible, during emergency situations, to achieve higher output levels for very short time periods. This could be done by using machines beyond their safe working limits and by asking labour to work longer than the contractually permitted hours. Obviously, this situation is not sustainable or recommended. It could result both in machines breaking down, and in workers being too stressed to sustain high levels of output in future.

Operating at under maximum capacity

When a business is operating at less than full capacity it means that there is excess capacity. Low levels of capacity utilisation lead to high unit fixed costs. What options do businesses have when trying to improve capacity utilisation? Options for improving capacity utilisation depend on whether the excess capacity is a short-term or long-term problem.

==excess capacity:== this exists when the current levels of output are less than the full-capacity output of a business; also known as spare capacity.

Short-term excess capacity

This might be caused by low seasonal demand. Options for improving capacity utilisation in the short term include:

- Maintaining high output levels. This strategy adds to inventories and could be expensive and risky if sales do not recover.
- Adopting a more flexible production system, allowing other products to be made that could be sold at other times of the year. This needs a flexible workforce and production resources.
- Insisting on flexible employment contracts so that, during periods of low demand and excess capacity, workers work fewer hours to reduce capacity and costs. This may have a negative impact on employee morale and motivation.

Long-term excess capacity

This might be caused by an economic recession or technological changes which reduce demand for a business's existing products. Table 25.2 examines the options a business has when experiencing long-term excess capacity.

> TIP If you are asked to make decisions about how to deal with excess capacity, you should consider both the length of time that the excess capacity might last and the causes of the problem.

Options

Advantages

Disadvantages

Rationalisationreducing capacity by closing factories/ production units.

– closing factories or other production units

• This reduces overheads.

• It results in higher capacity utilisation from the remaining production units.

• Redundancy payments might have to be paid.

• Workers may worry about job security.

• Industrial action may be a risk.

• Capacity may be needed later if the economy picks up or if the business develops new products.

• The business may be criticised for not fulfilling its social responsibilities.

Research and develop new products

• New products will replace existing products and make the business more competitive.

• If introduced quickly enough, new products might prevent rationalisation and associated problems.

• This may be expensive.

• It may take too long to prevent cutbacks in capacity and rationalisation.

• Without long-term planning, new products are introduced too quickly, without a clear market strategy, and may be unsuccessful.

Table 25.2: Advantages and disadvantages of methods for improving capacity utilisation (reducing excess capacity) in the long term

Capacity shortage

What options does a business have if the demand for its products exceeds current output capacity? The business has a capacity shortage, which is the opposite situation to excess capacity. To consider the management options it is essential to analyse the cause of the excess demand and the time period it is likely to last. For instance, if excess demand results from a reduction in output caused by a faulty machine that will be repaired next month, then action to raise capacity is unnecessary. If, however, the firm has been producing at near 100% capacity for some time and there seems to be no sign of demand falling, then long-term options need to be considered. Should the business:

==capacity shortage:== when demand for a business's products exceeds production capacity.

- increase its scale of operation by acquiring more production resources?
- keep existing capacity but outsource or subcontract more work to other businesses?
- keep working at full capacity and not expand, perhaps because of the danger that demand might fall back in the near future? The final decision will depend on many factors, not least the cost of expanding the scale of operations. The time factor is again important. It may prove to be quicker to place work contracts with outside firms, which could produce components that used to be made within the factory, than to build a new factory. Building a factory could take years to complete and, by the time it is ready, demand may have fallen anyway, perhaps because of an economic downturn.

These are important decisions because the success or failure of a business expansion could determine the future profitability of a business. Failure to expand capacity in a growing market could leave the business with a shrinking market share or becoming increasingly dependent on external contractors. Rapid expansion that takes place before demand trends are clear could lead to excess capacity problems if demand trends change. (See Table 25.4.)

Options

Advantages

Disadvantages

Use subcontractors or outsourcing of supplies, components or even finished goods

• No major capital investment is required.

• It should be quite quick to arrange.

• It offers much greater flexibility than expansion of facilities – if demand falls back, then contracts with other firms can be ended.

• It gives less control over the quality of output.

• It may add to administration and transport costs.

• There may be uncertainty over delivery times and reliability of delivery.

• Unit cost may be higher than in-house production due to the supplier's profit margin.

Invest capital in the expansion of production facilities

• It increases capacity for the long term.

• The business is in control of quality and final delivery times.

• The new facilities should be able to use the latest equipment and methods.

• Other economies of scale should be possible too.

• The capital cost may be high.

• There may be problems with raising capital.

• It increases total capacity, but problems could occur if demand should fall for a long period.

• It takes time to build and equip a new facility and customers may not wait.

Table 25.4: Advantages and disadvantages of methods for reducing long-term capacity shortages

25.2 Outsourcing

The growth of outsourcing in recent years is not just driven by shortage of capacity. There are various other reasons for outsourcing:

- Reduction and control of operating costs: Instead of employing expensive specialists who might not be required at all times, it could be cheaper to buy in specialist services as and when they are needed. These specialist service providers may be cheaper because they benefit from economies of scale, as they provide similar services to other businesses as well. Much outsourcing involves offshoring, i.e. buying in services, components or completed products from low-wage economies.
- Increased flexibility: By removing departments altogether and buying in services when needed, the fixed costs of office and factory space and salaried employees are converted into variable costs. Additional capacity can be obtained from outsourcing just when needed. It demand falls, contracts can be cancelled much more quickly than the rationalisation of existing production units owned by the business.
- Improved company focus: By outsourcing peripheral activities, the management can concentrate on the main objectives and tasks of the business. These are called the core parts of the business. So, a small hotel might use management time to improve customer service and outsource the accounting function completely.
- Access to quality service or resources that are not available internally. Many outsourcing firms employ quality specialists that small to medium-sized businesses could not afford to employ directly.
- Freeing up internal resources for use in other areas. For example, if the HR department of an insurance company is closed and HR functions are bought in, then the office space and computer facilities previously used by HR could be made available to improve customer service. There are also potential drawbacks to outsourcing:
- Loss of jobs within the business: This can have a negative impact on employee motivation. Workers who remain directly employed may experience a loss of job security. Bad publicity may result from redundancies too, especially if the business is accused of employing very low-wage employees in other countries in place of the jobs lost. This could lead to the firm's ethical standards being questioned.
- Quality issues: The quality levels of the goods or services being outsourced will be difficult to check on. A clear contract with minimum service level agreements or product quality standards will be needed. The company outsourcing the functions may have to send the employees responsible for quality control to the business used for outsourcing, in order to ensure that product quality and customer service standards will be met.
- Customer resistance: This could take several forms. Overseas telephone call centres have led to criticism from customers about their inability to understand foreign operators. Customers may object to dealing with overseas outsourced operations. Bought-in components and functions may

raise doubts in customers' minds about quality and reliability.

- Security: Using outside businesses to perform important IT functions may be a security risk. If important data were lost by the business, who would take responsibility for this?
- Corporate social responsibility (CSR): Using outsourced contracts, especially in low-wage economies, means that the business is less able to ensure that its CSR policy towards workers or the environment is being upheld.

> TIP If you are asked to evaluate outsourcing decisions, remember that the more important an activity is to the overall reputation of the business, the less likely it is that outsourcing will be appropriate.

Outsourcing evaluation

The global trend towards outsourcing will continue as businesses look for further ways of improving operational efficiency, and as more opportunities arise due to globalisation. The process is not without its risks, however. Before any substantial business process outsourcing (BPO) of complete functions is undertaken or before any stage of the production process is outsourced, the company must undertake a substantial cost–benefit analysis of the decision. Having closed or run down a whole department to outsource its functions, it would be time-consuming and expensive to reopen and re-establish the department if the outsourcing fails to deliver.

==business process outsourcing (BPO):== a form of outsourcing that uses specialist contractors to take responsibility for certain business functions, such as human resources and finance.

One of the key factors in any business decision on outsourcing is to identify the core activities that must be kept within direct control of the business. The nature of these core activities will vary from business to business.

> KEY CONCEPT LINK The 2020 global COVID-19 pandemic changed the context in which most businesses operate. Supply chain problems were often greatest for those businesses that used extensive outsourcing. The strategy of outsourcing to suppliers in countries most affected by the pandemic will be reconsidered by many businesses.

Image Image

26.1 Location decisions

Deciding on the best location for a new business, or relocating an existing one, is often crucial to its success. It is a major operations management decision, which affects the productive efficiency of the business.

The benefits of an optimal location

Location decisions have three key characteristics. They are:

- strategic in nature, as they are long term and have an impact on the whole business
- difficult to reverse if an error of judgement is made, due to the costs of relocation
- taken at the highest management levels, not delegated to subordinates. An optimal location decision is one that selects the best site for a new business or for relocating an existing one. This best site should maximise the long-term profits of the business. In practice, it is not easy to select this best site because the optimal location is nearly always a compromise between conflicting benefits and drawbacks.

==optimal location:== a business location that gives the best combination of quantitative and qualitative factors.

Example 1: A well-positioned high street shop will have the potential for high sales but will have higher rental charges than a similar-sized shop out of town.

Example 2: A factory location on an industrial estate many kilometres from a large city may have relatively low rental costs. However, the business could have problems recruiting employees due to the lack of a suitably trained working population.

So, an optimal location is likely to be a compromise that balances:

- the high fixed costs of the site with convenience for customers and potential sales
- the low costs of a remote site with the limited supply of suitably qualified labour
- quantitative factorsissues that managers should consider that can be measured in financial or numerical terms. with qualitative factorsissues that managers should consider that are not measurable in financial or numerical terms.(see below)
- the opportunities of receiving government grants in areas of high unemployment with the risks of low sales because of low average incomes in these areas. Some of the potential drawbacks of non-optimal locations are shown in Table 26.1.

Problem

Disadvantages to business

High fixed site costs

• high break-even level of production

- low profits or even losses
- if capacity utilisation is low, unit fixed costs will be high

High labour costs

- low contribution per unit produced or sold
- low profits or even losses
- high average variable costs reduce competitiveness

Low unemployment rate

- problems with recruiting suitable employees
- labour turnover likely to be a problem
- pay levels may have to be raised to attract and retain workers

High unemployment rate

- average consumer disposable incomes may be low, leading to relatively low demand for income-elastic products

Poor transport infrastructure

- raises transport costs for both materials and finished products
- relatively inaccessible to customers
- difficult to operate a JIT (just-in-time) inventory management system due to unreliable deliveries

Table 26.1: Disadvantages to a business of non-optimal location

Figure 26.2: In Singapore, a Marina Bay Sands shop will have high rents but many potential shoppers too Figure 26.2: In Singapore, a Marina Bay Sands shop will have high rents but many potential shoppers too

> TIP When answering questions about business location, you could show evaluation by suggesting that the 'best' location for a business will not always remain competitive. Cost, local competitors and other factors can change over a period of time and this is why many businesses decide to relocate.

Quantitative factors that determine location and relocation decisions

Managers will consider a range of factors before making location or relocation decisions. These can be split between qualitative factors (dealt with further below) and the following quantitative factors.

Site and other fixed costs such as buildings

These vary greatly from region to region within a country and between countries too. The best office and retail sites may be so expensive that the cost of them is beyond the resources of all but the largest companies. The cost of building on a 'greenfield' site (one that has never been developed) must be compared with the costs of adapting existing buildings on a developed site.

Labour costs

The relative importance of these as a locational factor depends on whether the business is capital or labour intensive. The customer call centre of an insurance company will need many workers. In contrast, the labour costs of a nuclear power station will be a very small proportion of its total costs. The attraction of much lower wage rates overseas has encouraged many European businesses to set up operations such as telephone call centres and manufacturing facilities in other countries.

Transport costs

Businesses that use heavy and bulky raw materials, such as steelmaking, incur high transport costs if suppliers are at a great distance from the steel plant. Goods that increase in bulk during production reduce transport costs by locating close to the market. Service industries, such as hotels and retailing, need to be conveniently located for customers, and transport costs are of less significance.

Potential revenue

The level of revenue achieved by a business is influenced by location. Confectionery shops and convenience stores have to be just that – convenient to potential customers. Some locations can add status and image to a business. This may lead to customers believing that the products have higher perceived value. Higher prices could be charged in these locations. This is true for high-class retailers situated in London's Bond Street or Ngee Ann City in Singapore, but also for financial specialists operating from New York's Wall Street.

Government grants

Most governments are very keen to encourage new businesses to locate in their country. Grants may be offered to act as an incentive. Existing businesses operating in a country can also be provided with grants to relocate to areas of high unemployment.

External economies and diseconomies of scale

These are explained in Section 26.2.

Once these quantitative factors have been identified and costs and revenues estimated, the following techniques can be used to assist in the location decision:

Profit estimates

By comparing the estimated revenues and costs of each location, the site with the highest annual potential profit may be identified.

Limitation: Annual profit forecasts alone are of limited use. They need to be compared with the capital cost of buying and developing the site. For example, a site offering 10% higher annual revenue than an alternative location is unlikely to be chosen if the capital cost is 50% higher.

Investment appraisal

Location decisions often involve a substantial capital investment. Investment appraisal methods can be used to identify locations with the highest potential returns over a number of years (see Chapter 35).

Limitation: These methods require estimates of costs and revenues for several years for each potential location. This introduces a considerable degree of inaccuracy and uncertainty into this form of quantitative decision-making.

Break-even analysis

This can be used to calculate the forecast break-even point of two or more possible locations. The lower this break-even level of output or sales, the less the risk of making a loss in this location. This information might be particularly important for businesses that pay high levels of fixed costs. They may benefit from a location with lower overheads.

Limitations: Break-even analysis should be used with caution. The limitations of this technique (see Section 31.4) apply when using it to help make location decisions.

Qualitative factors that determine location and relocation decisions

The main qualitative factors considered in location and relocation decisions are as follows.

Safety

The production method may create potential risks to the public and damage to the company's reputation if there is an accident. Some industrial plants need to be located in remote areas, even though this may increase transport and other costs.

Space for further expansion

It is expensive to relocate if a site proves to be too small to accommodate an expanding business. If a location has space for further expansion, then this might be an important long-term consideration.

Managers' preferences

In small businesses, managers' personal preferences regarding desirable work and home environments could influence location decisions of the business. In larger organisations, such as a public limited company, this is unlikely to be a factor. Earning profits and increasing returns to shareholders will be key priorities in location decisions.

Ethical considerations

A business deciding to relocate from its existing site is likely to make workers redundant. This will cause bad publicity. It could also be against the ethical code of the business and stakeholders may view it as being immoral.

If the relocation is to a country with much weaker controls over worker welfare and the environment, there could be claims that the business is acting unethically. This might lead to negative pressure-group activity.

Environmental concerns

A business might be reluctant to set up in an area that is particularly sensitive from an environmental viewpoint, such as near a public park. Locating in a beautiful area could lead to poor public relations and action from pressure groups.

Infrastructure

The quality of the local infrastructure, especially transport and communication links, will influence the choice of location. For example, Singapore's huge port facilities have encouraged many of the world's largest shipping firms to set up bases there. The quality of information technology (IT) infrastructure varies considerably around the world. This is an important consideration for companies that need quick communication with customers or different sites. The growth of online shopping may lead to some retailers opening fewer high street stores but setting up more warehouse operations to supply consumers directly.

Planning restrictions

Local authorities want business and industry located in their area because jobs are created. However, these authorities want to protect the environment of the towns and villages. In some areas, large development corporations have been set up to develop a town or city into a much more successful combination of dwellings and industrial activity. In most countries, local or central government have set up industrial estates and business parks that both businesses and consumers find very attractive.

Advantages of multi-site locations

Most large businesses operate on more than one site. Major retailing companies, for example, expand mainly by opening new sites in new locations. It would be pointless trying to serve the whole of a country from one shop unless, of course, the business sold only over the internet. In the case of Amazon, one giant warehouse might prove to be adequate to provide supplies to consumers throughout a relatively small country.

Primary producers, such as oil exploration companies and mining businesses, operate in more than one location to avoid the risk of exhaustion of supplies from just one site. Very large secondary manufacturing businesses also operate from more than one location, despite the potential cost advantages from operating on one site.

Banks, building societies, hotels, hairdressers and other tertiary service providers must operate from more than one site if they wish to expand beyond a certain size by offering convenient customer services in several locations.

Figure 26.3: By opening more branches, Starbucks has greater market reach as well as economies of scale Figure 26.3: By opening more branches, Starbucks has greater market reach as well as economies of scale

> TIP An effective way for you to evaluate location decisions is to explain that the lowest-cost location might not be the optimal location. If product quality is low or if there is negative public reaction to products being made by low-paid workers, then low revenue might be more significant than low costs.

Differences between local, national and international location decisions

Local location decisions refer to businesses that often have one branch or office and are located close to the owner's home. The business could actually be located in the owner's home, such as website designers or hairdressers who 'live above the shop'. The business owner's desire to live and work in a particular place is the major influencing factor on location.

National location decisions apply to much larger businesses that operate several or many branches in different regions of one country. This is the case for many supermarket groups and other retailers who have expanded beyond just one local branch. The major influencing factors for retail location decisions on a national level will be site costs, convenience for customers and size of the target market in the region.

International location decisions apply to businesses with operations in more than one country – multinationals. The reasons for international locations are the same as those that explain the rapid growth of offshoring (see below).

==offshoring:== the relocation of a business process from one country to another country.

Reasons for and impact of offshoring

This has become a very widely adopted approach to the location of business operations. It has been encouraged by the trend towards globalisation (see below) and the pressure on businesses to reduce costs to remain competitive.

> TIP In your answers, do not confuse offshoring with outsourcing. Outsourcing is transferring a business function to another company. Offshoring is undertaking a business function in another country. However, a business can outsource work to a company in another country, and this is also offshoring.

Reducing costs

Labour wage rates in India, Malaysia, China and Eastern Europe are a fraction of those in Western Europe and the USA, so it is not surprising that businesses wanting to stay competitive often relocate operations to low-wage economies. Examples include:

- AMEX financial services, which offshored customer services (including call centres) to India and the Philippines
- Ford Cars, which offshored IT systems to India
- Dyson, which offshored vacuum cleaner manufacturing to Malaysia. Table 26.4 shows the legal minimum wage rates in selected countries. There are obvious labour cost advantages to multinational companies when they locate operations in countries such as India, Pakistan and Mexico.

Country	Minimum wage rates per hour $ (2019)
India	0.50
Pakistan	0.70
Mexico	1.05
Brazil	

2.20

Slovakia

3.40

South Korea

6.90

Luxembourg

13.80

Table 26.4: Minimum wage rates in selected countries

Supply of well-qualified workforce

Low labour costs are not always the most important factor in international location decisions. Skill levels and availability of qualified employees are important too. Countries such as India, China, Pakistan and Malaysia, which have invested in education and training of workers, have benefited most from companies offshoring operations to them.

Accessing global markets

Rapid economic growth in less-developed countries has created market potential for most consumer products. Access to these markets is often best achieved by direct operation in the countries concerned. This helps to explain Carrefour's international expansion. Carrefour's supermarkets are now common sights in Thailand and Eastern Europe. Its expansion in China has helped to compensate for slow supermarket sales growth in its home country of France. Carrefour sources a high proportion of the products it sells in these overseas countries from businesses located locally in those countries.

Avoiding protectionist trade barriers

Barriers to free international trade are rapidly being reduced. However, some still exist, notably between the large trading blocs, such as the EU and Association of Southeast Asian Nations (ASEAN). To avoid trade barriers on imported goods, operations can be located within the country or trading bloc concerned. Toyota's decision to assemble cars in a factory in France was made, partly, to avoid trade barriers imposed on Japanese imports.

==trade barriers:== taxes (tariffs) or other limitations on the free international movement of goods and services.

Other reasons for offshoring

These include:

- government financial support to relocating businesses
- overcoming problems from exchange rate fluctuations. It is difficult to make pricing decisions for imported products when currency rates fluctuate considerably. One solution is to locate production in the country where the products are being sold.

Reasons for and impact of reshoring

The offshoring of business operations or processes has clear potential for increasing business competitiveness. However, there can be problems. In recent years, there has been a move by some companies to return offshored operations back to the head office country. This is referred to as reshoring. The main reasons for reshoring are based on the following limitations of offshoring:

==reshoring:== transferring a business operation that was moved overseas back to the country where it was originally located.

Language and other communication barriers

Distance is often a problem for effective communication. For example, direct face-to-face contact is less likely. This problem is made worse when some operations are abroad and when company employees, suppliers or customers use different languages.

Cultural differences

Different consumer tastes, cultures and religious beliefs impact on marketing decisions when selling products abroad. Cultural differences also exist in the workplace. Toyota found that the typical Mexican worker is self-reliant and independent, yet the Toyota manufacturing system depends greatly on teamwork and cooperation. Effective employee training may be necessary to ensure that cultural differences do not prevent successful overseas expansion.

Product quality and level-of-service concerns

This applies particularly to the offshored international customer call centres, technical support centres and business functions such as accounting. Some business analysts argue that offshoring of these services has led to inferior customer service due to time difference problems, time delays in phone messages, language barriers, and different practices and conventions (for example, with accounting systems).

Supply-chain concerns

There may be some loss of control over quality and reliability of delivery with overseas manufacturers being part of the supply chain. This reason is always cited by Zara, the clothing company, for their decision not to offshore clothing production to cheaper countries. Fast fashion (getting new designs into shops quickly) requires very close contact with suppliers. Using JIT manufacturing may become much riskier if important supplies have to be shipped thousands of miles to an assembly plant.

Ethical considerations

There may be a loss of jobs when a company locates all or some of its operations abroad and this may lead to a consumer boycott. When Burberry clothing shut down its factory in Wales, there were claims by some pressure groups that the company's decision was not 'the right thing to do'. In addition, many high street clothing retailers have been accused of sourcing supplies from Asian factories that use child labour and very low-wage labour. Could this negative publicity cancel out the competitive advantage of low-cost supplies? This important consideration is another reason why many businesses are considering reshoring some operations. This might involve higher costs but carries less risk of unethical practices.

Figure 26.4: Is it right to sell clothing in European shops that has been made by low-wage labour in Asian countries? Figure 26.4: Is it right to sell clothing in European shops that has been made by low-wage labour in Asian countries?

Impact of globalisation on location and relocation decisions

One of the main features of globalisation is the growing trend for businesses to relocate completely to another country or to set up new operating bases abroad. Most of the world's largest corporations are now multinationals. Globalisation has made this process easier by:

- allowing free movement of capital between countries
- reducing trade barriers to allow capital and consumer goods to be traded more freely
- making it easier for businesses to legally establish subsidiaries and operations in other countries. The global recession in 2020 caused by COVID-19 has raised doubts in the minds of some analysts about the future of globalisation. This pandemic has made governments and companies consider that:
- The freer movement of people around the globe as a result of globalisation makes controlling the transfer of viruses and other health issues much more difficult.
- Overdependence on international suppliers or offshored operations should be reduced. When they are closed down by government controls to stop the spread of disease, for example, supply chains fail. To avoid this, further reshoring of business processes can be expected in future.

KEY CONCEPT LINK Considering the business context is never more important than in location decision-making. The specific needs of the operations method for land and resources, for example, will have a much greater impact on some manufacturing businesses than on some tertiary-sector businesses.

26.2 Scale of operations

There is a huge difference between the scale of operations of a small business, perhaps operated by just one person, and the largest companies in the world. Some of the latter have total annual sales exceeding the GDP of small countries. In 2018, ExxonMobil recorded sales of more than $279 billion, yet the GDP of Kenya, for example, was $88 billion.

==scale of operations:== the maximum output that can be achieved using the available inputs (resources).

Factors that influence the scale of operations of a business include:

- owners' objectives – they may wish to keep the business small and easy to manage
- capital available – if this is limited, growth will be less likely
- size of the market the firm operates in – a very small market will not require large-scale production
- number of competitors – the market share of each firm may be small if there are many rivals
- scope for scale economies – if these are substantial, as in water supply, each business is likely to operate on a large scale.

Increasing the scale of operations

The scale of operations can only be increased in the long term by employing more of all inputs. The decision to expand the scale of operations of a business is a long-term strategic one. There will be high costs involved (e.g. in purchasing land, buildings, equipment and in employing more people) and the capital needed for this will always have alternative uses. Business expansion, by employing more of all factors of production, is referred to as an increase in the scale of production.

Businesses expand to increase capacity to satisfy customer demand, but they also benefit from the advantages of large-scale production. These are called internal economies of scale.

==internal economies of scale:== factors that cause reductions in unit (average) costs of production as the business expands its scale of operations.

Internal economies of scale

These cost benefits can be so substantial in some industries that small businesses are unlikely to survive due to lack of competitiveness, such as in oil refining or soft drinks production. The cost benefits arise for five main reasons.

Purchasing economies

These economies are often known as bulk buying economies. Suppliers will often offer substantial discounts for large orders. It is cheaper for them to process and deliver one large order rather than several smaller ones. They will also want to keep a very large customer happy due to the profits made on the large quantities sold.

Big firms employ specialist buyers who may travel the globe to obtain the best possible deals for materials and components at the lowest possible prices. There is a growing trend of businesses buying supplies over the internet. This process is a form of B2B (business-to-business) trading. Cheaper deals are offered if greater quantities are ordered.

Technical economies

Large businesses are more likely to be able to justify the cost of flow production lines. If these are worked at a high capacity level, then they offer lower unit costs than other production methods. The latest and most advanced technical equipment, such as computer systems, is often expensive. It can usually only be afforded by big firms. Such costs can only be justified when output is high, so that fixed costs can be averaged over a high number of units. A lower level of output would raise the unit fixed costs. It is often the case that such equipment is indivisible: this means that it cannot be purchased in the form of smaller models with a lower total capacity.

Financial economies

Large organisations have two distinct cost advantages when raising finance. Firstly, banks and other lending institutions often show preference for lending to a big business with a proven track record and a diversified range of products. Interest rates charged to these firms may be lower than the rates charged to small, especially newly formed, businesses.

Secondly, raising finance by going public or by further public issues of shares for existing public limited companies is very expensive. Professional advisers' fees, prospectus publishing costs and advertising charges will not vary greatly whether it is a large or a small issue of shares. Therefore, the average cost of raising finance will be lower for large businesses selling many millions of dollars' worth of shares.

Marketing economies

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

Managerial economies

Small businesses often employ general managers who have a range of management functions to perform. Business expansion provides finance to be able to employ specialist functional managers who should operate more efficiently than general managers. The extreme case of a small business not benefiting from this economy would be a sole trader managed by just the owner. The skills of specialist managers and the chance of them making fewer mistakes because of their training is a potential economy for larger organisations.

> TIP When answering questions about economies of scale, make sure your answer is applied to the business specified in the question.

Figure 26.5: Economies of scale: supertankers hold much more oil than smaller tankers for a lower unit cost per tonne Figure 26.5: Economies of scale: supertankers hold much more oil than smaller tankers for a lower unit cost per tonne

Internal diseconomies of scale

If there were no disadvantages to large-scale operations, industries and markets would be dominated by huge corporations. Some industries are, of course, as with oil exploration, oil refining and petrol retailing. The benefits of large-scale production and economies of scale are so substantial that smaller businesses are probably not able to operate as profitably.

In many other industries, the existence of internal diseconomies of scale prevents one or just a few businesses from dominating. Diseconomies of scale are those factors that increase unit costs as the scale of operations increases beyond a certain size. These diseconomies are all related to the management problems of trying to control and direct an organisation with many thousands of workers. These organisations may be grouped into many separate divisions, often operating in several different countries. There are three main causes of these internal diseconomies of scale.

==internal diseconomies of scale:== factors that cause unit costs of production to increase when a business increases its scale of operations.

Communication problems

Large-scale operations often lead to:

- poor communication of feedback from and to workers
- excessive use of non-personal communication media
- communication overload because a great number of messages are sent

- distortion of messages caused by the long chain of command. These communication inefficiencies may lead to poor decisions being made, due to inadequate or delayed information. Poor feedback reduces employee motivation. Communication overload is 'noise' that may prevent the really important messages being acted upon first. All of these factors reduce management efficiency and lead to higher average costs.

Alienation of the workforce

The bigger the organisation, the more difficult it becomes to directly involve every worker. This can lead to a lack of a sense of purpose and achievement in their work. Employees may feel so insignificant to the overall business plan that they become demotivated and fail to give of their best.

Large manufacturers are most likely to adopt flow-line production, and workforce alienation is a real problem resulting from this operations method. The use of cellworking, teamworking and other job enrichment methods has helped to minimise this problem, but the risk of workers' alienation is ever-present in large businesses.

Poor coordination

Business expansion is often associated with a more complex organisational structure, with more departments, divisions and products. The number of countries a business operates in often increases too. Senior management will have difficulties coordinating and controlling these operations to ensure that all divisions of the business are aiming to achieve the same objectives.

Adopting the same ethical code is important too. For example, if one division of an oil company in one country adopts a weaker ethical stance on issues such as pollution than the divisions in other countries, then poor publicity for the whole business could be the result. Another problem could be the existence of more than one research department, with wasteful duplication of research into similar products. These are all issues that result from poor coordination. They could lead to substantially higher production costs than for a smaller business with much tighter control over operations.

> TIP In your answers, do not confuse 'producing more' with increasing the scale of operations. More can be produced from existing resources by raising capacity utilisation. Changing the scale of operations means using more (or less) of all resources.

Are internal diseconomies of scale avoidable?

Nearly all managers recognise the problems inherent in operating large-scale operations. Can these problems be reduced, and diseconomies avoided? Three approaches could be used to overcome the impact of potential diseconomies:

- Management by objectives: This will assist in avoiding coordination problems by giving each division and department agreed objectives to work towards that are components of the long-term aims of the whole business.

- Decentralisation: This gives divisions a considerable degree of autonomy and independence. Divisions are operated more like smaller business units. Control is exercised by managers with direct experience. Only significant strategic issues need to be communicated to the head office as they might be the only issues requiring centralised decisions. The main problem is that decentralised business units must avoid pursuing conflicting objectives as this results in poor coordination.
- Reduce diversification: Some analysts suggest that moving to a less diversified business that concentrates on core activities may help to reduce coordination problems and communication problems. This could be achieved by a demergerseparating one business unit from another, especially to reverse an earlier merger.. This divides a business up into two or more separate units, which are managed and controlled as independent businesses. This reduces the risk of all of the diseconomies of scale occurring.

External economies of scale

It is common for businesses in the same industry to be clustered in the same region. Silicon Valley in the USA and Bengaluru in India have a very high concentration of IT-focused businesses. All IT firms in these regions benefit from the attraction of a pool of qualified labour to the area. Local college and university courses focused on IT increase the supply of suitable employees. A network of suppliers is already likely to exist, which should result in lower component costs. It is easier to arrange cooperation and joint ventures when the businesses are located close to each other. These factors lead to cost advantages and are referred to as external economies of scale.

==external economies of scale:== factors causing unit cost reductions that can benefit a business as the industry expands in one region.

External diseconomies of scale

If an industry continues to grow in one location it can lead to cost increases for businesses. There will be increased demand for land or property and increased demand for suitable labour. These demand pressures will cause unit costs to rise for businesses in the industry operating in this location. These cost disadvantages are called external diseconomies of scale.

==external diseconomies of scale:== factors causing unit costs to rise as an industry expands, especially in a given region.

Economies and diseconomies of scale and unit costs

The combined effect of economies of scale and diseconomies of scale on unit (average) costs of production is shown in Figure 26.6. It is important to point out that there is not one particular point of operation at which economies of scale cease and diseconomies begin. The process is much more difficult to measure than this. Certain economies of scale may continue to be received as scale increases but at the same time there will be some diseconomies. The significance of diseconomies gradually increases with bigger scale, and average costs may rise. In practice, it is often impossible to identify the level of output at which average costs do start to rise. Many managers may expand their business unaware that the forces causing diseconomies are building up to a significant degree.

Figure 26.6: The impact of economies and diseconomies of scale on average costs
Figure 26.6: The impact of economies and diseconomies of scale on average costs

Image Image

27.1 Quality control and quality assurance

Most businesses claim to put 'quality first', but what does quality mean and why is it important?

Quality: meeting customer expectations

A quality product does not necessarily have to be the best possible. As Activity 27.1 shows, consumer expectations will be very different for goods and services sold at different prices. A quality product does not have to be made with the highest quality materials to the most exacting standards, but it must meet consumer expectations and be fit for purpose.

==quality product:== a good or service that meets customers' expectations and therefore fulfils its intended purpose.

In certain cases, a product must meet the highest quality standards. The high cost of producing it becomes almost insignificant. For example, the internal parts for a jet engine used on a passenger plane will be expected to have a failure rate of less than one in a million. However, if fashion clothing was made to the same exacting standards for stitching, buttons, zips and so on, how much would a pair of jeans cost? Designing too much quality into a product that consumers do not expect to last for many years can make the product very expensive and uncompetitive.

A quality product does not have to be expensive. If low-cost light bulbs and clothes pegs last for several years in normal use, then they are likely to meet consumer expectations and be of the required quality. A low-priced product can be considered good quality if it performs as expected. On the other hand, even a highly priced good may still be of low quality if it fails to meet consumer requirements.

Quality is therefore a relative concept and not an absolute one: it depends on the product's price and the expectations of consumers.

How can consumer expectations or requirements be established by a business? The most common methods would be using market research and analysing results of consumer feedback data. This research can establish the quality standards that customers expect.

==quality standards:== the expectations of customers expressed in terms of the minimum acceptable production or service standards.

It is easy to think of quality standards in terms of manufactured goods – the reliability of cars or the wear-rate of clothes, for example. Quality is also a crucial issue for service providers and their customers. The quality of service offered by a bank, for example, can be assessed by:

- the time and manner in which telephone calls are answered
- queuing time in branches
- the number of accounts errors
- the quality of financial advice.

The importance of quality

There are many benefits to a business from producing quality products:

- helps create customer loyalty
- reduces costs of customer complaints: paying compensation, replacing defective products and loss of consumer goodwill
- helps prolong product life cycles
- reduces the cost of advertising, as the brand will establish a quality image through the performance of its products
- raises the prices that can be charged for quality goods and services. Quality can be profitable.

Business competitiveness is affected by quality

Most markets are now more competitive than ever before and businesses have to compete in order to survive. Globalisation has increased this trend and so has consumer access to the internet. Quality of the product can affect business competitiveness:

- Reducing prices is not necessarily the best method of increasing competitiveness. Achieving consistent quality is often a more effective method of competing in both domestic and international markets.
- Consistent high quality can lead to such a well-known brand image that higher prices can be justified for this unique selling point (USP).
- Average consumer incomes are increasing which raises consumer expectations. It is vital for businesses to differentiate themselves with a quality

brand image. However, cost factors involved in improving quality must always be weighed against the expected gains in competitiveness.

TIP Quality is often viewed as an absolute concept and not a relative one. In answers to questions about quality management, quality must be explained with reference to the expectations of target market consumers.

Quality control

There are two approaches that a business can take when attempting to achieve quality output: quality control and quality assurance. In practice, these two approaches can become blurred as elements of both can often be adopted.

==quality control:== checking based on inspection of the product or a sample of products.

==quality assurance:== a system of agreeing and meeting quality standards at each stage of production to ensure consumer satisfaction.

Quality control is based on inspection or checking, usually of the completed product or of the service as it is being provided to a consumer. For example:

- testing a tablet computer at the end of the production line for its battery-charging capability
- listening to and recording a telephone banking adviser's call to a customer.

Quality control methods

There are three stages to effective quality control:

1. Prevention: This is the most effective way of improving quality. If the design of the product satisfies the requirements of the customer and allows for accurate production, then the other two stages will be less significant. Quality should be designed into a product.
2. Inspection: Traditionally this has been the most important stage. It involves high costs as technically qualified inspectors are needed to check the finished product.
3. Correction and improvement: This is not just about correcting faulty products but is also concerned with correcting the process that caused the fault in the first place. This will improve quality in the future.

Quality control inspection

Traditionally, quality control has been achieved by inspecting products at the end of the production process. Some checking might take place at different stages of the process, but the emphasis is on the quality of the finished article. Quality inspection is expensive as qualified engineers have to be used. These checks can involve damaging the product (for example, dropping computers to see if they will still work). A sampling process must therefore be used, and this cannot guarantee that every product is of the appropriate quality. When quality checks are used during the production process, then statistical techniques are used to record and respond to results.

A typical quality control chart is shown in Figure 27.2 for the recording of weights of loaves of bread. If the recorded weight falls outside the warning limits, then action needs to be taken to improve the accuracy of the production process.

Figure 27.2: A typical quality control chart Figure 27.2: A typical quality control chart

Impact of quality control on business

Quality control based on inspection involves a group of quality control inspectors who check the output of workers. There are several problems with this:

- Inspection is looking for problems and is negative in its culture. Inspectors believe that they have been successful when they find faults. This can cause resentment among workers.
- Employees may view inspectors as management employees who are there just to check on output and to find problems with the work. Workers may find it satisfying if a faulty product escapes the notice of this team of inspectors. This level of mistrust is not good for working relationships and the overall levels of morale in the firm.
- The job of inspection can be tedious, so inspectors become demotivated and may not carry out their tasks efficiently.
- If checking takes place only at a few points in the production process, faulty products may pass through several production stages before being picked up. Much time is spent finding the source of the fault between the quality checkpoints.
- It reduces workers' responsibility for quality. Inspectors have full authority for checking products. The workers will not see quality as their responsibility and will not feel that it is part of their task to ensure that it is maintained. This lack of responsibility is demotivating and will result in lower-quality output. As quality control has many weaknesses, it is not surprising that there has been a move away from this approach in recent years.

Quality assurance

Quality assurance is based on setting agreed quality standards at all stages of production to ensure that customers' satisfaction is achieved. It does not just focus on the finished product.

Quality assurance methods

This approach to quality often involves self-checking by workers of their own output against these agreed quality standards. Quality assurance:

- puts much emphasis on the prevention of poor quality by designing products for easy fault-free manufacture and this should result in getting the quality right first time
- stresses the importance of workers aiming for zero defects, so reducing the chances of faulty products being made or expensive reworking of faulty goods
- establishes quality standards and targets for each stage of the production process for goods and services
- checks components, materials and services bought into the business at their point of arrival, and not at the end of the production process. The quality assurance department analyses how quality can be improved at all production stages. Agreed standards must be established at all stages from initial product idea to the product finally reaching the consumer. These stages include:

1. Product design: The product needs to be designed to meet the expectations of consumers.
2. Quality of inputs: Quality must not be let down by bought-in components. Suppliers will have to accept and keep to strict quality standards.
3. Production quality: This can be improved by all employees taking quality seriously and being responsible for it. Workers should realise that quality levels must not drop below pre-set standards.
4. Delivery systems: Customers need goods and services delivered at times that are convenient to them. The punctuality and reliability of delivery systems must be monitored.
5. Customer service, including after-sales service: Continued customer satisfaction will depend on the quality of contact with consumers after purchase. This is a form of customer relationship marketing. Examples:

- In Nissan car factories, predetermined quality standards are checked at each stage of the assembly of vehicles by the workers accountable for them.
- First Direct, a telephone banking organisation, sets limits on waiting times for calls to be answered, the average times to be taken for meeting each customer's requests and assurance standards to monitor that customer requests have been acted on correctly.

Figure 27.3: Companies often record telephone conversations between employees and customers to help ensure customer care quality assurance Figure 27.3:

Companies often record telephone conversations between employees and customers to help ensure customer care quality assurance

Possible impacts of quality assurance on business are as follows:

- Everyone is responsible for quality – this can be a form of job enrichment.
- Worker motivation is increased when employees are responsible for self-checking products and services, and being involved in efforts to improve quality.
- The system can be used to trace quality problems back to the stage of the production process where a problem is occurring.
- It reduces the need for the high costs of final inspection and reworking of faulty products.
- Quality standards are set for all stages of production. The quality of work at each stage is assessed against these standards before the product is completed.
- It reduces total quality costs. An overall culture of quality can lead to reduced costs of wastage and faulty products.
- It can gain accreditation for quality assurance awards such as ISO 9000an internationally recognised standard that acknowledges the existence of a quality assurance method that meets certain conditions.. These awards can give a business great status and can be used in promotions for its products. To obtain the ISO 9000 certificate, a business must demonstrate that it has:
- employee training and appraisal methods
- methods for checking on suppliers
- quality standards in all areas of the business including after-sales service
- procedures for dealing with defective products and quality failures. There are important marketing benefits for a business of establishing a quality assurance framework and receiving this internationally recognised qualification. There are, however, drawbacks such as the costs of preparing for inspection and the bureaucratic form-filling required to gain the certificate.

TIP In your answers, you may be given the opportunity to stress that quality is not just an issue for large businesses. Small and medium-sized businesses also need to give consideration to this vital operations management area to maintain customer loyalty.

The impact of total quality management on business

This approach to quality requires the involvement of all employees in a business. Total quality management (TQM) is based on the principle that everyone within a business has a contribution to make to the overall quality of the finished product or service.

==Total quality management (TQM):== an approach to quality that aims to involve all employees in quality improvement.

TQM often involves a significant change in the culture of an organisation. Employees can no longer think that quality is someone else's responsibility. The search for quality must affect the attitudes and actions of every employee. When adopting this concept, every worker needs to think about the quality of the work they are performing as another employee is, in effect, their internal customer. Every department is obliged to meet the standards expected by its internal customer(s). These departmental relationships are sometimes known as quality chains. All businesses can, therefore, be described as a series of supplier and customer relationships. Examples include:

==internal customer:== people within the organisation who depend upon the quality of work being done by others.

- A truck driver who drops off supplies to retailers is the internal customer of the team loading the vehicle. Goods must be handled carefully and loaded in the right order. The truck driver has to face the retailer if goods are damaged or the wrong ones are delivered.
- A computer assembly team is the internal customer of the teams producing the individual components. A fault with any component means the assembled computer will not meet quality standards. The TQM concept has revolutionised the way workers view quality. To be effective, the concept must be fully explained and training given to all workers. TQM is not a technique – it is a philosophy that quality is everyone's responsibility. The aim is to make all workers at all levels accept that the quality of the work they perform is important. Workers should be empowered with the responsibility of checking this quality level before passing their work on to the next production stage.

This approach fits in well with the Herzberg principles of job enrichment. In addition, TQM should almost eliminate the need for a separate quality control department with inspectors separated from the production line itself.

TQM aims to cut the costs of faulty or defective products by encouraging all workers to 'get it right first time' and to achieve zero defects. With TQM, if quality is improved and guaranteed, then reject costs should fall and the demand for the products will rise over time.

==zero defects:== a way of thinking to ensure that products meet customer expectations every time.

TQM will only work effectively if everyone in the business is committed to the idea. It cannot be introduced into one section of a business if defective products coming from other sections are not reduced. The philosophy requires a commitment from senior management to allow the workforce authority and empowerment. TQM will not operate well in a rigid and authoritarian structure.

Figure 27.4 summarises the TQM approach.

Figure 27.4: The TQM approach Figure 27.4: The TQM approach

27.2 Benchmarking

The term benchmarking is short for 'best practice benchmarking'. This is a comparison exercise between a particular business and the best in the industry. It identifies areas of the business that need to be improved to meet the standards of quality and productivity of the best-performing businesses. In large businesses, internal benchmarking can be used to identify the best-performing divisions of the company.

==benchmarking:== comparing a business against the performance standards of the best businesses in the same industry.

Stages in the benchmarking process are as follows:

1. Identify performance indicators of the business to be benchmarked: This could be decided by interviewing customers and finding out what they consider to be most important. For example, research may reveal that the most important factors are the reliability of the product, speed of delivery and after-sales service. These then become the benchmark performance indicators (BPI)the areas of business performance that are measured and compared with other businesses..

2. Measure performance in these areas: For example, reliability records, delivery records and the number of customer complaints could be used to gather data.

3. Identify the businesses in the industry that are considered to be the best: The best businesses might be assessed by management consultants or by benchmarking schemes operated by government or industry organisations.

4. Use BPI data from the best businesses to establish the weaknesses in the business: This data could be obtained from other businesses by mutual agreement or from published accounts, specialist industry publications, or contact with customers and suppliers.

5. Set standards for improvement: These might be the standards set by the best firms or they could be set even higher to create a competitive advantage.

6. Change processes to achieve the standards set: This may require nothing more than a different way of performing one task. However, more substantial changes may be necessary.
7. Re-measure: The changes to the process need to be checked to see if the new, higher standards are being reached. Benchmarking is not a one-off exercise and, to be effective, it should become a continuous process.

Figure 27.5: Stages in the benchmarking process Figure 27.5: Stages in the benchmarking process

Importance of benchmarking in quality management

Benchmarking is a very widely used approach to managing and improving quality:

- Benchmarking is a more effective way of identifying and solving business problems than trying to solve production or quality problems without external comparisons.
- The areas of greatest significance for customers are identified, and action is directed to improving these.
- It is a process that can help a business increase international competitiveness.
- Comparisons between businesses in different industries – for example, customer service departments in a retailer compared with a bank – can lead to a useful crossover of ideas.
- It is important to involve the workforce, then their participation can lead to better ideas for improvement and increased motivation.
- Internal benchmarking is comparing performances of different divisions of the same business. This form of benchmarking uses internal data which is easy to obtain. The benchmarking approach has some limitations, however:
- Benchmarking depends on obtaining relevant and up-to-date information from other businesses in the industry. If this is difficult to obtain, then the process will be limited.
- Merely copying the ideas and practices of other businesses may discourage initiative and original ideas.
- The costs of the comparison exercise may not be recovered by the improvements obtained from benchmarking.

Quality management: an evaluation

- Quality is not an option. It is a fundamental aspect of all successful businesses.
- Quality is an issue for all businesses, not just manufacturers. Service-sector providers, such as those in tourism and insurance, should also make the quality of their products and customer service a priority to survive in competitive markets.
- Improving quality has obvious cost advantages if the rate of defective products is reduced. The marketing and people benefits should not be overlooked. Satisfying customers gives clear advantages when seeking further sales. Involving workers in quality-improvement programmes can lead to a more motivated workforce.
- Improving quality needs to be the driving force throughout the business.
- The meaning of quality must not be forgotten. It is not necessary to produce the best product or service at all costs, but to achieve the quality of product or service that the customer expects. This will encourage customers to return in the future.

  KEY CONCEPT LINK A strategy of benchmarking against the best in the industry allows a business to assess its performance in the context of its competitors.

Image Image

Introduction

There have been many recent developments in operations management and this chapter focuses on these strategies as well as the need to plan and control major projects.

28.1 Operations decisions

Major operations decisions usually have important consequences for the resources required by a business.

The influence of resource availability on operations decisions

Strategic operations decisions include:

- expanding or reducing capacity
- locating a business or relocating it

- offshoring or reshoring
- outsourcing
- changing operations (production) methods
- application of IT and AI. These important, long-term decisions all require the operations department to assess the resources of the whole business: human resources, marketing and financial. These decisions will not only have an operations impact. If there are insufficient resources available from the human resources, marketing and finance departments, then operations decisions may have to be revised or abandoned altogether.

For example, decisions to:

- Expand capacity will require long-term sales forecasts from the marketing department, a revised workforce plan from human resources and financial resources to pay for it. If these resources are not available, the decision to expand might have to be abandoned.
- Relocate operations will require a suitable supply of labour in the new location, an efficient distribution system to customers from the proposed site, and financial resources to pay for the costs of buying and developing the site. If these resources are not available or are inadequate, then an alternative site will be needed, or the decision could even be made to remain on the existing site.

  TIP You should be prepared to analyse the influence of the availability of human resources, marketing resources and financial resources on strategic operations decisions.

The changing role of IT and AI in operations management

The role of IT in business operations has expanded greatly for both service providers and product manufacturers. The following examples illustrate the impact that IT and AI are having, and will continue to have, on business operations.

Computer-aided design

This type of IT software may be developed for specific applications, such as architectural designs. It is widely used for computer animation and special effects in movies, advertising and other applications where the graphic design itself is the finished product. Computer-aided design (CAD) is also used to design physical products in a wide range of industries such as furniture-making. The software performs calculations for determining an optimum shape and size for a variety of product and industrial design applications.

==Computer-aided design (CAD):== the use of computer programs to create two- or three-dimensional (2D or 3D) graphical representations of physical objects.

In product and industrial design, CAD is used mainly for the creation of detailed 3D models. CAD is also used throughout the engineering process from design of products, through analysis of component assemblies to the structure of manufacturing methods. This allows an engineer to interactively and automatically analyse design variations in order to find the best design for manufacturing, while minimising the use of costly physical versions of the product.

Figure 28.1: 3D computer-aided design Figure 28.1: 3D computer-aided design

The benefits of CAD include:

- lower product development costs
- increased productivity
- improved product quality
- quicker development of new products and reduced time to bring them to market
- good visualisation of the final product and its major components
- great accuracy, so errors in production are reduced. The limitations of CAD include:
- complexity and cost of the programs
- need for extensive employee training
- it requires large amounts of computer processing power, which can be expensive.

Computer-aided manufacturing

Through the use of computer-aided manufacturing (CAM), a factory can become highly automated. A CAM system usually seeks to control the production process through automation. These processes are carried out by robotic tools, such as lathes, milling machines and welding machines. Each of the manufacturing processes in a CAM system is controlled by computers, so a high degree of precision and consistency can be achieved, which is not possible with machinery that must be controlled by people.

==computer-aided manufacturing (CAM):== the use of computer software to control machine tools and related equipment in the manufacturing of components or complete products.

Figure 28.2: Computer-controlled robotic machines Figure 28.2: Computer-controlled robotic machines

The benefits of CAM include:

- Precise manufacturing and reduced quality problems.

- Faster production and increased labour productivity.
- More flexible production operations, which allow quick changeover from one product to another.
- Integrating with CAD and CAM allows more design variants of a product to be produced. This means that niche products can be produced as well as mainstream mass-market products, often on the same production line. This form of mass customisation increases the competitiveness of businesses in both small and large market segments. The limitations of CAM include:
- Costs of hardware, programs and employee training. These costs may mean that smaller businesses cannot access the benefits of CAM, although technology is becoming cheaper.
- Hardware failure and breakdowns can occur, which can be complex and time-consuming to solve.
- Quality assurance is still needed. Errors in programs can produce faults that have to be spotted and rectified before being passed on to the next stage of production.

AI applications in business operations

The use of AI to enhance business operations is developing rapidly. These applications can automate repetitive and commonly occurring tasks to increase productivity and improve customer service. For example, AI customer call centre applications can answer customer calls within 5 seconds on a 24 hour a day, 365 days a year basis, and accurately address customers' problems on the first call 90% of the time. They can transfer complex issues to employees to be dealt with. Research has shown that under half of the customers know that they are interacting with a machine.

The great benefit of these and similar AI applications stems from their ability to reduce search time and process more data to inform decisions. This is how they can boost productivity. They also free up employees' time so that they can perform higher-level work that requires human flexibility and creativity. AI applications in business operations can improve operational efficiency, customer satisfaction and the working experience of employees.

Other AI applications in business operations include:

- banking applications for processing loan requests, which give customers a much quicker response
- online payment systems which identify potential fraud
- legal applications for identifying relevant previous court cases

- manufacturing applications for scheduling the best time to maintain equipment
- pharmaceutical research and development applications for predicting the success of medical drugs that are being developed
- cyber security software to monitor online behaviour, detect abnormal behaviour, issue alerts and respond to threats.

28.2 Flexibility and innovation

Future demand patterns are not easy to predict accurately. If actual demand turns out to be either higher or lower than forecast, there is a great need for operational flexibility.

==operational flexibility:== the ability of a business to vary both the level of production and the range of products following changes in customer demand.

The importance of operational flexibility

This flexibility can improve business efficiency by:

- adapting the volume of output to changes in market demand
- changing delivery time schedules to meet changes in the timing of customer requirements
- responding to the demand from customers for unique or unusual product specifications. Operational flexibility can be improved in a number of ways, as listed below. The benefits and potential limitations of these are considered in other chapters.
- Increasing capacity by extending buildings and buying more equipment (see Section 25.1).
- Outsourcing some production so that output can be varied rapidly (see Section 25.2).
- Holding high inventories just in case consumer demand increases in unpredictable ways (see Section 24.1).
- Employing a flexible and adaptable labour force (see Chapter 16).
- Investing in production systems that allow for mass customisation (see Section 23.4).

Process innovation

Many new ways of producing goods or delivering services are being developed each year. Some recent examples help to show the extent and importance of some of these new methods of process innovation:

==process innovation:== the use of new or much-improved production methods or service delivery methods.

- robots in manufacturing
- faster machines to manufacture microchips for computers
- computer tracking of inventories (e.g. by using bar codes and scanners) to reduce the chances of customers finding businesses out of stock
- internet tracking of the exact location of parcels being delivered worldwide to improve the speed of delivery. Example 1: The float-glass production process revolutionised the manufacture of sheet glass. The UK-based business, Pilkington, patented this process and gained a competitive advantage as the float-glass production process both is cheaper than traditional processes and produces the very highest quality of glass. The company has developed an unrivalled reputation for innovation and research in this industry.

Example 2: Amazon is testing unmanned flying drones to deliver parcels to customers to improve workflow and speed of delivery. This system will be called Prime Air. According to CEO Jeff Bezos, the drones will be able to deliver parcels weighing up to 2.3 kg to customers within 30 minutes of the placing of an order.

Figure 28.3: Amazon is testing drones to deliver small parcels Figure 28.3: Amazon is testing drones to deliver small parcels

Example 3: Zara's fast fashion innovation has revolutionised the production and selling process in the clothing industry. Only 15–25% of Zara's clothes are produced before each new season starts. All other clothes are produced at the start of the season or during it, according to both customer demand and new styles suddenly becoming fashionable. It takes a maximum of four weeks from a new style being developed to it being available in Zara shops. Other clothing retailers struggle to achieve this in four months.

The main benefits of process innovation are lower-cost and more effective production methods, making the business more competitive. It is also possible, if the innovation involves patents of new techniques, that these could be sold or licensed to other businesses.

> KEY CONCEPT LINK Innovation can be one of the most important factors that determine the competitiveness of a business. Product innovation can create new market opportunities; process innovation can transform the efficiency of a manufacturing system.

28.3 Enterprise resource planning

Enterprise resource planning (ERP) has become possible in recent years with increased computerisation and the use of a single database program across all departments of business. ERP links all business functions, such as manufacturing, marketing, human resources and finance, through one software platform.

==Enterprise resource planning (ERP):== the use of a single computer application to plan the purchase and use of resources in an organisation in order to improve operations efficiency.

By using this type of database program, it is possible to coordinate and link together all of the systems of a business needed to complete a customer's order: controlling inventory, ordering supplies, planning operations, marketing, planning human resources and invoicing customers.

The following two examples demonstrate the scope of the benefits of using ERP in operations management.

Example 1 – Specialist bicycle manufacturer: A unique racing bicycle is ordered by a customer (credit sale). The order is recorded on the manufacturer's ERP program. The program automatically sends a purchase order to suppliers for the specialist components required. A skilled worker is allocated the task of assembling the bicycle. The total labour time taken plus the cost of components is added together so that the marketing department can calculate the selling price. The customer is sent an invoice. When payment is made, the accounting records are updated. The ERP program could also handle bicycle repair orders, manage spare parts inventories and provide forecasts of future sales to plan workforce needs over the next few months.

Example 2 – Water supply company: A customer requests repair to a water supply pipe. A date is scheduled in by the company's ERP system. The job is allocated to a team of workers. The correct spare parts are ordered. When the job is completed, it is entered on the database. The customer is sent an invoice for the job and their payment is recorded in the accounts section of the database.

ERP software will monitor all of these stages. By using the internet, ERP allows the supply chain of a business to be linked into the supply chains of customers and suppliers in a single overall network. This is a good example of B2B (business-to-business) communication.

The efficiency improvements gained from ERP software include:

- Supply only according to demand, avoiding waste and moving the business towards achieving sustainability in its operations.
- More effective utilisation of capacity and quicker response to changes, such as variations in consumer demand. These improvements are also a result of the greater workforce flexibility that ERP achieves.

- Just-in-time ordering of inventories (see Section 24.2).
- Reductions in costs at all stages of the supply chain. Materials and products are electronically tracked at all stages.
- More accurate costing and pricing of products as components and labour costs are appropriately allocated to each product.
- Improved delivery times and better customer service.
- Departments linked more closely together by the single database, resulting in better coordination between them and less waste.
- Management information is increased. Data from all stages of the production process and all the supporting departments is available to senior management via the computer system. This could help in future decision-making (e.g. changing suppliers if lower-priced supplies of consistent quality are offered).

Figure 28.4: An example of ERP in action Figure 28.4: An example of ERP in action

ERP has potential limitations too:

- The costs of the database and computer systems have to be considered, although these costs are falling with technological advances in computing power.
- Employee training costs have to be incurred as a badly implemented ERP system could make operations less efficient.
- The different ways in which different departments can operate now have to be reduced to one common system. This may cause resentment as departments are forced to give up tried-and-tested ways of operating.
- In most businesses the full implementation of ERP can take one to three years. Technological advances over this period could make the chosen software obsolete. Financing further investment in the most up-to-date ERP system might require other projects to be abandoned.

28.4 Lean production

Lean production started as a Japanese production concept but is now widely adopted throughout global industry. It is closely linked with some of the approaches that have already been considered, such as empowerment of workers, efficient use of capacity, JIT and TQM. Any business process that aims to reduce waste is considered to be a form of lean production.

Aims and purposes of lean production

The overall objective of lean production is to produce quality output with fewer resources. This means less waste, less duplication and elimination of unnecessary non-added-value activities. Lean means cutting out anything in the production process that adds complexity, cost and time, and that does not add value to the customer.

The main sources of wasted resources in industry are:

- excessive transportation of components and products
- excessive inventory holding
- unnecessary movement by employees (e.g. to get supplies of components from the storeroom)
- waiting time (delays in the production process)
- over-production (producing in excess of demand)
- over-processing (making goods that are too complex although they could have been designed more simply)
- defects (products that do not come up to quality standards and have to be rejected or corrected)
- underutilised talent (not giving employees the opportunity to use all of their abilities). The essential purpose of the lean production concept is to reduce or remove all of these causes of waste.

Figure 28.5: The different causes of waste Figure 28.5: The different causes of waste

Lean production approaches

The objectives of lean production can be achieved by adopting the following approaches.

Kaizen

The philosophy behind kaizen is that all employees have something to contribute to improving business efficiency and the way a product is made. Traditional styles of Theory X management never give workers the opportunity to suggest improvements to the way things are done. The assumption is that trained managers know best. The objective of managers adopting this approach is to maintain high output levels and develop one-off improvements through process innovations or new equipment and machines.

==kaizen:== a Japanese term meaning continuous improvement.

The kaizen philosophy is very different. It suggests that very often workers actually know more than managers about how a job should be done or how productivity could be improved. Someone who works at a task every day might know how to change it to improve either quality or productivity better than a manager with no hands-on experience of production. Another feature of kaizen is that improvements in productivity do not just result from big one-off investments in new technology. A series of small improvements suggested by employees, can, over time, result in as big an improvement in efficiency as a major new investment (see Figure 28.6).

Figure 28.6: Kaizen compared to one-off changes Figure 28.6: Kaizen compared to one-off changes

The following conditions are necessary for kaizen to operate:

- Management culture must allow for employee involvement. Employees' views and ideas should be given great importance. Managers should accept that in decision-making, work experience will count for as much as theoretical knowledge.
- Teamworking is essential. Suggesting and discussing new ideas to improve quality or productivity is best done in groups. Kaizen groups are likely to be drawn from the work team operating in the workplace. Each group should meet regularly. Management must provide the time and necessary training for employees to discuss identified problems. Recommendations for change are put forward to managers. Each group may be empowered to put their own ideas into practice.
- Each kaizen group should be given the power to take decisions regarding workplace improvements. This leads to the quick introduction of new ideas and motivates employees to come up with even more ideas. Many businesses now use the kaizen approach. The process has a knock-on effect as improvements in one part of the production system require improvements further down the line. For example, a worker on a production line that assembles cars finds a way to save five seconds from the time it takes to weld the roof panels onto the support struts. The workers who are responsible for the next process must also find a way to save five seconds or there will be a bottleneck and production delays. This example highlights the need for all employees to be involved in kaizen if the business is to fully benefit from it.

  TIP It would be good analysis to link the kaizen principle to the work of Herzberg on job enrichment.

Limitations of the kaizen approach

- Some changes cannot be introduced gradually and may need a radical and expensive solution such as an AI-based operations system.
- There may be resistance from senior managers to such a programme due to their existing culture. Kaizen will only work effectively if there is real

empowerment of the groups involved. Authoritarian managers find this impossible to accept.

- In the short term, there may be tangible costs to the business of such a scheme, such as employee training and lost output as a result of group meeting times.
- The most important advances tend to be made early on during the kaizen programme. Later changes can be less significant. Some business analysts believe there could be diminishing returns from kaizen.

Quality circles

This is a Japanese-originated approach to quality. It is based on worker involvement in improving quality, using small groups of employees to discuss quality issues. Teamworking and participation can both improve quality and increase worker participation. The overall aim of quality circles is to investigate quality problems and present solutions to management – or, if a group is fully empowered, to put the improvements into effect itself. (See Table 28.)

Main benefits of quality circles

Main conditions determining success

- They improve quality through joint discussion of ideas and solutions.
- They improve motivation through participation.
- They make full use of the knowledge and experience of the employees.
- Circle members must be committed to improving quality.
- Members must be given training in holding meetings and problem-solving.
- They need full support from management.
- Teams should be empowered to implement the recommendations.

Simultaneous engineering

This is a method of developing new products which saves time. The stages of design, market research, costing and engineering tasks are all done at the same time as each other (simultaneously), not one after the other (sequentially).

As most products become more advanced and complicated, it could take longer and longer to develop new designs. During this period, competitors might launch their new products earlier and technology might advance during the design stage, making the newly developed product obsolete as soon as it is launched on the market.

The advantage of simultaneous engineering is that new products can be in the marketplace months or even years earlier than would have been the case with sequential methods. This benefit is illustrated in Figure 28.7 for new car models.

Section 28.5 explains a planning technique known as network analysis, which assists with the application of simultaneous engineering.

==simultaneous engineering:== product development organised so that different stages are done at the same time instead of in sequence.

Figure 28.7: The benefits of simultaneous engineering Figure 28.7: The benefits of simultaneous engineering

Cell production

Cell production is a form of flow production. The production line is split into several self-contained mini-production units known as cells. Each individual cell produces a complete unit of work (for example, a complete washing machine motor), not just one small part of it. Each cell has a team leader and below that a single level of hierarchy made up of multi-skilled workers. The performance of each cell is measured against pre-set targets. These targets include output levels, quality and lead times. Cells are responsible for the quality of their own complete units of work.

==Cell production:== flow production split into selfcontained groups that are responsible for a complete unit of work.

This links in with total quality management (TQM), discussed in Section 27.1. Cell production avoids some of the common limitations of traditional flow production, as workers do not just undertake one boring and repetitive task.

The cell production system has led to:

- significant improvements in worker commitment and motivation
- increased teamwork and a sense of ownership of the complete unit of work
- job rotation within the cell
- increased productivity. The success of cell production depends on a well-trained, multi-skilled workforce prepared and able to be flexible enough to accept a more responsible style of working (see Figure 28.8).

Figure 28.8: How cell production might be organised in an assembly plant Figure 28.8: How cell production might be organised in an assembly plant

Just-in-time inventory-control principle

This was discussed in Section 24.2. It is clearly part of the lean production concept because it involves fewer resources being tied up in buffer inventories. Figure 28.9 illustrates the differences between a production system based on buffer inventories and one that is JIT-based.

Figure 28.9: Eliminating buffers, reducing transfer distance and streamlining processes mean higher-quality products will be delivered to customers more

quickly Figure 28.9: Eliminating buffers, reducing transfer distance and streamlining processes mean higher-quality products will be delivered to customers more quickly

Waste management

The entire lean production approach is about reducing the causes of waste in business organisation. Specifically, the waste of physical resources, resulting from damage in inventory or defective products that have to be rejected, can be reduced by:

- JIT to reduce inventory holdings and the risk of damage before materials and components are needed in production.
- Adopting TQM and zero-defect principles. These reduce the cost of resources which have to be rejected for failure to reach quality assurance standards.
- The use of production methods that allow for the use of recycled materials. This will also improve the sustainability of the operations of the business.

Main advantages of lean production

- Waste of time and resources is reduced or eliminated: sustainability of operations is improved.
- Efficiency is increased and average costs are reduced, leading to higher profits.
- The work area is less crowded and easier to operate in.
- There is less risk of damage to inventories as lower (or even zero) levels are held.
- New products are launched more quickly.
- Quality is improved.
- Employees' jobs are enriched, their roles enhanced and motivation improved.
- Flexible working improves capacity management by allowing resources to be switched from processes with spare capacity to processes reaching maximum capacity.

Limitations of strategies to achieve lean production

The approaches to lean production might have limitations in the following business situations:

- Businesses may have difficulty in forecasting demand. If JIT is adopted in these cases, there could be a major problem if demand rises unexpectedly.

- Some businesses depend on customer service as their unique selling point. In these situations, a less lean approach with higher inventories could support this USP. It will be important to give customers a wide choice of finished products and guaranteed delivery dates.
- Lean production can result in job losses as this is one aspect of increased efficiency. Social enterprises may reject lean production techniques if they result in redundancies as this might be against the 'social' objective of these businesses.
- The costs of new technology and retraining might be too high. Some businesses with limited resources might have to survive on making existing systems more efficient rather than fully adopting lean production approaches.
- Some manufacturers which specialise in one-off job production may decide against investing in lean production techniques. By specialising in niche-market products, which are less price-sensitive, businesses may be able to maintain competitiveness without adopting lean production.

Links between lean production and other operations issues

- Inventory control (see JIT in Section 24.2).
- Quality. The principles of TQM and zero-defects are important because they aim to reduce waste (see Section 27.1).
- Employees' roles. The need for flexibility, which is an important feature of lean production, can impact on employees' roles in three ways:
- Capacity management. Flexible and lean operations lead to more effective use of available capacity. For example, spare capacity can be reduced by adapting existing designs to meet consumer demands in niche markets. This should lead to increased demand and output.
- Efficiency. This section has examined ways in which lean production techniques improve business efficiency by reducing waste. These efficiency improvements will make businesses more competitive by driving down the average cost of production.

28.5 Operations planning

Major operations decisions often involve major projects, such as relocation, factory or office space expansion, and changes in operations methods.

Need for planning operations

Operations decisions need to be planned carefully to minimise resource use, including the time taken to complete the chosen project.

Projects are specific tasks that result from the need for an organisation to change. The need for change might be relatively minor, such as the opening of a new shop for a retail company that has 200 outlets already. The need for change could also be much more significant, such as a car manufacturer developing and manufacturing a hybrid vehicle for the first time in response to environmental pressures.

Other examples of business projects include:

- setting up a new IT system
- relocating company operations
- installing new machinery
- marketing products in another country
- building a factory. All these projects involve the use of resources. Labour, buildings, machines, management time, and factory or office space will all, to varying degrees, need to be used for a new project. Resources are expensive. The most expensive resource is one that is not used or under-used. Unused inventories take up space and working capital, machinery left idle wastes capital and can require protective maintenance, and labour left waiting for supplies to arrive will add unnecessarily to the wages bill.

Efficient firms always aim to use their resources as intensively as possible and avoid wasted time and idle assets. Keeping assets busy is not always as easy as it sounds, especially when the project being worked on is a complex one. For example, consider the construction of a house:

- The builder only wants to employ specialist workers on a subcontract basis when the job is ready for their particular skills.
- The builder also wants to only order bricks and other materials to arrive just as they are needed. If these materials arrived weeks before, they would block up the site, waste working capital and encourage theft. The builder certainly does not want them to arrive three days late, with specialist workers kept waiting.
- Specialist equipment is often hired in, and to keep it for a day more than necessary will raise costs and affect cash flow. How can all the different tasks involved in building a house be put into order so that the right goods and labour can be employed just at the right time? The answer for many businesses is to use a technique known as critical path analysis (CPA) which uses network diagrams.

==critical path analysis (CPA):== a planning technique that identifies all tasks in a project, puts them in the correct sequence and allows for the identification of the critical path.

==network diagrams:== the diagram used in critical path analysis that shows the logical sequence of activities and the logical dependencies between them, so the critical path can be identified.

Network diagrams and critical path analysis: an introduction

CPA uses network diagrams to indicate the shortest possible time in which a project can be completed. The activities that must be completed to achieve this shortest time make up what is known as the critical path. The process of using CPA involves the following steps:

==critical path:== the sequence of activities that must be completed on time for the whole project to be completed by the agreed date.

1. Identify the objective of the project (e.g. build a factory in six weeks).
2. Put the tasks that make up the project into the right sequence and draw a network diagram of that sequence (see below).
3. Add the durations of each of the activities.
4. Identify the critical path – those activities that must be finished on time for the project to be finished in the shortest time.
5. Use the network as a control tool when problems occur during the project.

Network diagrams

A network diagram can be drawn to help identify the critical path.

For example, Figure 28.10 shows the network diagram for a business with the objective of installing a new machine and training employees to operate it within three weeks (assume a five-day working week).

Figure 28.10: Installing a new machine — the network Figure 28.10: Installing a new machine — the network

A network diagram uses the following notation:

- An arrow indicates each activity.
- An activity takes up time and resources.
- A node (circle) indicates the end of each activity. The activities involved in the project shown in Figure 28.11 and the estimated time for each activity (duration) are:
- Strip out the old machine (A) – three days.
- Order the new machine and await its arrival (B) – one day.
- Prepare the site for the new machine (C) – two days.
- Assemble the new machine (D) – two days.

- Install the new machine (E) – one week.
- Demonstrate the machine to workers (F) – two days.
- Obtain the necessary raw materials (G) – one day.
- Trial test run (H) – three days. You will notice from the diagram that from the first node, two activities can start. This is because stripping out the old machine and ordering the new one are independent activities. They can be done simultaneously and do not have to be performed in sequence.

Clearly, this is a relatively simple project and, if the durations are added to the network diagram (Figure 28.11), it is possible to determine visually:

- which is the critical path of activities – these activities are indicated with pairs of short parallel lines
- that the project can be completed within three weeks. It is clear that the critical activities are A, C, E, F and H. If these should be delayed in any way (for example, if the preparation of the site takes more than two days), then the whole task will take longer than three weeks. It can be seen that the other activities are not time-critical. These, in fact, may have some spare time. This is termed 'float time'. In more complex projects, this can be useful for achieving an even more efficient use of resources (see 'The benefits of critical path analysis').

Figure 28.11: Adding durations to find the critical path Figure 28.11: Adding durations to find the critical path

How the critical path is determined

Here is a more complex example of determining a critical path. The objective is to construct a house in 42 days. To create the network diagram, the tasks to be performed in order to build the house have been broken down into ten main activities, such as digging foundations and tiling the roof. These activities must be done in a certain order (e.g. the roof cannot be tiled before the walls are built) and this order of tasks is shown in Table 28.2.

The network diagram for these activities is shown in Figure 28.12. You will notice that each of the nodes has been numbered for ease of reference.

Figure 28.12: The main stages of building a house Figure 28.12: The main stages of building a house

The duration times for each activity (shown in Table 28.3) can then be added to the network diagram (Figure 28.13).

Activity

Preceding activities

A

B

C

D

E

F

G

H

I

J

–

–

A

B and C

A

E

F and D

B and C

G and H

I

Activity

Duration (days)

A

B

C

D

E

F

G

H

I

J

8

6

12

6

14

10

3

14

3

4

Table 28.3: Duration times of the tasks in building a house

Figure 28.13: Adding in the activities and durations Figure 28.13: Adding in the activities and durations

These durations are very important. They allow us to calculate both the critical path, and the spare time (or float time) for the non-critical activities. The critical path is indicated by calculating, at each node, the earliest start time (EST) and the latest finish time (LFT). These have already been added to the nodes in Figure 28.13 – the EST is the top number and the LFT is the number below it.

==earliest start time:== an activity cannot begin before this time.

==latest finish time:== an activity cannot finish later than this time without delaying a project.

Calculating the EST

The EST is the earliest time each activity can begin, taking into account all of the preceding activities. So, Activity E cannot start before day 8 because A will not be finished before then. And D cannot start before day 20 because both A and C have to be completed first.

Calculating the LFT

The LFT is the latest time an activity can finish without delaying the whole project. So, Activity I (and all preceding activities) must be finished by day 38 or the entire project will take longer than 42 days (because four days must be allowed to finish J). Activity F (and all preceding activities) must finish by day 32 or the time taken to complete G, I and J will take the total project time over 42 days.

The easiest way to calculate the LFTs is to work from right to left. The LFT at node 8 must be 42: the total project time. The duration of Activity J is now subtracted from this to give 38. This is the LFT at node 7. Where there is a choice of routes back to a node, the aim is to achieve the lowest number for LFT. The LFT for node 4 is therefore 21, achieved by working back through J, I and H, even though a higher number could be reached by working through J, I, G and D. Remember, the lowest number at each node is what is required for the LFT.

Calculating float times for non-critical activities

Look again at the network diagram for building a home (Figure 28.13). Non-critical activities B, C, D and H have float time. All of the non-critical activities (those not on the critical path) will have a certain amount of spare time. This spare time is called float. There are two types: total float and free float.

==total float:== the amount of time an activity can be delayed without delaying the whole project duration.

==free float:== the length of time an activity can be delayed without delaying the start of the following activities.

Total float

Total float is calculated by the formula:

Take Activity D as an example. The LFT of D is 32 and the duration is 6. The EST of D is 20 and therefore:

Activity D could be delayed by up to six days without extending the total project duration or changing the critical path.

Free float

Free float is calculated by the formula:

Take Activity B as an example. The EST of the next activity after B is 20. The duration of B is 6. The EST at the start of B is 0 and therefore:

Activity B could be delayed by 14 days without delaying the start of either H or D, which are the following activities (see Table 28.4).

Activity

Total float

Free float

B

C

D

H

15

1

6

1

14

0

6

1

Table 28.4: Float time for all non-critical activities

What is the critical path for this project?

Those activities that have no spare time are the critical ones. These activities are shown by those nodes where EST and LFT are equal. Take node 3 as an example. The EST of F is 22. This is the same as the LFT of E. Therefore, no delay is possible: Activity F must start on time or the whole project will overrun. Therefore, the critical path is made up of activities A, E, F, G, I and J. These will take 42 days to complete, so this becomes the project duration. Float times have very significant applications in managing resource (see 'The benefits of critical path analysis').

Dummy activities

A dummy activity is not strictly an activity at all. It is shown by a dotted line on a network diagram. It does not consume either time or resources. It shows a logical dependency between other activities that must be included in certain networks to prevent an illogical path from being created.

==dummy activity:== a device to show logical dependency between activities, but which consume no time and no resources themselves.

Consider the following activities and the relationships between them:

- Activities A and B are the start of the project. They have no preceding activities.
- Activity C follows A.
- Activity D follows A and B. How can the network be drawn? Figure 28.14 shows one attempt, but it is wrong. Can you see why? The network shows that both C and D require A and B to be finished, whereas only C requires A to finish before it can start.

The correct network is shown in Figure 28.15, which shows the correct logical dependencies. C starts when A is finished, but D has to wait until both A and B are finished. The dummy activity (the dotted line) shows the relationship between A and D, with the arrow indicating the direction of the dependency.

Figure 28.14: First attempt at drawing a network Figure 28.14: First attempt at drawing a network

Figure 28.15: The correct network Figure 28.15: The correct network

The benefits of critical path analysis (CPA)

It has already been stated that network analysis can be used to assist the planning and management of complex projects. The following are some of the advantages that result from using the technique:

- Using a network diagram to calculate the total project duration allows businesses to give accurate delivery dates. Customers may insist on a particular completion date and the critical time shows whether the firm can make this date or not.
- Calculating an EST for each activity allows the operations manager to order special equipment or materials needed for that task at the correct time. This ties the use of network analysis in with JIT strategies and assists in the control of cash flow and working capital.
- Calculating the LFT of each activity provides a useful control tool for the operations manager. The manager will be able to see whether the project is up to schedule by checking the actual completion times of activities against the network LFT.
- Knowing the critical path is important. If there is a delay on a critical activity, as there is no float time, this will put back the timing of the whole project. This could lead to expensive damage claims from customers. By knowing the critical path, the operations manager can see which other activities need to be speeded up if one has been delayed. For instance, in the network in Figure 28.13, if Activity E was delayed by two days due to bad weather or non-arrival of equipment, the operations manager would know that one of the critical activities that follows needs to be accelerated to catch up the time lost.
- The additional resources for speeding up a critical activity could come from the non-critical ones. To use the house building example in Figure 28.13, if Activity F is to be reduced to eight days to counter the delay on E, the resources of labour, materials and machinery could be taken from D or H, as they both have spare time. This will allow a better and more efficient use of the firm's resources. This shows how the existence of float times on D and H allows resources to be allocated more efficiently.

- The sequential and logical structure of the diagram lends itself well to computer applications and nearly all business applications of network analysis are now run on computer.
- The need to put all activities into sequence in order to structure the diagram forces managers to plan each project carefully by putting activities in the correct order.
- The need for rapid development of new products is now very great in today's fast-changing consumer markets. Network analysis gives design and engineering departments an advantage by showing them the tasks that can be undertaken simultaneously in developing a new product. Reducing the total time taken by the new project is based on the principle of simultaneous engineering.

  TIP You could evaluate the CPA techniques in your answers by suggesting that no planning technique, however good, can ensure that a project will reach a successful conclusion.

Critical path analysis: evaluation

CPA (or network analysis) is a planning and control technique to assist with project management. It cannot guarantee a successful project by itself and, as with any plan, requires skilled and motivated employees to put it into effect.

A plan is only as good as the management behind it. If management of the project is poor, then even a good critical path network diagram will not ensure success. This is particularly true when attempting to make up for lost time on a critical activity. Experienced managers need to identify the cheapest option for using and switching resources from non-critical activities.

Workers will feel more committed to the plan of operation if they have been consulted during its construction, for example, over likely duration times for each activity.

When using CPA for a completely new project, there may be considerable guesswork involved in estimating the durations for each activity. There will be no previous experience to go on. Although the drawing of the network and addition of duration and float times are likely to be aided by computer, it can take skilled labour hours to put a complex project onto a computer. This time and cost must be justified by the efficiency savings of applying the technique.

Image Image

29.1 The need for business finance

All business activity requires finance. Inadequate finance can lead to business failure. Choosing appropriate sources of finance is a vital decision for managers to take.

Why businesses need finance

Here is a list of just some of the main business activities and situations that require financing:

- Setting up a business will require cash injections from the owner(s) to purchase essential capital equipment and, possibly, premises. This is called start-up capitalthe capital needed by an entrepreneur to set up a business..
- All businesses need to finance their working capitalthe capital needed to pay for raw materials, day-to-day running costs and credit offered to customers., the day-to-day finance needed to pay bills and expenses and to build up inventories. In accounting terms, working capital = current assets − current liabilities.
- When businesses grow, further finance will be needed to buy more assets and to pay for higher working capital needs. Growth through developing new products will require finance for research and development.
- Growth can be achieved by taking over other businesses. Finance is then needed to buy out the owners of the other firm.
- Special situations may lead to a need for finance. A decline in sales, possibly as a result of economic recession, could lead to the need for additional finance so that the business can pay its debts. If a large customer fails to pay for goods, finance will quickly be needed to pay for essential expenses. In these cases, finance is needed for the survival of the business.

The distinction between short- and long-term need for finance

Some of these activities and situations will need finance for many years or even permanently. Other cases will need only short-term funding. No single source or type of finance is likely to be suitable for all business needs. Managers have to decide which type and source of finance is best in each situation.

Many businesses, especially small ones, often need short-term finance instead of long-term finance. Short-term loans are helpful to businesses that experience seasonal demand, such as retail businesses in a tourist region, which have to hold more inventory for the holiday season. Such a business might need a short-term loan to buy inventory before the busiest months. It probably will not be able to repay the loan until after the holidays. This is an excellent example of the need for short-term finance.

==short-term finance:== money required for short periods of time of up to one year.

==long-term finance:== money required for more than one year.

When a business is expanding by buying more buildings and equipment, a short-term loan of less than one year would be inappropriate. The chances of being able to pay back a short-term loan from the income earned on these assets in just one year would be small. This is a good example of the need for long-term finance.

The difference between cash and profit

Many business failures result from owners and managers not understanding the difference between cash and profit. In contrast, all successful entrepreneurs and managers understand that these two financial concepts do not have the same meaning or significance. It is very common for profitable businesses to run short of cash. On the other hand, loss-making businesses can have high business inflows of cash in the short term.

==profit:== the value of goods sold (revenue) less costs.

The essential difference between cash and profit can be explained with three simple examples:

Example 1: Jhumpa buys fresh fish from a market every day. She pays cash to the fishermen. She sells all of her stock on a high street stall to shoppers who also pay her cash. In a typical week Jhumpa buys fish costing $1 000, sells them for $2 000 and − ignoring other costs − makes $1 000 profit. The difference between her inflows and outflows of cash in a typical week is also $1 000, because all purchases and sales are in cash. In this very simplified example, cash = profit at the end of the week (ignoring other expenses).

Example 2: Shula owns Fine Foods, a specialist delicatessen. Last month she bought $500 of fresh goods from a supplier who offered her one month's credit. The goods sold very slowly during the month and she was forced to cut her prices several times. Eventually she sold them all for only $300, paid in cash by her customers. She made a loss of $200 because, even though she has not yet paid for the goods, they are still recorded as a cost. However, during this month she had a positive cash inflow of $300 because she has not yet paid the supplier. During this month, cash is not the same as profit for this business.

Example 3: Sanjit is concerned about competition for his jewellery shop. He buys most of his stock over the internet for cash but has decided to increase the credit terms he gives to his customers to two months. This month he bought some rings for $3 000 and paid in cash. He sold them all during the month for $7 000 but will not receive payment for another two months.

Sanjit made $4 000 profit. The rings have been sold and revenue recorded from the sale even though no cash payment has been made. However, this month he recorded a negative cash outflow of $3 000. He may be very short of cash until he receives payment from his customers. During this month, cash is not the same as profit for this business. There is a real danger that Sanjit could run out of cash to pay everyday costs, such as wages and rent. His business may have a low level of liquidity.

==liquidity:== the ability of a business to pay its short-term debts.

> TIP When asked about the differences between profit and cash, always emphasise the importance of having enough cash in the short term. Profit can wait to be earned in the long term, but cash payments are always being made.

Administration, bankruptcy and liquidation

Lack of finance is the single most common cause of business failure. If a business fails due to lack of finance, it is often placed in administration. Specialist administration accountants are appointed to try to keep the business operational and to find a buyer for it. If this proves impossible, then bankruptcy will result. This means that a legal process begins which will lead to liquidation of the assets of the business. The aim of liquidation is to raise as much finance as possible to pay back those people and companies the bankrupt business owes money to.

==administration:== when administrators manage a business that is unable to pay its debts with the intention of selling it as a going concern.

==bankruptcy:== the legal procedure for liquidating a business (or property owned by a sole trader) which cannot fully pay its debts out of its current assets.

==liquidation:== when a business ceases trading and its assets are sold for cash to pay suppliers and other creditors.

29.2 Working capital

We all need some cash or other finance to enable our everyday spending. The day-to-day finance needs of business are referred to as working capital.

Meaning and importance of working capital

Working capital is the finance needed by all businesses to pay for everyday expenses, such as wages and buying inventory.

Without sufficient working capital, a business will be illiquid and unable to pay its immediate or short-term debts. What happens in cases such as this? Either the business raises finance quickly, for example as a bank loan, or it may be forced into liquidation or administration by its creditors (the firms it owes money to).

A high level of working capital can also be a disadvantage. There is an opportunity cost of having too much capital tied up in inventories, accounts receivable and idle cash. It is likely that this money could earn a higher return elsewhere in the business, possibly by being invested in fixed assets.

The working capital requirement for any business will depend upon the length of its working capital cycle. The longer the time period from buying materials and paying for them to receiving payment from customers, the greater the working capital needs of the business (see Figure 29.2).

Figure 29.2: The working capital cycle Figure 29.2: The working capital cycle

The simple calculation for working capital is: current assets less current liabilities.

==current assets:== assets that either are cash or likely to be turned into cash within 12 months (inventory and trade receivables or debtors).

==current liabilities:== debts that usually have to be paid within one year.

Where does the capital come from to finance these important current assets? Most businesses obtain some of this finance in the form of current liabilities. Overdrafts and trade payables (creditors who need to be paid by the business) are the main forms. However, it would be unwise to obtain all of the funds needed from these sources. These debts may have to be repaid at very short notice, resulting in a liquidity problem.

A permanent increase in working capital

When businesses expand, they generally need higher inventory levels and the total value of products sold on credit will increase. This increase in working capital is likely to be permanent, so long-term or permanent sources of finance will be needed, such as bank (long-term) loans or share capital.

Managing working capital

Managing the level of working capital can be achieved by managing inventory, managing trade payables and/or managing trade receivables (debtors who owe the business money).

Inventory can be managed in the following ways:

- keeping smaller inventory levels
- using computer systems to record sales and inventory levels, and to order inventory as required
- efficient inventory control, inventory use and inventory handling so as to reduce losses through damage, wastage and shrinkage
- minimise the working capital tied up in inventories by producing only when orders have been received (just-in-time inventory ordering)
- getting goods to customers as quickly as possible to speed up payments from them. Trade payables can be managed by:
- delaying payments to suppliers to increase the credit period

- only buying goods from suppliers who will offer credit. Trade receivables can be managed by:
- only selling products for cash and not on credit
- reducing the credit period offered to customers (see Section 30.1).

Capital expenditure and revenue expenditure

Capital expenditure and revenue expenditure will almost certainly be financed in different ways. A major factor influencing the finance choice is the length of time each of these types of expenditure is required for.

==Capital expenditure:== the purchase of non-current assets that are expected to last for more than one year, such as buildings and machinery.

==revenue expenditure:== spending on all costs and assets other than non-current assets, which includes wages, salaries and inventory of materials.

29.3 Sources of finance

Managers need to consider many factors before selecting an appropriate source of finance. One of these is the form of business ownership.

Business ownership and sources of finance

Business ownership has a big impact on the sources of finance available to any particular firm. For example, as explained in Section 2.2, sole traders and partnerships cannot sell shares to raise capital. This section deals initially with sources of finance for limited companies and then considers sole traders and partnerships.

Finance for limited companies

Companies are able to raise finance from a wide range of sources. These are classified as:

- internal sourcesraising finance from the business's own assets or from profits left in the business (retained earnings).
- external sourcesraising finance from sources outside the business, for example banks.. Another classification is also often made: short- and long-term finance. This distinction is made clearer in Figure 29.3.

Figure 29.3: Sources of finance for limited companies Figure 29.3: Sources of finance for limited companies

Internal sources of finance

There are various internal sources of finance for companies, as outlined below.

Retained earnings (retained profit)

A profitable company will have to pay some tax to the government (profit or corporation tax). Dividends will nearly always be paid out to the shareholders. If any profit remains, this is kept or retained in the business and, if held in cash form, becomes a source of finance for future activities. Clearly, a newly formed company or one trading at a loss will not have access to this source of finance. For other companies, retained earnings is a very significant source of funds for expansion. Once invested back into the business, these retained earnings will not be paid out to shareholders, so they represent a permanent source of finance.

==retained earnings:== profit after tax retained in a company rather than paid out to shareholders as dividends.

Figure 29.4: The Coca-Cola Company and its bottling partner, COFCO Coca-Cola Beverages Ltd, continue to expand in China, financed mainly from retained earnings Figure 29.4: The Coca-Cola Company and its bottling partner, COFCO Coca-Cola Beverages Ltd, continue to expand in China, financed mainly from retained earnings

Sale of unwanted assets

Established companies often find that they have assets that are no longer fully employed. These could be sold to raise cash.

Sale and leaseback of non-current assets

In addition, some businesses will sell non-current assets that they still intend to use, but which they do not need to own. The assets could be sold to a specialist financial institution and leased back by the company. This will raise capital, but the lease payment becomes an additional fixed cost.

==non-current assets:== assets kept and used by the business for more than one year.

Working capital

When companies reduce the finance held as working capital, finance is released for other uses. So, reducing the level of inventory releases cash into the business. There are risks in cutting down on working capital, however. Cutting back on current assets by selling inventories or reducing trade receivables may reduce the liquidity of the business – its ability to pay short-term debts – to risky levels.

Evaluation of internal sources of finance

This type of capital has no direct cost to the business, although if assets are leased back once sold there will be leasing charges. Internal finance does not increase the liabilities or debts of the business, and there is no risk of loss of control by the original owners as no shares are sold. However, depending solely on internal sources of finance for expansion can slow down business growth. The rate of growth will be limited by the level of annual profits or the value of assets sold. Thus, rapidly expanding companies are often dependent on external sources for much of their finance.

> TIP It is important to remember that although shareholders own a company, the finance they provide (by buying shares) is a form of external finance for companies. Companies are separate legal units and therefore the shareholders are external providers of finance.

Short-term external sources of finance

There are three main sources of short-term external finance:

- bank overdraftsa credit that a bank agrees can be borrowed by a business up to an agreed limit as and when required.
- trade credit
- debt factoringselling of claims over trade receivables (debtors) to a specialist organisation (debt factor) in exchange for immediate liquidity.. Bank overdrafts

A bank overdraft is the most flexible of all sources of finance. The amount raised can vary from day to day, depending on the needs of the business. The bank allows the business to overdraw on its account at the bank by making payments up to a greater value than the balance in the account. This overdrawn amount should always be agreed in advance and always has a limit beyond which the business should not go. Businesses may need to increase the overdraft for short periods of time if customers do not pay as quickly as expected, or if a large delivery of supplies has to be paid for.

This form of finance often carries high interest charges. In addition, if a bank becomes concerned about the stability of one of its customers, it can call in the overdraft and force the firm to pay it back. In extreme cases this can lead to business failure.

Bank overdrafts are also an important source of finance for unincorporated businesses.

Trade credit

By delaying payment to suppliers for goods or services received, a business is, in effect, obtaining finance. Its suppliers become trade payables or trade creditors. They supply goods and services without receiving immediate payment. The drawback to these periods of credit is that they are not free. Discounts for quick payment are often lost if the business takes too long to pay its suppliers.

Debt factoring

When a business sells goods on credit, it creates trade receivables. The longer the time allowed to pay up, the more finance the business has to find to carry on trading. One option, if it is commercially unwise to insist on cash payments, is to sell these claims on trade receivables to a debt factor. In this way immediate cash is obtained, but not for the full amount of the debt. This is because the debt factoring company's profits are made by discounting the debts and not paying their full value. When full payment is received from the original customer, the debt factor makes a profit. Smaller firms who sell goods on hire purchase often sell the debt to credit loan firms, so that the credit agreement is never with the firm but with the specialist provider.

Long-term external sources of finance

The main sources of long-term finance are:

- hire purchasea company purchases an asset and agrees to pay fixed repayments over an agreed time period. The asset belongs to the purchasing company once the final payment has been made. and leasingobtaining the use of an asset and paying a leasing charge over a fixed period, avoiding the need to raise long-term capital to buy the asset. The asset is owned by the leasing company. (usually for up to five years)
- bank (long-term) loansloans that do not have to be repaid for at least one year.
- debentureslong-term bonds issued by companies to raise debt finance, often with a fixed rate of interest. (also known as loan stock or corporate bonds)
- share capitalpermanent finance raised by companies through the sale of shares. (or equity capital)
- business mortgageslong-term loans to companies purchasing a property for business premises, with the property acting as collateral security on the loan.
- government grants
- venture capitalrisk capital invested in business startups or expanding small businesses that have good profit potential but do not find it easy to gain finance from other sources.. Hire purchase

This is a form of credit for purchasing an asset over a period of time. This avoids making a large initial cash payment to buy the asset. The hire purchase agreement allows the purchasing business to own the asset. The interest rate can be higher than for a bank loan. Regular payments of interest and partial repayments of the capital sum have to be made.

Leasing

Leasing involves a contract with a leasing company to acquire an asset, but not necessarily to purchase it. Regular payments are made over the life of the agreement, but the business does not have to purchase the asset at the end. Leasing allows businesses to avoid the cash purchase of the asset. The risk of using unreliable or outdated equipment is reduced, as the leasing company will repair and update the asset as part of the agreement. Leasing can be a high-cost option, but it reduces the inconvenience of having to repair, maintain and sell the asset. However, leasing does improve the short-term cash position of a company compared to the outright purchase of an asset with cash.

Bank (long-term) loans

These can be for any period of time over one year. Machinery and vehicles, for example, are often purchased with loans of up to five years until repayment. Property purchases and other forms of business growth can be financed with even longer-term loans.

Bank loans may be offered at either a variable or a fixed interest rate. Fixed rates provide more certainty, but they can turn out to be expensive if the loan is agreed at a time of high interest rates. Companies borrowing from banks will often have to provide security or collateral for the loan. This means the right to sell an asset is given to the bank if the company cannot repay the debt. Businesses with few assets to act as security may find it difficult to obtain loans or may be asked to pay higher rates of interest.

Debentures

A company wanting to raise funds can issue or sell debentures (also known as bonds) to interested investors. The company agrees to pay a fixed rate of interest each year for the life of the debenture, which can be up to 25 years. The buyers may resell to other investors if they want to raise cash before the debenture matures. Debentures can be a very important source of long-term finance. No collateral security will be required over any non-current assets. Convertible debentures can (if the borrower requests it) be converted into shares after a certain period of time. This means that the company issuing them will never have to pay the debenture back.

==collateral security:== an asset which a business pledges to a lender and which must be sold off to pay a debt if the loan is not repaid.

Business mortgages

Banks and other financial institutions may offer loans to a business specifically for the purpose of buying premises and these are called business mortgages. The interest rate can be fixed or variable. The loan will be secured by the property as the lender will sell the property if the business fails.

Share or equity capital

All limited companies issue shares when they are first formed. The capital raised will be used to purchase assets. Both private limited and public limited companies are able to sell additional shares – up to the limit of their authorised share capital – in order to raise further permanent finance. This capital never has to be repaid unless the company is liquidated as a result of ceasing to trade.

Private limited companies can sell further shares to existing shareholders. This has the advantage of not changing the control or ownership of the company, as long as all shareholders buy shares in proportion to those already owned. Owners of a private limited company can also decide to go public and obtain the necessary authority to sell shares to the wider public. This has the potential to raise much more capital than from just the existing shareholders. There is the risk of some loss of control to the new shareholders.

Selling shares to the public can be done in two ways, which are common in many countries:

- Obtain a listing on the Alternative Investment Market. This is part of the Stock Exchange concerned with smaller companies that want to raise only limited amounts of additional capital. The strict requirements for a full Stock Exchange listing are relaxed.
- Apply for a full listing on the Stock Exchange by satisfying the criteria of (a) selling at least £50 000 worth of shares and (b) having a satisfactory trading record to give investors some confidence in the security of their investment. This sale of shares can be undertaken in two main ways: Evaluation of loan (debt) capital and share capital

Which method of long-term finance should a company choose? There is no easy answer to this question. Some companies will use a combination of loans and share or equity capital for very large projects. Table 29.1 summarises the advantages of these two sources of finance.

Government grants

There are agencies that are prepared, under certain circumstances, to grant funds to businesses. The two major sources in most European countries are the central government and the European Union. Usually, grants from these two bodies are given to small businesses or those expanding in developing regions of the country. Grants often come with conditions attached, such as location and the number of jobs to be created, but if these conditions are met, grants do not have to be repaid.

Advantages of loans

Advantages of share capital

• No shares are sold so ownership of the company does not change and is not diluted by the issue of additional shares.

• Loans will be repaid eventually so there is no permanent increase in the liabilities of the business.

• Lenders have no voting rights at the annual general meetings.

• Interest charges are an expense of the business and are paid out before corporation tax is deducted. Dividends on shares, however, have to be paid from profits after tax.

• The level of indebtedness (gearing) of the company increases and this gives shareholders the chance of higher returns in the future (see Section 34.4).

• It never has to be repaid. It is permanent capital, unlike loans which must eventually be repaid.

• Dividends do not have to be paid every year. Directors can decide to retain more earnings by reducing dividend payments. In contrast, loan interest must be paid even if the profit of the business is low or a loss is made.

• It lowers the indebtedness of the business, so debt finance becomes a lower proportion of total long-term finance.

Table 29.1: Comparing loans and share capital as sources of finance

Venture capital

Small companies that are not listed on the Stock Exchange (unquoted companies) can gain long-term investment funds from venture capitalists. These are specialist organisations or wealthy individuals. They are prepared to lend risk capital to, or purchase shares in, business start-ups or small to medium-sized businesses that find it difficult to raise capital from other sources. This could be because of the risky nature of the business enterprise. These risks could come from the new technology that the company is dealing in or the complex research it is planning. Other providers of finance may not be prepared to get involved.

Venture capitalists take great risks and could lose all of their money, but the rewards can be great. The value of Apple, Zappos and other high-tech businesses has grown rapidly and many were financed, at least in part, by venture capital. Venture capitalists generally expect a share of the future profits or a sizeable stake in the business in return for their investment.

Finance for unincorporated businesses

Unincorporated businesses – sole traders and partnerships – cannot raise finance from the sale of shares. They are unlikely to be successful in selling debentures as they are likely to be relatively unknown firms.

These businesses can obtain finance from:

- bank overdrafts and bank loans, including microfinance
- crowd funding
- credit from suppliers (trade payables)
- loans from family and friends
- owners' investment

- taking on partners with capital to invest. All owners or partners in an unincorporated business have unlimited liability. Lenders are often reluctant to offer loans or overdrafts to unincorporated businesses unless the owners give personal guarantees, supported by their own assets, should the business fail. Family and friends might lend finance, but they may find it difficult to charge interest and can insist upon repayment at any time. Any non-repayment could damage relationships too. Owners may have insufficient savings to invest in the business. Sole traders can ask potential partners to inject finance. The advantages and disadvantages of taking on partners were explained in Table 2.4.

Grants are available to small and newly formed businesses as part of most governments' assistance to small businesses.

> TIP When answering case study questions, you should analyse the form of ownership of the business and what sources of finance are available to it.

Microfinance

Microfinance provides small capital sums to entrepreneurs. It is now a very important source of finance in developing, relatively low-income countries. In 1974, Muhammad Yunus, an economics lecturer at the University of Chittagong, Bangladesh, lent $27 to a group of very poor villagers. They repaid this loan in full after their business ideas had been successful. It led eventually to Yunus winning the Nobel Peace Prize. He founded the Grameen Bank in 1983 to make very small loans – perhaps $20 a time – to poor people with no bank accounts and no chance of obtaining finance through traditional means. Since its foundation, the Grameen Bank has lent $6 billion to more than 6 million Asian people, many of whom have set up their own very small enterprises with the capital.

==Microfinance:== providing financial services for poor and low-income customers who do not have access to the banking services, such as loans and overdrafts, offered by traditional commercial banks.

Figure 29.6: Muhammad Yunus, founder of the Grameen Bank Figure 29.6: Muhammad Yunus, founder of the Grameen Bank

Many business entrepreneurs in Bangladesh and other Asian countries have received microfinance to help start their business. In some of these countries, more than 75% of successful applicants for microfinance are women. Females, in some traditional societies, have always found it very difficult to obtain loans or banking services from traditional banks. There is evidence that entrepreneurship is greater in regions with microfinance schemes in operation – and that average incomes are rising because of more successful businesses.

One possible drawback to microfinance is that interest rates can be quite high as the administration costs of many very small loans are considerable. Some economists also suggest that if a small business start-up financed by microfinance fails, then the scheme has encouraged very poor people to take on debts that they cannot repay.

Crowd funding

This is an increasingly significant source of finance for new business start-ups. The idea behind it is that entrepreneurs rarely have sufficient finance to set up their own businesses. Banks may be unwilling to lend or may charge very high interest rates, especially if the entrepreneur has no proven business record. Crowd funding websites allow an individual to promote their new business idea to many thousands – perhaps millions – of people, who may be willing to each invest a small sum, such as $10. There are many established websites, such as Kickstarter and Crowdcube, that allow entrepreneurs to publicise their new ideas. Through these websites, the entrepreneur will explain, perhaps with the aid of a video and graphics, what the business is about, what its objectives are and why finance is needed. Investors can commit small sums of money to the new venture until the target sum is reached. The publicity generated can also be an effective form of promotion for the new business and its product.

==Crowd funding:== the use of small amounts of capital from a large number of individuals to finance a new business venture.

Some new business ideas, such as some social enterprises, do not aim to make a large profit, or any return at all. In these cases, the crowd funding investors are, in effect, just making a donation. In all other situations, investors will hope to make a return on their investment. The failure rate of newly created businesses is high and investors may not receive any returns at all. In business ventures that are successful, the crowd funding investors will receive either:

- their initial capital back plus interest – this is sometimes known as peer-to-peer lending – or
- an equity stake in the business and a share in profits when these are eventually made. Small businesses using crowd funding finance benefit from the capital that would otherwise have been difficult to obtain. However, they must keep accurate records of thousands of investors to pay back either interest and capital, or a share of the profits. Also, exposing a new project idea on the internet means that it could be copied by others before the entrepreneur has had a chance to start the business up.

29.4 Factors affecting the source of finance

Selecting the most appropriate source of finance is essential for long-term business success. A source which is too costly, inflexible or can be withdrawn quickly might end up destroying the business. Finance managers and directors have very important finance decisions to make and must consider a number of factors before selecting the best source. These key factors influencing the financing choice are analysed in Table 29.3.

KEY CONCEPT LINK The strategies for sourcing finance adopted by business managers can have a very significant impact, not just on the future growth and profitability of a business. When choosing appropriate sources, managers must consider the business context: for example, whether it is a limited company or not.

Factors influencing finance choice

Why factor is important

Why finance is needed and the time period it is needed for

• It is risky and expensive to use long-term finance to pay for short-term needs. Businesses should match the sources of finance to the length of time it is needed for.

• Permanent capital such as issues of shares may be needed for long-term business expansion or long-term research projects.

• Short-term finance would be advisable to finance a short-term need to increase inventories or pay creditors.

Cost

• Obtaining finance is never free – even internal finance may have an opportunity cost.

• Loans may become very costly during a period of rising interest rates.

• A Stock Exchange listing of a newly formed public limited company can cost millions of dollars in fees and promotion of the share sale.

• Once equity finance has been raised, dividends to shareholders are not tax deductible for the business, unlike loan interest.

Amount required

• Issues of new shares and debentures, because of administration and other costs, are generally used only for large capital sums.

• Small bank loans, overdrafts or reducing trade receivables' payment period could be used to raise small sums.

• Retained profit may be too low to provide the finance needed for a major expansion programme. External finance may be required too.

Form of business ownership and desire to retain control

• Share issues can only be used by limited companies, and only public limited companies can sell shares directly to the public.

• Issuing additional shares risks the current owners losing some control, unless they all buy shares with a rights issue.

• If the owners want to retain control of the business at all costs, then a sale of shares might be unwise.

Level of existing borrowing

• The higher the existing debts of a business (compared with its equity capital), the greater the risk of borrowing more. Banks and other lenders will become anxious about lending more finance.

• This concept is referred to as gearing (see Section 34.4).

• A high level of existing debt might mean that internal sources should be considered, such as the sale of assets.

Flexibility

• When a firm has a variable need for finance (for example, it has a seasonal pattern of sales and cash receipts), a flexible form of finance is better than a long-term and inflexible source.

Table 29.3: Factors affecting the sources of finance to be used

29.5 Selecting the appropriate source of finance

The need to carefully match each need for finance with suitable sources has been emphasised throughout this chapter. The factors influencing which sources of finance are the most appropriate are summarised in Table 29.3. As a further check of your understanding of these factors and the need to link finance need with finance source, you should now answer Activity 29.7.

Image Image

30.1 Cash flow forecasts: meaning and purpose

For any business to survive, having sufficient cash to pay suppliers, banks and employees is the single most important financial factor. A business could have high revenue and low expenses, but if it does not manage cash effectively, it could still have negative cash flow. Without positive cash flow, any company – no matter how promising its business model – will become insolvent and bankrupt.

==insolvent:== when a business cannot meet its short-term debts.

The planning of cash flows using cash flow forecasts is particularly important for entrepreneurs starting a new business because:

==cash flow forecasts:== an estimate of the future cash inflows and outflows of a business.

- New business start-ups are often offered much shorter credit to pay suppliers than larger, well-established firms.

- Banks and other lenders will need to see evidence of a cash flow forecast before making any finance available.
- Finance is often very tight at start-up, so accurate planning is much more significant for new businesses. Forecasting cash flow means trying to estimate future cash inflows and cash outflows, usually on a month-by-month basis. Let's take the case of Mohammed, an entrepreneur planning to open a car valeting service, offering car cleaning to individual customers and owners of car fleets, such as taxi firms.

==cash inflows:== cash payments into a business.

==cash outflows:== cash payments out of a business.

Interpretation of cash flow forecasts

Cash flow forecasts, such as Mohammed's shown in Table 30.1, contain the following data on cash inflows and cash outflows.

Cash inflows

- Owner's own capital injection: This is easy to forecast as it is under Mohammed's direct control.
- Bank loan payments: These are easy to forecast if they have been agreed with the bank in advance, in terms of both amount and timing.
- Customers' cash purchases: These are difficult to forecast as they depend on sales, so a sales forecast will be necessary. But how accurate might this be?
- Trade receivables payments: These are difficult to forecast as they depend on two unknowns. What proportion of sales will be on credit? When will trade receivables (debtors) actually pay? One month's credit may have been agreed with customers, but payment after this period can never be guaranteed.

Cash outflows

- Lease payment for premises: This is easy to forecast as it will be in the estate agent's details of the property.
- Annual rent payment: This is easy to forecast as this will be fixed and agreed for a certain time period. However, the landlord may increase the rent after this period.
- Electricity, gas, water and telephone bills are difficult to forecast as these will vary with many factors, such as the number of customers, seasonal weather conditions and energy prices.

- Wage payments: These forecasts will be based largely on demand forecasts and the hourly wage rate that is to be paid. These payments could vary from week to week if demand fluctuates and if staff are on flexible contracts.
- Cost of materials and payments to suppliers: The cost of materials should vary with the level of output or sales. The longer the period of credit offered by suppliers, the lower the initial start-up cash needs of the business will be.

  TIP You should never fall into the trap of referring to forecasts as actual accounts. Forecasts are financial planning estimates that deal with the future. There is always considerable uncertainty over the accuracy of cash flow forecasts because of this.

The structure of cash flow forecasts

A cash flow forecast is typically constructed monthly, often for the next 12 months, but it can cover a shorter time period. A simplified cash flow forecast is shown in Table 30.1. It is based on Mohammed's car valeting service. Although there are different styles of presenting this information, all cash flow forecasts have three basic sections:

- Cash inflows: This section records the cash payments to the business, including cash sales, payments for credit sales, and capital inflows.
- Cash outflows: This section records the cash payments made by the business, including wages, materials, rent and other costs.
- Net cash flow and opening and closing balance: This shows the net cash flowestimated difference between cash inflows and cash outflows for the period (for example one month). for the period and the cash balances at the start and end of the period (the opening cash balancecash held by the business at the start of the month. and the closing cash balancecash held by the business at the end of the month, which becomes next month's opening balance.). If the closing balance is negative (shown by a figure in brackets), then a bank overdraft will almost certainly be necessary to finance this.

  TIP The layout of actual cash flow forecasts can vary slightly, so you should be prepared for the main classifications to be in a different order. Essentially, all cash flow forecasts record the same basic predictions.

What does the forecast in Table 30.1 tell Mohammed about the prospects for his business? In cash terms, the business should be in a good position after four months. This is because:

- In April, the closing cash balance is positive, so the bank overdraft has been fully repaid.

- The net cash flow is positive in three months out of four and only negative in the first month of operation. However, these are only forecasts. The reliability of the cash flow forecast will depend greatly on how accurate Mohammed was in forecasting his demand, revenue and material costs.

All figures in $000

January

February

March

April

CASH INFLOWS

Owner's capital injection

6

0

0

0

Cash sales

3

4

6

6

Payments by trade receivables (customers who were given credit)

0

2

2

3

Total cash in

9

6

8

9

CASH OUTFLOWS

Lease

8

0

0

0

Rent

1

1

1

1

Payments to trade payables (suppliers giving credit period for materials)

0.5

1

3

2

Labour

1

2

3

3

Other costs

0.5

1

0.5

1.5

Total cash out

11

5

7.5

7.5

NET CASH FLOW

(2)

1

0.5

1.5

Opening balance

0

(2)

(1)

(0.5)

Closing balance

(2)

(1)

(0.5)

1

Table 30.1: Mohammed's cash flow forecast for the first four months (figures in brackets are negative)

Amendments of simple cash flow forecasts: calculating opening and closing balances

Table 30.1 shows that the opening cash balance at the start of the business was zero. Cash inflows were received during the first month of operation and cash outflows (payments) also occurred. The closing cash balance at the end of the first month is calculated by this formula:

(Note: All accounting figures in brackets like this ( ) indicate negative values.)

Mohammed has a negative closing balance of ($2 000), which will probably be financed by a bank overdraft. This closing balance becomes next month's opening balance, as can be seen in Table 30.1.

Benefits of cash flow forecasting

There are several important advantages to preparing cash flow forecasts:

- They show negative closing cash flows. This means that plans can be made to source additional finance, such as a bank overdraft or the injection of more capital from the owner.
- They indicate periods of time when negative net cash flows are excessive. The business can plan to reduce these by taking measures to improve cash flow, as explained in Table 30.3.

- They are essential to all business plans. A business start-up will never gain finance unless investors and bankers have access to a cash flow forecast and the assumptions behind it.

Limitations of cash flow forecasting

Many factors, either internal to the business or in the external environment, can change and therefore affect the accuracy of a cash flow forecast. This means that cash flow forecasts must be used with caution and the ways in which the cash flows have been estimated should be understood. Here are the most common limitations of forecasts:

- Mistakes can be made in preparing the revenue and cost forecasts, or they may be drawn up by inexperienced entrepreneurs or staff.
- Unexpected cost increases lead to major inaccuracies in forecasts.
- Incorrect assumptions can be made in estimating the sales of the business, perhaps based on poor market research. This will make the cash inflow forecasts inaccurate.

Causes of cash flow problems

Most businesses face cash flow problems at some time or other. Before evaluating the methods of improving cash flow, it is important to understand why these problems can arise. There are several causes of cash flow problems:

Lack of planning

Cash flow forecasts help greatly in predicting future cash problems for a business. Financial planning can be used to predict potential cash flow problems so that business managers can take action to overcome them in plenty of time. Some businesses have insufficient plans for cash flow management and this is a major cause of cash flow problems.

Poor credit control

The credit control department of a business keeps a check on all customers' accounts. They record who has paid, who is paying on time and which customers are not paying on time. If this credit control is badly managed, then trade receivables will not be chased for payment and potential bad debts will not be identified.

==credit control:== monitoring of debts to ensure that credit periods are not exceeded.

==bad debts:== unpaid customers' bills that are now very unlikely to ever be paid.

Allowing customers too long to pay debts

Many businesses have to offer trade credit to customers in order to be competitive. A customer may have a choice between two suppliers selling very similar products. If one insists on cash payment on delivery and the other allows two months' trade credit, then the customer will probably choose credit because this improves their cash flow. Allowing customers too long to pay means reducing short-term cash inflows, which leads to cash flow problems.

Expanding too rapidly

When a business expands rapidly, it has to pay for the expansion and for increased wages and materials months before it receives cash from additional sales. This overtrading can lead to serious cash flow shortages even though the business is successful and expanding.

==overtrading:== expanding a business rapidly without obtaining all of the necessary finance, resulting in a cash flow shortage.

Unexpected events

Unforeseen increases in costs could lead to negative net cash flows not being indicated on the original cash flow forecast. Factors such as the breakdown of a delivery truck that must be replaced or a competitor lowering prices unexpectedly will make the original cash flow forecast inaccurate.

Figure 30.2: Every day this truck is off the road for repairs reduces the cash inflows for the transport company Figure 30.2: Every day this truck is off the road for repairs reduces the cash inflows for the transport company

Methods of improving cash flow

There are two ways to improve net cash flow:

- increase cash inflows
- reduce cash outflows (see Figure 30.3).

Figure 30.3: Symbolic drawing of the 'cash flow tank', with leakages and injections of cash Figure 30.3: Symbolic drawing of the 'cash flow tank', with leakages and injections of cash

Care needs to be taken here. The aim is to improve the cash position of the business, not revenue or profit. These are different concepts. For example, a decision to advertise more in order to increase sales, which will eventually lead to increased cash flows, will make the short-term cash position worse as the advertising has to be paid for.

See Tables 30.3 and 30.4 for methods of increasing cash inflows and reducing cash outflows.

Method

How it works

Possible drawbacks

Overdraft

A flexible source of cash from a bank which a business can draw on as necessary up to an agreed limit.

• Interest rates can be high and there may be an arrangement fee.

• Overdrafts can be withdrawn by the bank, which often causes insolvency.

Short-term loan

A fixed amount can be borrowed for an agreed length of time.

• The interest costs have to be paid.

• The loan must be repaid by the due date.

Sale of assets

Cash receipts can be obtained from selling off redundant assets, which will boost cash inflow.

• Selling assets quickly can result in a low price.

• The assets might be required at a later date for expansion.

• The assets could have been used as collateral for future loans.

Sale and leaseback

Assets can be sold (for example to a finance company), but the assets can be leased back from the new owner.

• The leasing costs add to annual overheads.

• There could be loss of potential profit if the assets rise in price.

• The assets could have been used as collateral for future loans.

Manage trade receivables

See the next sub-section.

Table 30.3: Methods to increase cash inflows and their possible drawbacks

Improving cash flow by managing trade receivables

Trade receivables can be managed to improve cash flow in several ways:

- Not extending credit to customers or asking customers to pay more quickly: Will customers still buy from this business? Will a major aspect of this business's marketing mix have been removed?

- Selling claims on trade receivables to specialist financial institutions called debt factors: These businesses will buy debts from other concerns that have an immediate need for cash.
- Finding out whether new customers are creditworthy: This can be done by requiring references, either from traders or from the bank, or by using the services of a credit enquiry agency.
- Offering a discount to customers who pay promptly: Although cash might be paid quickly, discounts reduce the profit margin on a sale.

Method

How it works

Possible drawbacks

Delay capital expenditure

By not buying equipment, vehicles etc. cash will not have to be paid to suppliers.

• The efficiency of the business may fall if inefficient equipment is not replaced.

• Expansion becomes very difficult.

Use leasing, not outright purchase, of capital equipment

The leasing company owns the asset and no large cash outlay is required.

• The asset is not owned by the business.

• Leasing charges include an interest cost and add to annual overheads.

Cut overhead costs that do not directly affect output (for example promotion costs)

These costs will not reduce production capacity and cash outflows will be reduced.

Future demand may be reduced by failing to promote the products effectively.

Manage trade payables

See the next sub-section.

Table 30.4: Methods to reduce cash outflows and their possible drawbacks

Improving cash flow by managing trade payables

Credit from suppliers (trade payables) can be managed to improve cash flow in two main ways:

- Purchasing more supplies on credit and not cash: If a business has a good credit rating, this may be easy, but in other circumstances it can be difficult.

- Extend the period of time taken to pay: The larger a business is, the easier it is to insist on longer credit periods from suppliers. This will improve the business's cash flow.

  KEY CONCEPT LINK Decision-making between the methods of improving cash flow requires very careful analysis of the advantages and disadvantages of each approach.

  TIP If you suggest cutting workers and using cheaper materials, this may reduce cash outflows, but what will be the negative impact on output, sales and future cash inflows? You should attempt to evaluate the longterm impact of any suggestions you make to improve cash flow.

Image Image

31.1 The need for accurate cost information

Effective business decisions would not be possible without cost data. Here are just some of the business uses of cost information:

- Calculation of profit or loss: costs are a key factor in the profit equation. To calculate profits or losses, accurate cost information is required. If businesses do not keep a record of their costs, they will be unable to take profitable decisions, such as where to locate.
- Pricing decisions: marketing managers use cost data to help make pricing decisions for new and existing products.
- Measuring performance: cost information allows comparisons to be made with past periods of time. In this way, the efficiency of a department or the profitability of a product may be measured and assessed over time.
- Setting budgets: cost information can help to set budgets and plans. These can act as targets for departments to work towards. Actual cost levels can then be compared with budgets.
- Resource use: comparing cost data can help in decisions about resource use. For example, if wage rates are very low, then labour intensive methods of production may be preferred over capital intensive ones.
- Making choices: calculating and comparing the costs of different options can assist managers in their decision-making. For example, comparing the costs of different production machinery or alternative locations can increase the chance of the most profitable decision being made.

Types of costs

The financial costs incurred in making a product or providing a service can be classified in several ways. Cost classification is not always as clear-cut as it seems.

Allocating costs to each good or service is not usually very straightforward in a business with more than one product.

Before cost information can be used to assist in making business decisions, it is important to understand the different cost classifications. The most important categories are discussed in the next sections.

Direct costs

These costs are easy to identify as being incurred by a particular cost centre. For example, one of the direct costs of:

==cost centre:== the section of a business, such as a department or a product, that incurs the costs.

==direct costs:== these costs can be clearly identified with each unit of production and can be allocated to a cost centre.

- a fast-food business is the purchase of the meat to make hamburgers
- a garage is the labour cost of the mechanic when repairing a car
- the Business department of a school is the salary of the Business teacher. The two most common direct costs in a manufacturing business are labour and materials. The most important direct cost in a service business, such as retailing, is the cost of the goods being sold.

Indirect costs

Indirect costs are often referred to as overheads. They are incurred by the business, but they cannot easily be divided up between cost centres. For example, one of the indirect costs of:

==Indirect costs:== costs that cannot be identified with a unit of production or allocated accurately to a cost centre.

- a farm is the purchase of a tractor
- a supermarket business is its promotional expenditure
- a garage is the rent
- a school is the cost of cleaning it.

Fixed and variable costs: how are costs affected by the level of output?

It is important for management to understand that not all costs will vary directly in line with production increases or decreases. In the short run (the period in which no changes to capacity can be made), costs may be classified as follows:

- Fixed costs:costs that do not vary with output in the short run. These do not change when the level of output changes, for example, the rent of a factory or shop.

- Variable costs:costs that vary with output. These vary as output changes, for example, the direct cost of materials used in making a washing machine or the electricity used to cook a fast-food meal. Semi-variable costs include both a fixed and a variable element. Examples of these include the fixed monthly cost of electricity plus the cost per unit used, or a salesperson's fixed basic wage plus a commission that varies with sales.

The fixed and variable costs of a business can be added together to give total costsin a time period.

==total costs:== variable cost plus fixed cost.

Figure 31.2: In this oil-fired power station in Cyprus, the indirect costs are a very high proportion of the total costs in electricity generation Figure 31.2: In this oil-fired power station in Cyprus, the indirect costs are a very high proportion of the total costs in electricity generation

Problems in classifying costs

Did you find it easy to classify all of the costs in Activity 31.1? In practice, it may not be very easy or even worthwhile to classify every cost into the categories explained above. Two examples explain why:

- Labour costs are often variable and direct costs. But, when labour is unoccupied because of a lack of orders, most businesses continue to pay workers in the short run. Wages then become a fixed cost. They also become an overhead cost as they cannot be directly allocated to any particular output. A TV presenter may be employed on a fixed-contract salary, which is not directly related to the number of shows they appear in. The salaries of administration, selling and non-production employees are always considered to be an indirect cost. These costs cannot be allocated to any one product or service. They are likely to be fixed in the short term too, as they do not vary directly with output.

- For example, electricity costs in a busy factory could be directly allocated to each range of products made. This would depend on keeping accurate and reliable energy-use records for each machine. In practice though, this may not be worthwhile and electricity costs would normally be classified as an indirect overhead expense.

  TIP You should remember that not all direct costs are variable costs. For example, if a hotel buys a new juicing machine for the bar department, this is a direct cost to that department, but the cost of the machine will not vary with the number of orange juices being served.

31.2 Approaches to costing

Calculating the cost of each product (or department, process or location) is not easy. Managers use two main methods to help with this costing process: full costing and contribution costing.

Costing methods: a major problem

In calculating the cost of a product, both direct labour and direct materials should be easy to identify and allocate to each product. For instance, the materials used in making a coat are allocated directly to the cost of that product. These are not the only costs involved, of course. Overheads, or indirect costs, cannot be allocated directly to particular units of production. They must be shared between all of the items produced by a business. There is more than one way of sharing or apportioning these costs and, therefore, there may be more than one answer to the question: 'How much does a product cost to produce?' This uncertainty causes potential problems when pricing products, when deciding whether to continue producing them, and when deciding whether to accept a new order for the product.

Important concepts

Before studying the two main costing methods, four important concepts need to be understood: cost centres, profit centres, overheads and average costs.

Cost centres

Examples of cost centres are:

- in a manufacturing business: products, departments, factories, particular processes or stages in production, such as assembly
- in a hotel: the restaurant, reception, bar, room letting and conference section
- in a school: different subject departments. Different businesses will use different cost centres as appropriate to their own needs.

Profit centres

Examples of profit centres are:

==profit centres:== a section of a business to which both costs and revenues can be allocated, so profit can be calculated.

- each branch of a chain of shops
- each department of a department store

- in a multi-product firm, each product in the overall portfolio of the business. The benefits of using cost and profit centres are:
- Managers and employees have targets to work towards. If these are reasonable and achievable, this should have a positive impact on motivation.
- These targets can be used to compare with actual performance and help identify those areas that are performing well and not so well.
- The individual performances of divisions and their managers can be assessed and compared.
- Work can be monitored and decisions made about the future. For example, should a profit centre be kept open or should the price of a product be increased?

Overheads

These indirect expenses of a business are usually classified into four main groups:

- Production overheads: including factory rent and rates, depreciation of equipment and power.
- Selling and distribution overheads: including warehouse, packing and distribution costs, and salaries of sales employees.
- Administration overheads: including office rent and rates, clerical and executive salaries.
- Finance overheads: including interest on loans.

Average cost

Average cost provides useful information for business managers. It is sometimes referred to as unit cost. The average cost of producing each unit of output is calculated by this formula:

==Average cost:== total cost divided by the number of units produced.

Example: A firm produces 20 000 desks at a total cost of $1 000 000. Unit cost is $1 000 000 divided by 20 000 = $50. Clearly, finding the unit cost is an essential step towards pricing the desks.

Full costing technique

Full costing allocates all costs to each product. If the business is only producing one type of product, then this is not a problem. In this case, the stages in full costing are:

==Full costing:== a method of costing in which all indirect and direct costs are allocated to the products, services or divisions of a business.

- Identify and add up all of the direct costs.
- Calculate the total overheads of the business for a given time period.
- Add the total direct costs of making the product.
- Calculate the average cost of producing each product by dividing total costs by output. Example 1

A pump manufacturer produces 5 000 pumps per year.

Total direct costs = $100 000

Total overhead costs = $50 000

Full cost of producing pumps = $150 000

Average (or unit) full cost per pump = $30

Comment

This is a straightforward calculation as there is just one product being made.

The main problem arises when a business produces two or more products. How should indirect expenses then be divided up between the two (or more) products? The division of indirect costs is called an 'allocation of indirect costs'. The easiest way is to divide total overhead costs by the number of different products being produced. In the following example, a manufacturer produces both Product A and Product B.

Can you see the problem with this allocation of overhead costs? The following example demonstrates the problem.

Example 2

Product A

Product B

Direct costs for each product

$45 000

$5 000

Allocated overheads (total overheads = $20 000)

$10 000

$10 000

Total or full cost

$55 000

$15 000

Annual output

10 000

500

Average full cost

$5.50

$30

Table 31.2: Simple full costing

Comment

This is an inaccurate division of indirect costs as Product A is obviously much more important to the business and incurs a much higher proportion of direct costs. This way of dividing overheads might lead to some very poor decisions, such as the pricing of Product B. As it has been allocated 50% of indirect costs then the final price, based on average cost, will be high and uncompetitive. Another way of allocating indirect costs must be used. Look at Example 3.

Example 3

Product A

Product B

Direct costs for each product

$45 000

$5 000

Proportion of total direct costs

90%

10%

Allocated overheads (total overheads = $20 000)

90% of $20 000 = $18 000

10% of $20 000 = $2 000

Total or full cost

$63 000

$7 000

Annual output

10 000

500

Average full cost

$6.30

$14

Table 31.3: Using direct cost information to allocate overheads

Comment

Now the indirect costs have been allocated differently. They have been allocated between the two products in proportion to how they incur direct costs. Product A incurs 90% of direct costs and is allocated 90% of indirect costs. Product B incurs 10% of direct costs so is allocated 10% of indirect costs. More accurate full cost figures are obtained, which will be much more useful for decision-making such as setting prices.

This method is not perfect. One reason is that Product B might take up just as much factory floor space as A or use as much electricity because it is more dependent on machinery than A. An allocation of indirect costs such as rent and electricity based on direct costs might still not be accurate.

Full costing: additional points

- A method of allocating indirect costs has to be selected and used.
- This method should not change over time, or cost comparisons over time will be difficult.
- Indirect costs can be allocated using several methods. Proportion of total direct costs was used above, but other methods include:

Uses of full costing

- Full costing is particularly relevant for single-product businesses. In these businesses there is no uncertainty about the share of overheads to be allocated to the product.
- All costs are allocated so no costs are left out of the calculation of total full cost or unit full cost.
- Full costing is a good basis for pricing decisions in single-product firms. If the full unit cost is calculated, this could then be used for cost-plus pricing.
- Full costing data can be compared from one time period to another to assess performance, as long as the same method of allocating overheads is used.

Limitations of full costing

- There is no attempt to allocate each overhead cost to cost centres or profit centres on the basis of actual expenditure incurred. For example, a product may take up a large proportion of factory space but use low-cost and easy-to-maintain machinery. Should all overheads be allocated on the basis of factory space?

- Inappropriate methods of overhead allocation can lead to inconsistencies between departments and products.
- It can be risky to use this cost method for making decisions. The cost figures arrived at can be misleading. See the section on 'Contribution costing and decision-making'.
- If full costing is used, it is essential to allocate overheads on the same basis over time as otherwise sensible year-on-year comparisons cannot be made.
- The full unit cost will only be accurate if the actual level of output is equal to that used in the calculation. A fall in output will push up the allocated overhead costs per unit.

Contribution or marginal costing

Contribution costing solves the problem of deciding on the most appropriate way to allocate or share out overhead costs between products – it does not allocate them at all. Instead, the method concentrates on two very important accounting concepts:

==Contribution costing:== costing method that allocates only direct costs to cost centres and profit centres, not overhead costs.

- Marginal costthe additional cost of producing one more unit of output. – the cost of producing an extra unit – is a variable direct cost. For example, if the total cost of producing 100 units is $400 000 and the total cost of producing 101 units is $400 050, the marginal (or extra) cost is $50.
- The contribution of a product is the revenue gained from selling a product less its marginal (variable direct) costs. This is not the same as profit. Profit can only be calculated after overheads have also been deducted. For example, if the 101st unit with a marginal cost of $50 is sold for $70, it has made a contribution towards indirect costs of $20. The unit contribution is the difference between the sale price ($70) and the marginal cost ($50) = $20.

Contribution costing and decision-making

Contribution costing has very important advantages over full costing when management plans to take important decisions based on cost data. An example contribution costing statement is shown in Table 31.5.

$000

Novel

	Textbook	
Revenue	50	100
Direct materials	15	35
Direct labour	20	50
Other direct costs	10	5
Total direct costs	45	90
Contribution	5	10

Table 31.5: Contribution costing statement for Cambridge Printers Ltd

This statement does not allocate overhead costs between the two products. Overheads cannot be ignored altogether, however. They are needed to calculate the profit or loss of the business:

- Total contribution for Cambridge Printers Ltd = \$15 000.
- Total indirect costs amounted to \$12 000.
- Profit = contribution less overheads.
- Therefore, the business has made a profit of \$3 000. This link between contribution to overheads and profit is a crucial one.

The following activities illustrate how contribution costing can be useful.

31.3 Uses of cost information

Cost information is important to businesses for many reasons. Average cost is often used to help set prices (see Section 23.2). Total cost data is essential when calculating profit or loss. Total cost information is also essential for the budgetary process, which is a key way of monitoring and improving business performance (see Section 31.1). Marginal cost information is used in decision-making when contribution costing is used (see Section 31.2).

This chapter now considers some other uses of contribution costing.

Contribution costing and decisions on stopping selling a product

If a business sells more than one product, contribution costing shows managers which product is making the greatest or least contribution to overheads and profit. If full costing were used instead, a manager could decide to stop producing a product that seemed to be making a loss. However, if it is still making a positive contribution, what would happen to profit if production was stopped? In cases such as this, stopping production of a product while it is earning a positive contribution will reduce the overall profits of the business. This is because the fixed overhead costs will still have to be paid, but there will be reduced contribution to pay for them. Activity 31.6 (some of which has been worked out for you) illustrates this point.

Contribution costing and special order decisions

If a business has spare capacity or if it is trying to enter a new market segment, contribution costing assists managers in deciding whether to accept an order at a price below the full cost of the product. For example, hotels often offer very low rates to customers in off-peak seasons. It is better to earn a contribution from additional guests than to leave rooms empty.

If a customer offers a special order contract at a price below full unit cost, this can lead to an increase in the total profits of the business. This is because the fixed overhead costs are being paid anyway and any extra contribution earned will increase profit. There are dangers in this policy, however:

- Existing customers may realise lower prices are being offered to new customers and demand a similar price. If all goods or services being sold by a business are sold at just above marginal cost, then this could lead to an overall loss being made.
- When high prices are a key feature in establishing the exclusivity of a brand, then to offer some customers lower prices could destroy a hard-won image.

- Where there is no excess capacity, sales at a price based on contribution cost may be reducing sales based on the full cost price.
- In some circumstances, lower-priced goods or services may be resold into the higher-priced market by customers themselves.

  TIP Even though accepting a new order might give a positive contribution, there are real dangers that other customers will find out that a lower price is being offered on a particular contract. Evaluate your answers to costing questions by explaining that qualitative factors are important too.

Situations when contribution costing would be used

- Contribution costing avoids inaccuracies and arbitrary indirect cost allocations and gives a contribution, not a profit total. Contribution costing can therefore be used in setting prices that just cover the direct costs of production.
- Decisions about a product or profit centre are made on the basis of its contribution to indirect costs – not profit or loss based on what may be an inaccurate full cost calculation. Contribution costing can therefore be used in decision-making over whether to close a cost/profit centre.
- Excess capacity is more likely to be effectively used, if special orders or contracts that make a positive contribution are accepted. Contribution costing can therefore be used in decision-making on special order decisions.

Situations when contribution costing would not be used

- By ignoring indirect costs, contribution costing does not take into account that some products may result in much higher indirect costs than others. In addition, single-product firms have to cover the fixed costs with revenue from this single product, so using contribution costing would not be used in this case.
- Contribution costing would not be used when making decisions about business expansion or developing new products. All costs of these developments will need to be considered, not just the direct costs.
- Contribution costing may lead managers to choose to maintain the production of goods just because of a positive contribution. Perhaps a brand-new product should be launched instead that could, in time, make an even greater contribution.
- As in all areas of decision-making, qualitative factors may be important too, such as the image a product gives the business.

31.4 Break-even analysis

Break-even analysis is widely used in business as it provides useful information for decision-making. One of the first questions an entrepreneur should ask is, 'How many customers do I need to cover my costs?' Existing businesses will also want to make sure that, at current output levels, they are not making a loss and are at least breaking even.

==Break-even analysis:== uses cost and revenue data to determine the break-even point of production.

Break-even analysis can be undertaken in two ways: the graphical method and the equation method.

The graphical method: the break-even chart

The break-even chart requires a graph with the axes shown in Figure 31.5. The chart itself is usually drawn showing three pieces of information:

- Fixed costs, which, in the short term, will not vary with the level of output and which must be paid whether the firm produces anything or not.
- Total costs, which are the addition of fixed and variable costs; we will assume, initially at least, that variable costs vary in direct proportion to output.
- Revenue, obtained by multiplying selling price by output level.

Figure 31.5: The axes for a break-even chart Figure 31.5: The axes for a break-even chart

Figure 31.6 shows a typical break-even chart. Note carefully the following points:

- The fixed cost line is horizontal, showing that fixed costs are constant at all output levels.
- Sales revenue starts at the origin (0) because if no sales are made, there can be no revenue.
- The variable cost line starts from the origin (0) because if no goods are produced, there will be no variable costs. It is drawn to aid your understanding of how the chart is constructed. It is not necessary to interpret the chart and is often omitted.
- The total cost line begins at the level of fixed costs, the difference between total and fixed costs being accounted for by variable costs.

Figure 31.6: A typical break-even chart Figure 31.6: A typical break-even chart

The point at which the total costs and sales revenue lines cross (BE) is the break-even point. At production levels below the break-even point, the business is making a loss; at production levels above the break-even point, the business is making a profit.

Margin of safety

This is a useful indication of how much sales could fall without the business making a loss. For example, if the break-even output is 400 units and current production is 600 units, the margin of safety is 200 units. This can be expressed as a percentage of the break-even point. For example:

==margin of safety:== the amount by which the current output level exceeds the break-even level of output.

production over break-even point = 200400 = 50.0%

If a business is producing below the break-even point, it is in danger. This is sometimes expressed as a negative margin of safety. Hence, if break-even output is 400 and the firm is producing at 350 units, it has a margin of safety of –50. The minus sign simply tells us that the production level is below break-even. (See Figure 31.7.)

Figure 31.7: A break-even chart showing the safety margin Figure 31.7: A break-even chart showing the safety margin

The break-even equation

A formula can be used to calculate break-even:

If fixed costs are $200 000 and the contribution per unitof output is $50, then the break-even level of production is:

==contribution per unit:== the price of a product less the direct (variable) costs of producing it.

This is an exact answer and, therefore, likely to be more accurate than many break-even graphs.

The same method can be used if a manager wants to determine a target profit level and establish the level of output required to achieve it. Suppose the target profit is $25 000. This is treated as if it was an extra fixed cost and the calculation is:

Further uses of break-even analysis

In addition to obtaining break-even levels of production and margins of safety, the break-even techniques can also be used to assist managers in making key decisions.

The charts can be redrawn showing a potential new situation and this can then be compared with the existing position of the business. Care must be taken in making these comparisons, as forecasts and predictions are usually necessary.

Here are further examples of uses of the break-even technique:

- A marketing decision – the impact of a price increase which makes the sales revenue line steeper (see SR2 on Figure 31.8). The assumption made in this example is that maximum sales will still be made. With a higher price level, this may be unlikely.
- An operations management decision – the purchase of new equipment which raises fixed costs (see FC2 on Figure 31.10) but which reduces variable costs resulting in reduced total costs (see TC2 on Figure 31.10).
- A location decision – using break-even data to help decide which location to select.

Figure 31.8: A break-even chart showing the effect on the break-even point and maximum total profit of a price rise (BE2) Figure 31.8: A break-even chart showing the effect on the break-even point and maximum total profit of a price rise (BE2)

The benefits of break-even analysis

- Charts are relatively easy to construct and interpret.
- Analysis provides useful guidelines to management on break-even points, safety margins and profit/loss levels at different rates of output.
- Comparisons can be made between different options by constructing new charts to show changed circumstances. In Activity 31.9, charts could be amended to show the possible impact on profit and break-even point of a change in the product's selling price.
- The equation produces a precise break-even result.
- Break-even analysis can be used to assist managers when taking important decisions, such as location decisions, whether to buy new equipment and which project to invest in.

Figure 31.10: A break-even chart showing the possible impact of new equipment, raising fixed costs but offering lower variable costs (BE2) Figure 31.10: A break-even chart showing the possible impact of new equipment, raising fixed costs but offering lower variable costs (BE2)

The limitations of break-even analysis

Although break-even analysis has advantages, it is important to recognise the limitations of this analysis in practice:

- The assumption that costs and revenues are always represented by straight lines is unrealistic. Some variable costs do not change directly with output. For example, labour costs may increase as output reaches its maximum due to higher shift payments or overtime rates.

- The revenue line could be influenced by the price reductions needed to sell a high level of output. The combined effects of these changing assumptions could create two break-even points in practice (see Figure 31.11).
- Not all costs can be easily classified into fixed and variable costs. The introduction of semi-variable costs will make the technique much more complicated.
- The break-even chart makes no allowance for inventory levels. It is assumed that all units produced are sold. This is unlikely to always be the case in practice.
- It is also unlikely that fixed costs will remain unchanged at different output levels up to maximum capacity.
- For new businesses, break-even data will be based on forecasts and these could be inaccurate.

  TIP You should remember that a break-even graph or calculation is only accurate for a limited period of time. Any changes in costs or price require a new break-even analysis. Suggesting these problems would be a good way to evaluate the break-even technique.

Figure 31.11: A break-even chart showing how non-linear assumptions can lead to two break-even points Figure 31.11: A break-even chart showing how non-linear assumptions can lead to two break-even points

> KEY CONCEPT LINK Understanding the classification of costs and being able to interpret break-even analysis are important skills that management need to use in order to adopt an appropriate strategy to add value to the operations of the business.

> KEY CONCEPT LINK Decision-making in business frequently makes use of contribution costing and break-even analysis. The impact of changes in costs and revenues should lead to contribution being recalculated and a revised break-even analysis.

Image Image

32.1 The meaning and purpose of budgets

Do you ever sit down and think about your income and spending plans for the next week or month? Do you make changes to these plans so that you do not overspend? At the end of the week or month, do you compare your actual income and spending with your original plans? If you do all of this, then you are budgeting!

==budgeting:== planning future activities by establishing performance targets, especially financial ones.

Financial planning for the future is important for all businesses. If no plans are made, a business will:

- be without a direction or purpose
- be unable to allocate the scarce resources of the business effectively
- have demotivated employees with no plans or targets to work towards
- be unable to measure its progress by measuring the plans against actual performance. Planning for the future must take into account the financial needs and likely consequences of these plans. This is the budgeting process: setting and agreeing financial targets for each section of a business. Budgets should be set for sales, revenue and costs. It is usual for each cost centre and profit centre to have budgets set for the next 12 months, broken down on a month-by-month basis.

The measurement of performance

All business managers should consider how they might measure the performance of their business. Knowing how the different departments and divisions of a business are performing helps managers assess the strengths and weaknesses of the organisation. Management action can then be taken to build upon strengths and correct the weaknesses. Assessing actual performance against pre-set targets is the best way of measuring the performance, over time, of each section of a business.

Non-financial targets can be established as well as financial ones. Non-financial targets might include those for customer loyalty, customer service levels and labour productivity. In order to review the financial performance of a business, financial targets will need to be set (for example revenue, costs and profit). These targets are called the budgets of the business and they should be established for all divisions and sections of a business. Measuring financial performance is one of the benefits of budgeting.

Benefits of using budgets

- Planning: The budgetary process makes managers consider future plans carefully so that realistic targets can be set. With a clear sales budget, for example, departments in the business will know how much to produce or how much to spend on sales promotion.
- Allocating resources: Budgets can be an effective way of making sure that the business does not spend more resources than it has access to. Without a detailed and coordinated set of plans for allocating the business's money and resources, who would decide 'who gets what'?
- Setting targets: Most people work better if they have a realistic target to aim for. This motivation will be greater if the budget holderthe individual

responsible for the initial setting and achievement of a budget. or profit centre manager has been delegated some accountability for setting and reaching budget levels.

- Coordination: Discussion about the allocation of resources to different departments and divisions requires coordination between these departments. Once budgets have been set, people will have to work effectively together if targets are to be achieved.
- Controlling and monitoring a business: Plans cannot be ignored once they have been set and agreed with the budget holder. Checks must be undertaken regularly to control and monitor the performance of the budget holder and their department. Many factors might have changed since the budget was set. Managers cannot assume that the budget target will be achieved without careful control and monitoring.
- Measuring and assessing performance: Once the budgeted period ends, variance analysis calculation of the differences between budgets and actual figures, and analysis of the reasons for such differences.is used to compare actual performance with the original budgets. This is an important way of assessing managers' performance. It would not be possible to assess how well individual departments had performed without a clear series of targets to compare actual performance with.

Potential drawbacks of using budgets

- Lack of flexibility: If budgets are set with no flexibility built into them, then sudden and unexpected changes in the external environment can make them very unrealistic. Unrealistic budgets will demotivate the budget holder and other employees.
- Focus on the short term: Budgets tend to be set for the relatively short term, for example, the next 12 months. Managers may take a short-term decision to stay within budget that may not be in the best long-term interests of the business. For example, cutting the size of the workforce to stay within the labour budget may restrict the ability of the business to increase output if sales rise quickly in the future.
- Unnecessary spending: If managers have underspent their budgets just before the end of the budgeting period, they might make decisions to spend unnecessarily so that the same level of budget can be justified next year. If a large surplus exists at the end of the budget period, how could managers justify the same level of resources next year?
- Training on budgets: Setting and keeping to budgets is not easy and all managers with delegated responsibility for budgets will need extensive training in this role.
- Budgets for new projects: Setting budgets for big new projects is very

difficult and often inaccurate. This is particularly true if similar projects – like a super-fast train line – have not been undertaken before.

Key features of effective budgeting

- A budget is not a forecast but a plan that businesses aim to fulfil. A forecast is a prediction of what could occur in the future given certain conditions.
- Budgets may be established for any part of an organisation as long as the outcome of its operation is measurable. This means most cost centres and profit centres will have budgets set, including budgets for sales, capital expenditure, labour costs and profit.
- Coordination between departments when establishing budgets is essential. This should avoid departments making conflicting plans.
- Budget setting should involve participation. Decisions regarding budgets should be made with the managers who will be responsible for meeting the targets. Those who are responsible for fulfilling a budget should be involved in setting it. This sense of 'ownership' not only helps to motivate the department concerned to achieve the targets but also leads to the establishment of more realistic targets. This approach to budgeting is called delegated budgetsbudgets for which junior managers have been given some authority for setting and achieving..
- Budgets are used to review the performance of each manager controlling a cost or profit centre. The managers will be appraised on their effectiveness in reaching targets. Successful and unsuccessful managers can therefore be identified.

  TIP It is a good idea to demonstrate that you understand the links between different topics in the syllabus. For example, delegated budgeting ties in with the motivational approach of Herzberg (see Section 11.3), making work more challenging and rewarding.

Setting and using budgets

There are several ways in which the budget level can be set.

Incremental budgeting

This method takes last year's budget and makes changes for this year based on last year's budget. The revised budget might be raised or lowered, depending on market conditions. Cost budgets will be adjusted for forecasted inflation and expected changes in output. Incremental budgeting does not allow for unforeseen events. Using last year's figure as a basis means that each department does not have to justify its whole budget for the coming year – only the change or increment. There is no fundamental appraisal of each department's targets or need for resources.

==Incremental budgeting:== uses last year's budget as a basis, and an adjustment is made for the coming year.

Zero budgeting

The zero budgeting approach requires all departments and budget holders to justify their whole budget each year. This is time-consuming, as a fundamental review of the work and importance of each budget-holding section is needed each year. However, it does provide added incentive for managers to defend the work of their own section. Also, changing situations, such as the external environment, can be reflected in very different budget levels each year.

==zero budgeting:== sets budgets to zero each year and budget holders have to argue their case for target levels and to receive any finance.

Flexible budgeting

Budgeted level

Actual level

Output

100 units

80 units

Direct materials

$20 000

$18 000

This shows a favourable variance of $2 000 because direct materials are lower than budgeted. Lower costs should increase profit. However, this ignores the fact that output is 20% below budget. This lower output should lead to lower material use anyway. A more realistic direct materials budget would adjust for the lower output figure. This is called flexible budgeting, which sets new budgets depending on the actual output level achieved.

==favourable variance:== a change from the budget that leads to higher than planned profit.

==flexible budgeting:== cost budgets for each expense are allowed to vary if sales or output vary from budgeted levels.

Fixed budget

Flexible budget*

Actual

Output

100

80

Direct materials

$20 000

$16 000

$18 000

Table 32.2 shows a new flexible budget for direct materials based on the lower output level. The actual level of direct materials now gives an adverse variance of $2 000. This shows that materials seem to be used less efficiently or are costing more per unit than originally budgeted.

==adverse variance:== a change from the budget that leads to lower than planned profit.

Flexible budgets are more motivating for budget-holding managers as they will not be criticised for adverse variances, which might occur just because output was lower than budgeted. The flexible targets are more realistic. Also, flexible budgets make it easier to produce valid and accurate variance analyses as they indicate changes in efficiency, not changes in output.

> TIP You are advised to remember that budgets are not forecasts. They may be based on sales forecasts but budgets are more like targets. They are set for departments and people in the organisation to aim towards.

32.2 Variance analysis

A variance is the difference between a budget and the actual figures achieved at the end of the budget period. It is important to calculate and analyse the reasons for these variances because:

- Variances measure differences from the planned performance of each department over a given period. Measuring performance is a key benefit of budgets.
- Finding out the reasons for variances can help set more realistic budgets in the future.
- Finding out the reasons for variances can help the business take better decisions. For example, if the revenue variance for a business was negative because of lower sales caused by an economic recession, then reducing prices might be the right decision to make.

- The performance of each individual cost centre and profit centre may be appraised in an accurate and objective way. If the variance has had the effect of increasing profit above budget, then it is called a favourable variance. If the variance has had the effect of reducing profit below budget, then it is called an unfavourable or adverse variance (see Table 32.3).

Managers may need to respond quickly to both adverse and favourable variances. Trying to find cheaper material supplies or increasing labour productivity will help to reduce adverse variances in future.

Favourable variances need analysing too. They may reflect a poor and inaccurate budgeting process where cost budgets were set too high. A favourable direct cost variance caused by output being much less than planned for is not a sign of success – why were sales and output lower than planned for?

Possible causes of adverse variances

Possible causes of favourable variances

• Revenue is below budget because either fewer units were sold or the selling price had to be lowered due to competition.

• Actual raw material costs are higher than planned because either output was higher than budgeted or the cost per unit of materials increased.

• Labour costs are above budget because either wage rates were raised due to shortages of workers or the labour time taken to complete the work was longer than expected.

• Overhead costs are higher than budgeted, perhaps because the annual rent rise was above the forecast.

• Revenue is above budget due to higher-than-expected economic growth or a competitor closing down.

• Raw material costs are lower because either output was below budget or the unit cost of materials was below budget.

• Labour costs are below budget because of either lower wage rates or quicker completion of the work.

• Overhead costs are lower than budgeted, perhaps because the interest rate on loans was reduced.

Table 32.3: Possible causes of adverse and favourable variances

Variance analysis: example

Table 32.4 shows a budget and variance analysis for one month for West Indian Computers (WIC).

(All figures $)

	Budget	Actual result	Variance	Favourable or adverse
Revenue	15 000	12 000	3 000	Adverse – this reduces profit
Direct costs	5 000	4 000	1 000	Favourable – this increases profit
Overhead costs	3 000	3 500	500	Adverse – this reduces profit
Profit	7 000	4 500	2 500	Adverse – profit is below budget

Table 32.4: Monthly budget and variance analysis for West Indian Computers

The variance calculations for WIC can be verified by checking the operating profit variance ($2 500 adverse) against the net sum of the other variances ($3 500 adverse – $1 000 favourable = $2 500 adverse).

The benefits to be gained from regular variance analysis include:

- Identifying potential problems early so that remedial action can be taken. Perhaps, in this case, a new competing computer retailer has opened up and WIC will have to quickly introduce strategies to combat this competition.

- Allowing managers to concentrate their time and efforts on the major problem areas. This is known as management by exception. In this case, it seems that managers should quickly investigate the likely causes of the lower-than-expected sales figures.

Image Image

Introduction

This chapter analyses the content and importance of the most significant financial statements of businesses.

Why keep financial (accounting) records?

Keeping financial records of every transaction a business makes is essential. The process of keeping these accounting records is not part of this Business course. We are only concerned with the financial or accounting statements that summarise the net result of all these transactions. However, it is useful to ask: Why is it necessary to keep accounting records? Table 33.2 outlines just some of the questions that could not be answered if accurate and detailed records of all financial transactions were not kept.

Question

Why this is important

Did the business make a profit or loss last year?

Profit or loss is a measure of business performance, and managers, shareholders and government (for tax purposes) need to know this.

How much do we owe our suppliers?

Suppliers need to be paid on time or they may refuse to send further deliveries.

How much do our customers owe the business?

If customers do not pay on time and the business has no record of whether they have paid, then a cash flow crisis could result.

Is the business able to repay the bank loan?

Banks loans have to be repaid by a certain date. Failure to do this will make further loan finance difficult to obtain.

Did the business pay wages to the workers last week?

Not paying workers on time, and not knowing whether they have been paid, could badly damage relations between managers and workers.

Is the business able to finance a dividend payment to shareholders?

Shareholders may sell shares in the company if dividends are not paid because the business is unsure whether it has sufficient finance.

Table 33.2: Why businesses need to keep accurate financial records

Main types of financial statement

At the end of each accounting period – usually one year – the finance department will draw up the financial statements of the business. For limited companies, these will be included in the annual report and accounts, which are sent to every shareholder. Table 33.3 outlines the two main financial statements of limited companies.

Financial statement

What it shows

Statement of profit or lossa statement that records the revenue, costs and profit (or loss) of a business over a given period of time.

The gross profit and profit from operations of the company. It includes details of how the profit from operations is split up between dividends to shareholders and retained earnings (profit).

Statement of financial positiona statement that records the values of a business's assets, liabilities and shareholders' equity at one point in time.

The net worth or equity of the company. This is the difference between the value of what a company owns (assetsan item of monetary value that is owned by a business.) and what it owes (liabilitiesa financial obligation of a business that it is required to pay in the future.).

Table 33.3: The main financial statements of limited companies

33.1 Statement of profit or loss

The statement of profit or loss can also be referred to as either an income statement or a profit or loss account.

A detailed statement of profit or loss is produced for internal use because managers need as much financial information as possible. It should be produced as frequently as managers need the information, perhaps once a month.

A less detailed summary statement of profit or loss is included in the published accounts of companies for external users. It is produced less frequently, but at least once a year. The content of this is laid down by each country's legislation on companies and provides a minimum of information. This is because published accounts are also available to competitors. Detailed data could give competitors a real insight into their rivals' strengths and weaknesses.

The version of statements of profit or loss used in this chapter is based on the published accounts of public limited companies, but with additional information where this helps understanding. An example is given in Table 33.4.

The contents of a statement of profit or loss

A statement of profit or loss has three sections: trading account, profit or loss section, and appropriation account. Each one gives a different profit figure.

Revenue

3 060

Trading account

(minus)

Cost of sales

(1 840)

(equals)

Gross profit

1 220

(minus)

Overheads/expenses

(580)

Profit or loss section

(equals)

Profit from operations (Operating profit)

640

(minus)

Interest

(80)

(equals)

Profit before tax

560

(minus)

Tax @ 20%

(112)

(equals)

Profit for the year

448

(minus)

Dividends to shareholders

200

Appropriation account

(equals)

Retained earnings

248

Table 33.4: Statement of profit or loss for Energen plc for the year ended 31 December 2021 ($000)

The trading account

This account shows how gross profit (or loss) has been made from the trading activities of the business.

==gross profit:== revenue less cost of sales.

It is most important to understand that, as not all sales are for cash in most businesses, the revenue figure is not the same as cash received by the business. This point is covered in more detail in Chapter 30. The formula for calculating total revenue is:

Therefore, if 120 items are sold at $2 each, the revenue is $240.

Revenue is not profit. Costs must be subtracted from revenue to calculate profit. There are different measures of profit.

The cost of sales figure is unlikely to be the same as the total value of goods purchased by the company during this year. This is because some items may have been added to inventories or taken from them. Only the goods used and sold during the year are recorded in cost of sales.

==cost of sales:== the direct cost of the goods that were sold during the financial year.

Gross profit is equal to:

The formula used to calculate cost of sales is:

This can be laid out as:

Opening inventories (at start of the year)$500

Purchases during the year$2 500

Total inventories available for sale$3 000

Closing inventories (at end of the year)($750)

Cost of sales$2 250

Profit or loss account section

This section of the statement of profit or loss calculates three profit figures:

- The profit from operationsgross profit less overhead expenses (also known as operating profit). (or operating profit) is calculated by subtracting expensesthe overhead costs that arise in operating the business, which are deducted from gross profit to calculate profit from operations. (such as overheads) from gross profit. Overhead costs are expenses of the business that are not directly related to the number of items made or sold. These can include rent and business rates, management salaries, marketing costs and depreciation.
- Profit before taxprofit from operations less interest costs. is calculated by subtracting interest costs from profit from operations.
- Finally, profit for the yearprofit before tax less profit (or corporation) tax. is calculated by subtracting profit (corporation) tax from profit before tax.

Appropriation account

This final section of the statement of profit or loss shows how the profit for the year is distributed between the owners, in the form of dividends to company shareholders and as retained earnings.

==dividends:== the share of the profits paid to shareholders as a return for investing in the company.

Uses of statements of profit or loss

The information contained in these statements can be used in a number of ways:

- It can be used to measure and compare the performance of a business over time or with other firms, and ratios can be used to help with this form of analysis (see Section 34.2).
- The actual profit data can be compared with the budgeted profit levels of the business.
- Bankers and creditors of the business will need the information to help decide whether to lend money to the business.
- Prospective investors will use the profit performance of the business as a guide to whether to buy shares in it or not. All of these users of profit

data need to be aware of the limitations of published accounting data referred to in Section 36.2. In addition, these users should also consider the quality of the profit being recorded. For example, a high profit figure resulting from the sale of a valuable asset for more than its expected value might not be repeatable. This is, therefore, said to be low-quality profit. However, profits made from developing, producing and selling exclusive product designs are high-quality profits because these are likely to be a continuous source of profit for some time to come.

==low-quality profit:== one-off profit that cannot easily be repeated or sustained.

==high-quality profits:== profit that can be repeated and sustained.

Amending statements of profit or loss

Accountants often have to make adjustments to the accounting statements they are preparing. When new financial data becomes available or when one of the key variables used in the final accounts changes, a revised statement has to be produced. As an A Level Business learner, it is important for you to remember these few basic rules when adapting existing accounts:

- Use the same format of presenting the statement of profit or loss as shown in the case study.
- If a change to the number of units produced and sold occurs, this is most likely to lead to changes in both revenue and cost of sales.
- Some overheads might change with a variation in the level of sales. Annual promotion or transport costs might be affected by variations in the number of units sold.

The impact of a change on the statement of profit or loss

Table 33.8 explains the impact on the statement of profit or loss following a change in one of its components (assuming no other change occurs).

Change

Impact on statement of profit or loss

Increase in price: demand for product is inelastic

Revenue, gross profit, profit from operations, profit before tax, profit for the year and retained earnings will all increase.

Increase in direct cost per unit

Cost of sales will increase; gross profit, profit from operations, profit before tax and profit for the year will all fall.

Increase in expenses

Profit from operations, profit before tax, profit for the year and retained earnings will all fall.

Reduction in the rate of profit (corporation) tax

Profit after tax and retained earnings will both increase.

Directors decide to increase dividends

Retained earnings will fall.

33.2 The statement of financial position: meaning and purpose

The statement of financial position records the net wealth or shareholders' equity of a business at one moment in time. In a company this net wealth belongs to the shareholders. The aim of most businesses is to increase the shareholders' equity by raising the value of the assets owned by the business by more than any increase in the value of liabilities. Shareholders' equity comes from two main sources:

==shareholders' equity:== the total value of assets less the total value of liabilities.

- The first and original source was the capital originally invested in the company through the purchase of shares. This is called share capitalthe total value of capital raised from shareholders by the issue of shares..
- The second source is the retained earnings of the company accumulated over time through its operations. These are sometimes referred to as reserves, which is rather misleading as they do not represent reserves of cash.

The contents of a statement of financial position

Table 33.9 shows an example of a statement of financial position with some explanatory notes, which do not appear in companies' published accounts. The figures have been presented in two columns to help your understanding of how subtotals are arrived at. In published accounts, all figures will be presented in one column. Your own answers to questions requiring a statement of financial position can also be presented in a single column.

Image Image

Points to note:

- Companies have to publish the statement of profit or loss and the statement of financial position for the previous financial year as well to allow easy comparison. These have not been included in the above examples for reasons of clarity.

- The titles of both accounts are very important as they identify both the account and the company.
- Whereas the statement of profit or loss provides data for the whole financial year, the statement of financial position is a statement of the value of the company at one moment in time, usually at the end of the financial year.

Non-current assets

The most common examples of fixed assets are land, buildings, vehicles and machinery. These are all tangible assets as they have a physical existence. The value of most of these assets declines over time (see Section 33.4 on depreciation).

Businesses can also own intangible assets. These cannot be seen but can contribute value to the business. Examples are patents, trademarks, copyrights and goodwill.

==goodwill:== arises when a business is valued at or bought for more than the balance sheet value of its assets.

There are some important points about intangible assets:

- Intangible assets are difficult to value.
- Statements of financial position, according to accepted accounting rules, do not record intangible assets unless acquired through takeover or merger.
- For many companies, intangible assets are the main source of future earnings, especially in a world increasingly dominated by the knowledge-based economy. This includes scientific research companies, publishing and music companies, and businesses with famous brand names.
- The market value of companies with substantial intangible assets will be much greater than the net asset value. Intangible assets such as patents and copyright are sometimes known as intellectual capital. Intangible assets give a business a higher market value. This is because they increase the total value of the business assets.

The reputation and prestige of a business that has been operating for some time also give value to the business above the value of its physical assets. This is called the goodwill of a business. It will normally only appear on a statement of financial position if a business takes over another firm at a cost higher than the net assets of that firm. At other times, goodwill will not appear on company accounts. This is because business reputation and its good name can disappear very rapidly, for example, if there is a scare over products that could cause a risk to consumers' health.

Disputes can arise between accountants about the valuation of intangible assets. For example, there is a current debate amongst accountants regarding the asset value of well-known brand names. There is scope for varying the value of these and other intangibles on the statement of financial position in order to give a better picture of the company's position. This is one aspect of window dressing of accounts that can reduce the objectivity of published accounts.

==window dressing:== techniques used by companies to manipulate financial statements and reports to show more favourable results.

Current assets

These are very important to a business. The value of current assets has a major impact on the liquidity of the business. The most common examples are inventories, trade receivables (debtors who have bought goods on credit) and the cash/bank balance.

Current liabilities

Typical current liabilities include trade payables (suppliers who have allowed the business credit), bank overdraft, unpaid dividends and unpaid tax.

Working capital

This concept was explained in Section 29.2. Working capital can be calculated from the statement of financial position by the formula:

It can also be referred to as net current assets.

==net current assets:== the amount of capital needed for day-to-day activities, also called working capital (= current assets less current liabilities).

Shareholders' equity

This is sometimes referred to as shareholders' funds or just equity. It comprises the capital originally paid into the business when the shareholders bought shares (share capital) plus the retained earnings / profits of the business. These retained earnings are also known as reserves.

==reserves:== accumulated retained profits and capital reserves from re-valuation of non-current assets.

They are calculated by:

Other reserves can also appear on the statement of financial position if a company believes that its fixed assets have increased in value (re-valuation reserve) or if it sells additional shares for more than their nominal value (share premium reserve). Shareholders' equity is the permanent capital of the business. It will never be repaid to shareholders unless the company ceases trading altogether, unlike loans that are repaid to creditors.

A common misunderstanding regarding reserves is to believe that they are cash reserves that can be called upon as a source of finance. They are not. Retained earnings arise due to profits being made that are not paid out in tax or dividends. Retained earnings reserves have already been invested back into the business when purchasing additional assets. Retained earnings are, therefore, no longer available as a source of liquid funds. The only cash funds available in the business are those indicated under 'cash' in the current assets section.

Non-current liabilities

These are the bank (long-term) loans owed by the business due to be paid over a period of time greater than one year. They include loans, commercial mortgages and debentures. The value of non-current liabilities compared to the total capital employed by the business is an important measure of the degree of risk being taken by the company's management.

Figure 33.2: Shivani owns a successful beauty business but is not an accountant
Figure 33.2: Shivani owns a successful beauty business but is not an accountant

Amendments to statements of financial position

When preparing a new statement of financial position it is common to start with the statement for the end of the previous financial year and then make amendments to it. Table 33.14 shows some of the amendments that are possible and the impact on the statement of financial position. There then has to be a balancing double entry adjustment to make sure that this statement still balances (that is, total assets still equal shareholders' equity + liabilities).

> TIP If a question asks you to amend a statement of profit or loss, or a statement of financial position, you should always use the same structure for the financial statement as shown in the case study.

Cause of amendment

Impact on statement of financial position

Balancing entry in the account

Sale of inventories for cash for the same price as valued in the accounts.

Value of inventories will fall.

Cash balance will increase.

Sale of inventories for cash at a higher price than valued in the accounts.

Value of inventories will fall.

Cash balance will increase.

Shareholders' equity will increase by the value of the profit recorded.

Depreciation of equipment.

Value of non-current assets will fall.

Shareholders' equity will fall as the company is now 'worth less' than before.

Intangible assets, such as intellectual property, are re-valued.

Value of non-current assets will increase.

Value of shareholders' equity will increase.

Trade payables (creditors) ask for immediate payment.

Value of trade payables will fall.

Cash balance will decline.

Additional shares are sold and the share capital raised is used to buy property.

Value of share capital will increase under shareholders' equity.

Value of property in non-current assets will increase.

Table 33.14: Common amendments to statements of financial position

Relationship between the financial statements

Although these two statements are separate financial accounts, there are important links between them. Table 33.16 outlines some of these links.

Change on statement of profit or loss

Change on statement of financial position

Retained earnings are made during the year.

Shareholder equity increases.

Cash increases (if the retained earnings are in cash form).

Loss is made during the year.

Shareholder equity falls.

Cash falls or non-current liabilities increase to cover the loss.

Non-current assets are depreciated and this is recorded as an expense.

Value of non-current assets falls.

Shareholder equity falls.

Value of closing inventory is reduced as it is now out-of-date; this increases cost of sales. Gross profit and retained profit will fall.

Inventory valuation falls (current asset).

Shareholder equity falls.

Table 33.16: Relationship between the statement of profit or loss and the statement of financial position

33.3 Inventory valuation

Inventories are unsold goods. They might also be in the form of raw materials and components that have not yet been made into completed units. Some inventories will be in the form of work-in-progress. How should these unsold goods and materials be valued on the business statement of financial position? Accountants are quite clear on this: inventories should be recorded at their purchase price (historical cost) or their net realisable value (NRV), whichever is the lower.

==net realisable value (NRV):== the amount for which inventory can be sold minus the cost of selling it.

Net realisable value is calculated as follows:

It is only used on statements of financial position when NRV is estimated to be below historical cost. NRV sounds very complicated, but actually it is easy to understand. Consider these examples:

Example 1: A shoe shop buys in ten pairs of shoes from a supplier for $10 a pair. At the end of the financial year, it has three pairs remaining unsold. They have now gone out of fashion. The shopkeeper believes that they could only be sold at a reduced price of $8, below the price he paid for them. Therefore, the NRV of the 3 pairs of shoes is only $24. It is this value – not $30 – that should appear on the statement of financial position. The accounting principle known as conservatism states that losses should be recorded as soon as they are believed to occur.

Example 2: A furniture retailer has a dining table that has been in stock for six months. It was bought from the manufacturer for $60. It has been damaged in the shop and needs a repair costing $20. The shopkeeper believes that after the repair the table could be sold for $70. The table should not be valued on the statement of financial position at $70 as this assumes that a profit will be made. It should not be valued at $60 as this ignores the fact that it is damaged. The NRV is $70 – $20 = $50. As this is less than the historical cost of the asset, this becomes its value on the statement of financial position.

33.4 Depreciation

Assets decline in value for two main reasons:

- normal wear and tear through usage
- technological change that makes the asset obsolete.

Role of depreciation in the accounts

Nearly all fixed/non-current assets will depreciate or decline in value over time. It seems reasonable, therefore, to record only the value of each year's depreciation as a cost on each year's income statement. This will overcome both of the problems referred to above:

==depreciation:== the decline in the estimated value of a non-current asset over time.

- The assets will retain some value on the statement of financial position each year until fully depreciated or sold off. This is the net book valuethe current statement of financial position value of a non-current asset = original cost less accumulated depreciation., calculated as follows:
- The profits will be reduced by the amount of that year's depreciation and will not be under- or over-recorded.

How depreciation is calculated: the straight line method of depreciation

There are a number of different methods that accountants can use to calculate depreciation, but you only need to understand the straight line method for this course. The title of this method indicates the way in which depreciation is calculated.

==straight line:== a constant amount of depreciation is subtracted from the value of the asset each year.

Annual depreciation is calculated by the formula:

To calculate the annual amount of depreciation, the following information is needed:

- the original or historical cost of the asset
- the expected useful life (in years) of the asset
- an estimation of the value of the asset at the end of its useful life (known as the residual value of the asset). The formula given above is then used to calculate the annual depreciation charge.

Example: A business purchases three new computers costing \$3 000 each. Experience with previous computers suggests that they will need to be updated after four years. At the end of this period, the second-hand value of each machine is estimated to be just \$200. Using straight line depreciation, the annual depreciation charge will be:

For each of the four years of the useful life of these computers, a depreciation charge of \$2 100 should be made. This should be included as overhead expenses on the statement of profit or loss. On the statement of financial position, the annual depreciation charge is subtracted from the value of the computers. At the end of four years, each computer will be valued at \$200 on the statement of financial position. Table 33.17 shows how the net book value of these computers falls over the four-year period.

Year	Annual depreciation charge	Net book value of the three computers
Present	0	$9 000
1	$2 100	$6 900
2	$2 100	$4 800
3	$2 100	$2 700
4	$2 100	$600

Table 33.17: Net book value declines with each annual depreciation

If, at the end of the fourth year, the computers are sold for more than their expected residual value, a profit will be recorded on the statement of profit or loss. If they are sold for a total of $900, the business has made a profit of $300. If, however, the computers are scrapped at the end of the fourth year because they are obsolete, the business will record a loss on the disposal of these assets of $600.

Straight line depreciation: an evaluation

Compared to other methods of depreciation, the straight line method is easy to calculate and understand. It is widely used by limited companies. You can check this for yourself. Look in the annual accounts of any public limited company and you will find a statement about the depreciation methods used. More often than not, the company will have used this method.

However, the method requires estimates to be made regarding both life expectancy and residual value. Any errors in these estimates lead to inaccurate depreciation charges being calculated.

In addition, cars, trucks and computers are examples of assets that tend to depreciate much more quickly in the first and second years than in subsequent years. This is not reflected in the straight line method calculation. All annual depreciation charges are the same.

Finally, the repairs and the maintenance costs of an asset usually increase with age and this will reduce the profitability of the asset. This is not reflected in the fixed depreciation charge of the straight line method.

Impact of depreciation and the financial statements

The amount of the annual charge for depreciation affects the main financial statements as follows:

- It is a business expense so it will reduce profit from operations on the statement of profit or loss.
- It reduces the net book value of a non-current asset. The value of non-current assets on the statement of financial position will fall as a consequence.

Image Image

> KEY CONCEPT LINK When senior managers take a decision to increase the capital equipment used by a business, this strategy will have an impact on the annual depreciation figure on the statement of profit or loss.

Image Image

Introduction

How much can we tell about a company's performance by studying the published accounts? It is easy to compare one year's profit figures with the previous year. Changes in revenue can also be identified, as can differences from one year to the next in current assets, current liabilities and shareholders' equity. Similar comparisons can be made between different companies too. However, in making these comparisons, one essential problem arises. One accounting figure, on its own, is a poor measure of business performance or efficiency. It needs to be compared with another figure to give a ratio result. Accountants make meaningful assessments by relating two accounting results to each other in the form of a ratio. Accounting ratios are grouped into five main categories. We start by considering liquidity ratios.

34.1 Liquidity ratios

One of the main reasons for business failure is shortage of liquid funds, such as cash, to pay debts.

The meaning and importance of liquidity

Liquidity is a measure of how easily a business could meet its short-term debts or liabilities. Liquidity ratios are an important measure of the ability of a business to continue trading. They are concerned with the working capital of the business. If there is too little working capital, then the business could become illiquid and be unable to pay short-term debts. Suppliers would refuse to deliver more materials and banks would refuse more loans. If the business has too much money tied up in working capital, then this could be used more effectively and profitably by investing in other assets.

There are two liquidity ratios: current ratio and acid test ratio.

Current ratio

The current ratio is measured by the formula:

==current ratio:== a ratio that compares the current assets with the current liabilities of the business.

The result is normally expressed as a ratio (for example 2:1). This result shows that this business could pay for its short-term debts twice over. It is in a very liquid position.

There is no particular result that can be considered a universal and reliable guide to a firm's liquidity. Many accountants recommend a result of around 1.5:1 to 2:1, but much depends on the industry the firm operates in and the recent trend in the current ratio. For instance, a result of around 1.5 could be a cause of concern if, last year, the current ratio had been much higher than this.

Look at the accounting data from two sports clothing manufacturers, Port Louis Sports (PLS) and Bengaluru Sports Kit (BSK), shown in Table 34.2.

All figures as at 31 December 2021 ($000)

Current assets

Current liabilities

Current ratio

PLS

100

50

1005=2:1

BSK

720

720

720720=1:1

Table 34.2: PLS and BSK: current ratios

Points to note:

- PLS is in a more liquid position than BSK. PLS has twice as many current assets as current liabilities. For every $1 of short-term debts, it has $2 of current assets to pay for them. This is a relatively safe liquidity position.
- The current ratio of BSK is more worrying. It only has $1 of current assets to pay for each $1 of short-term debt. In the (unlikely) event that all of its short-term creditors demanded repayment at the same time, it would struggle to pay them all. This would be even more of a problem if some of its current assets could not be converted into cash quickly.
- Very low current ratios might not be unusual for businesses such as food retailers, which have regular inflows of cash that they can rely on to pay short-term debts.
- Current ratio results over 2:1 might suggest that too many funds are tied up in unprofitable inventories, trade receivables and cash. It might be better to place some of these current assets in a more profitable form, such as equipment, to increase efficiency.
- A low ratio might lead to corrective management action to increase current assets held by the business.

Acid test ratio

The acid test ratio, also known as the quick ratio, is a stricter test of a firm's liquidity. It is measured by:

==acid test ratio:== compares liquid assets to current liabilities.

Liquid assets are calculated by:

The acid test ratio ignores the least liquid of the firm's current assets: inventories. Inventories, by definition, have not yet been sold and there can be no certainty that they will be sold in the short term. By eliminating the value of inventories when calculating the acid test ratio, a clearer picture is given of the ability of the business to pay short-term debts.

Using the two businesses PLS and BSK again (see Table 34.3):

All figures as at 31 December 2021 ($000)

Liquid assets

Current liabilities

Acid test ratio

PLS

50

50

1:1

BSK

540

720

0.75:1

Table 34.3: PLS and BSK: acid test ratios

Points to note:

- Results below 1:1 are often viewed with caution by accountants. Such results mean that the business has less than $1 of liquid assets to pay each $1 of short-term debt. Therefore, BSK may well have a liquidity problem. However, the trend in this result over recent years would be informative.
- The full picture needs to be gained by looking at previous years' results. For example, if last year BSK had an acid test of 0.5:1, this means that over the past 12 months its liquidity has actually improved. This is more favourable than if its result last year had been 1:1, showing a decline in liquidity in the current year.
- Businesses with high inventory levels will record very different current and acid test ratios. This is not a problem if inventory levels are always high for this type of business, such as with a furniture retailer. It would be a cause for concern for other types of businesses, such as computer manufacturers, where inventories lose value rapidly due to technological changes.
- Selling inventories for cash will not improve the current ratio: both items are included in current assets. However, it will improve the acid test ratio as cash is a liquid asset but inventories are not.

Methods of improving liquidity

See Table 34.4 for an evaluation of methods to improve liquidity.

Method to increase liquidity

Examples

Evaluation of method

Sell off fixed assets for cash. They could be leased back if still needed by the business.

Land and property could be sold to a leasing company.

• If assets are sold quickly, they might not achieve their true value.

• If assets are still needed, then leasing charges will add to overheads and reduce the operating profit margin.

Sell off inventories for cash (this will improve the acid test ratio, but not the current ratio).

Inventories of finished goods could be sold off at a discount to raise cash.

• This will reduce the gross profit margin if inventories are sold at a discount.

• Brand image may be damaged if inventories are sold off at low prices.

Use JIT inventory management.

JIT inventory management will cut inventories held.

• Inventories might be needed to meet changing customer demand levels. JIT might be difficult to adopt in some industries.

Increase loans to inject cash into the business and increase working capital.

Bank (long-term) loans could be taken out if the bank is confident of the company's prospects.

• These will increase the gearing ratio (see Section 34.4).

• Increased interest costs will reduce profit for the year.

Table 34.4: Evaluation of methods to improve liquidity

34.2 Profitability ratios

As profit is a major objective for many businesses, it is important to be able to measure profit against the targets that managers set.

The meaning and importance of profitability

A high level of profit does not necessarily mean a high level of profitability if sales and capital invested are also very high. Look at these profit figures from the two sports clothing manufacturers PLS and BSK (see Table 34.6):

==profitability:== a relative measure of a business's ability to make a profit from sales or a capital investment.

2021 Operating profit ($000)

PLS

50

BSK

500

Table 34.6: PLS and BSK: operating profit, 2021

How much can we tell about the performance of the two companies from these results? Is BSK more successful than PLS? Are the managers of PLS less effective? Are the companies becoming more profitable? Would they make good investments for future shareholders? Are the strategies adopted by BSK much more successful than those of PLS?

The answer to all of these questions is the same: we cannot tell from the information given. The only correct statement that can be made is that one company (BSK) made an operating profit ten times greater than that of the other company.

Now look at other information about these two businesses (see Table 34.7):

2021 Revenue ($000)

PLS

250

BSK

3 200

Table 34.7: PLS and BSK: revenue, 2021

This additional data starts to give a more detailed picture of the performance of these two businesses. The comparison would be even clearer if the revenue data and the profit data were analysed together. Which management team has been more effective at converting revenue into profit?

Profitability of a business is very important. It measures business performance more effectively than the overall level of profit. This is because profitability assesses business performance by comparing profit levels with sales or capital invested. The higher the level of profitability, the greater the chance of high returns to investors.

There are three profitability ratios included in the A Level Business syllabus: gross profit margin, operating profit margin and return on capital employed.

Gross profit margin ratio

The gross profit margin ratio is used to assess how successful the management of a business is at converting revenue into gross profit. It is widely used to measure the performance of a company and its management team. The gross profit margin ratio is measured by the formula:

==gross profit margin ratio:== a ratio that compares gross profit (profit before deduction of overhead expenses) with revenue.

Using the two businesses, PLS and BSK (see Table 34.8):

Gross profit $000

Revenue $000

Gross profit margin

PLS

125

250

125250×100=50%

BSK

800

3 200

8003 200×100=25%

Table 34.8: PLS and BSK: gross profit margins, 2021

Points to note:

- Although BSK recorded a much higher gross profit figure, it has a lower gross profit margin. Higher profit does not mean higher profitability. This is because its revenue was 12.8 times greater than that of PLS, but its gross profit was only 6.4 times greater.
- The lower gross profit margin could result from BSK adopting a low-price strategy to increase sales or be because it has a higher cost of sales per unit.
- Higher cost of sales per unit could be the result of higher material costs or higher direct labour costs compared with PLS. Perhaps the management of BSK is less effective in controlling costs than managers at PLS.
- The gross profit margin is a good indicator of how effectively managers have added value to the cost of sales.
- Methods that could be used to improve profitability are analysed in Table 34.11.
- It is misleading to compare the ratios of firms in different industries because the level of risk and gross profit margin will differ greatly.

Operating profit margin ratio

This ratio uses the operating profit data. This is calculated by subtracting overhead expenses from gross profit. The operating profit margin measures how successful a business is in converting sales into profit from operations. It is measured by the formula:

==operating profit margin:== a ratio that compares operating profit for the year with revenue.

Using the same two businesses (see Table 34.9):

	Operating profit $000	Revenue $000	Operating profit margin
PLS	50	250	$\frac{50}{250} \times 100 = 20\%$
BSK	500	3 200	$\frac{500}{3\,200} \times 100 = 15.6\%$

Table 34.9: PLS and BSK: operating profit margins, 2021

Points to note:

- The profitability gap between these two businesses has narrowed. The difference in gross profit margins is substantial but the difference in operating profit margins is much less. However, the results show that, compared with PLS, BSK has relatively high overhead expenses and lower operating profit compared with revenue.
- BSK could narrow the gap further by reducing overhead expenses while maintaining revenue or by increasing revenue without increasing overhead expenses.
- A comparison of results with those of previous years would indicate whether the performance and profitability of either company were improving or worsening. This would give a more complete analysis of the level of management performance.
- The operating profit margin, and the trend in this ratio over time, indicate management effectiveness at converting revenue into profit after all expenses have been subtracted.

  TIP Many learners state that, 'To increase profit margins the business should increase sales'. This is a poor answer unless revenue can be increased at a greater rate than the costs of the business.

Return on capital employed ratio

The return on capital employed (RoCE) ratio is the most commonly used measure of the profitability of a business. It is often referred to as the primary efficiency ratio. It compares operating profit with the capital that has been invested in the business. Return on capital employed is measured by:

==return on capital employed (RoCE) ratio:== a ratio that compares operating profit (profit from operations) and the capital employed in the business.

$$\text{return on capital employed ratio} = \frac{\text{operating profit}}{\text{capital employed}} \times 100$$

Capital employed is measured by:

==Capital employed:== the total value of all long-term finance invested in a business.

Using the same two businesses (see Table 34.10):

	Operating profit $m	Capital employed $m	Return on capital employed
PLS	50	400	$\frac{50}{400} \times 100 = 12.5\%$
BSK	500	5 000	$\frac{500}{5000} \times 100 = 10\%$

Table 34.10: PLS and BSK: return on capital employed, 2021

From these results, it is clear that the management of PLS is more effective at making the capital invested in the business earn profit from operations.

Points to note:

- The higher the value of this ratio, the greater the return on the capital invested in the business.
- The return can be compared both with other companies and with the RoCE of the previous year's performance. Making comparisons over time allows the trend of profitability in the company to be identified.
- The result can also be compared with the return from interest accounts. Could the capital be invested in a bank at a higher rate of interest with no risk?

- RoCE results should be compared with the interest cost of borrowing finance. If it is less than this interest rate, an increase in borrowing will reduce returns to shareholders.
- The RoCE of a business can be raised by increasing the profitable, efficient use of the assets owned by the business, which were purchased by the capital employed. See Tables 34.11 and 34.13 for an evaluation of methods to increase profitability.

  KEY CONCEPT LINK The profitability ratios are a very important way for management and shareholders to assess business performance. Comparisons should be made with companies in the same industry as the context in which they operate will be similar. Comparing profitability ratios with businesses in other industries can be misleading.

Methods of improving profitability

Methods to increase profit margins

Examples

Evaluation of method

Reduce direct costs

Use lower-cost materials.

Quality image may be damaged, which could hit the product's reputation.

Cut labour costs (for example, offshoring production to low-cost countries).

Quality may be at risk – there may be communication problems with distant factories.

Cut labour costs by increasing productivity through automation.

Purchasing machinery will increase overhead costs, workers will need retraining and short-term profits may be cut.

Cut wage costs by reducing workers' pay.

Motivation levels might fall, which could reduce productivity and quality.

Increase prices

This will increase profit on each item sold.

Total profit could fall if too many consumers switch to competitors. This links to price elasticity of demand.

Increase profit margin by reducing overhead costs / cutting interest costs

Relocate to low-cost site.

Lower rental costs could mean moving to a less attractive area, which could damage image.

Reduce promotion costs.

Cutting promotion costs could lead to sales falling by more than fixed costs.

Delayer the organisation.

Having fewer managers could reduce the efficient operation of the business.

Reduce long-term borrowing, perhaps by raising finance from a new issue of shares.

The success of a new issue of shares will depend on the prospects for the business and investor confidence.

Table 34.11: Evaluating methods to improve profit margins

Methods to increase RoCE

Evaluation of method

Increase operating profit without increasing capital employed. For example:

- raise prices
- Demand could be price elastic.
- reduce direct costs per unit
- Cheaper materials could cut back on quality.
- reduce overheads, such as delayering or reducing promotion costs.
- This may not be effective in increasing profit in the short run and may have drawbacks (for example, less promotion could reduce sales).

Reduce capital employed. For example:

- sell assets that contribute nothing or little to sales/profit, and use the capital raised to reduce debts.
- The assets may be needed in the future (for example, for expansion of the business).

Table 34.13: Evaluating methods for improving RoCE

> TIP Many questions will ask for methods to increase the profitability of a business. If the question needs an evaluative answer, it is very important that you consider at least one reason why your suggestion might not be effective.

> TIP When commenting on ratio results, it is often advisable to question the accuracy of the data used. In addition, try to explain the limitations of using just a limited number of ratio results or results from just one year in your analysis.

34.3 Financial efficiency ratios

Efficiency is often associated with operations, but a business can also measure the efficiency with which it uses its financial resources.

The meaning and importance of financial efficiency

There are several ratios that can be used to assess how efficiently the assets or resources of a business are being used by management. High levels of financial efficiency are important as it means that managers are using the assets of the business effectively and minimising the amount that needs to be borrowed. Reducing the capital required to operate the business reduces the cost of financing its operations.

The three most commonly used financial efficiency ratios are: rate of inventory turnover, trade receivables turnover and trade payables turnover.

Inventory turnover

In principle, the lower the amount of capital used in holding inventories, the better. Modern inventory-control theory focuses on minimising the finance tied up in inventories. The rate of inventory turnover records the number of times the inventory of a business is bought in and resold in a period of time. If this ratio increases over time, then the business is reducing the finance used to hold inventories. This is being financially efficient. If a business bought inventory just once each year, sufficient for the whole year, its inventory turnover would be 2 and investment in inventories would be high.

==rate of inventory turnover:== the number of times in a year that inventory is bought in and sold.

The rate of inventory turnover is measured by the formula:

Average inventory is calculated by the formula:

Going back to the two businesses, PLS and BSK (see Table 34.16):

Cost of sales $m (2021)

Average inventory $m (2021)

Rate of inventory turnover

PLS

125

40

12540=3.125

BSK

2 400

200

2 400200=12

Table 34.16: PLS and BSK: rate of inventory turnover, 2021

Note that in Table 34.16 the average inventory figures are not equal to the difference between current assets and liquid assets (in the tables) above because they are average inventory data for the whole year.

According to the 2021 rate of inventory turnover, BSK has more efficient inventory management. It has a lower level of inventories compared to costs of sales than PLS. If PLS introduced a system of JIT inventory management, then suppliers' deliveries would be more frequent but smaller in size. Its average inventory level would be lower. This would increase its rate of inventory turnover.

Points to note:

- The result is not a percentage, but the number of times inventory turns over in the time period, usually one year.
- The higher the number, the more efficient the managers are in selling inventory rapidly. Very efficient management, by using JIT, will give a high rate of inventory turnover.
- The normal result for a business depends very much on the industry it operates in. For instance, a fresh fish retailer would (hopefully) have a much higher rate of inventory turnover than a car dealer. Comparison with businesses in other industries is therefore difficult.
- For service sector firms, such as insurance companies, this rate has little relevance, as they are not selling products held in inventories.

Trade receivables turnover (days)

The trade receivables turnover (days) measures how long, on average, it takes a business to recover payment from customers who have bought goods on credit (the trade receivables). The shorter this time period is, the better the management is at controlling its working capital.

==trade receivables turnover (days):== the average time taken (in days) to receive payment from customers who have bought products on credit.

The trade receivables turnover is measured by the following formula:

In the example of PLS and BSK, all sales were on credit so credit sales equals revenue. This will not be true for businesses that sell products for cash as well as on credit.

Trade receivables (31/12/21) $m

Revenue for year ending 31/12/21 $m

Trade receivables turnover

PLS

45

250

45250×365=65.7 days

BSK

500

3 200

5003 200×365=57 days

Table 34.17: PLS and BSK: trade receivables turnover, 2021

These results show that both companies give their customers about two months to pay debts. Perhaps the sports clothing market is very competitive in these two countries. To gain orders from sport clothing retailers, longer credit periods have to be offered. However, relatively high trade receivables turnover results will increase companies' working capital requirements.

Points to note:

- There is no right or wrong result: it will vary from business to business and industry to industry. A business that is able to put pressure on its credit customers may have a very low trade receivables turnover.
- A high result for trade receivables turnover may be a deliberate management strategy. Customers will be attracted to businesses that give extended credit. Despite this, the results shown above are higher than the average for most businesses. They could result from poor management of trade receivables and repayment periods.
- The value of this ratio could be reduced by giving shorter credit terms. Customers could be asked to pay in 30 days instead of 60 days. Improved credit control could involve refusing to offer credit terms to frequent late payers. The impact on sales of such policies must always be analysed. Perhaps the marketing department wants to increase credit terms for customers to sell more, but the finance department wants all customers to pay for products as soon as possible.

Trade payables turnover (days)

The trade payables turnover (days) measures the average length of time the business takes to pay its suppliers. The longer this period is, the lower the working capital needs of the business will be. The formula can use either credit purchases or cost of goods sold.

==trade payables turnover (days):== the average time taken (in days) to pay suppliers for supplies bought on credit.

==credit purchases:== the value of materials and other supplies bought by a business on credit (over one year).

The trade payables turnover is measured by the following formula:

In our example, both PLS and BSK recorded credit purchases of 80% of the cost of sales.

	Trade payables (31/12/21) $m	Credit purchases $m	Trade payables turnover
PLS	16	100	$\frac{16}{100}\times 365 = 58.4$ days
BSK	280	1 920	$\frac{280}{1\,920}\times 365 = 53.2$ days

Table 34.18: PLS and BSK: trade payables turnover, 2021

Points to note:

- BSK pays its suppliers more quickly than PLS. Both companies pay their suppliers more quickly than they receive payment from trade receivables. This creates a cash flow problem. Paying suppliers more quickly than customers pay the business leads to a greater need for working capital finance. This is not good financial efficiency.
- Although PLS takes much longer to pay its suppliers, it still has the same problem. It must find additional finance to cover the very long period before it receives payment from its customers.
- Both businesses would benefit from methods to improve financial efficiency (see Table 34.19).

Figure 34.2: Delaying payment to trade payables keeps cash in the business in the short term Figure 34.2: Delaying payment to trade payables keeps cash in the business in the short term

Methods of improving financial efficiency

Financial efficiency can be improved in several ways. These would all reduce the need for high levels of working capital.

Method

Evaluation

Increase inventory turnover by adopting JIT inventory management.

• See evaluation of this concept in Section 24.2 (for example, the risk of zero-inventory problems if supplies are delayed).

Reduce the credit period offered to customers. This will reduce the debt collection period.

• Customers may switch demand to another business that offers a longer credit period.

Delay payment to suppliers. This will increase the creditor payment period.

• Discounts from suppliers for quick payment might be reduced.

• Suppliers may refuse to supply unless quick payment is made.

Table 34.19: Methods to improve financial efficiency

34.4 Gearing ratio

When a business takes out loans this provides finance which could lead to profitable expansion. However, it also adds to the level of risk that the business is accepting.

The meaning and importance of gearing

The gearing ratio measures the degree to which the capital of a business is financed from debts. The greater the reliance of a business on loan capital, the more highly geared it is said to be. A highly geared business runs the risk of not being able to repay debts or the interest on them, especially if profits fall significantly. Gearing is therefore a very important concept.

==gearing ratio:== a ratio that measures the proportion of capital employed in the business that is financed by long-term borrowing (non-current liabilities).

Calculation and interpretation of gearing ratios

The gearing ratio is measured by the formula:

Returning to the two businesses, PLS and BSK (see Table 34.21):

Non-current liabilities

Capital employed

Gearing ratio

PLS

40

400

40400×100=10%

BSK

2 000

5 000

2 0005 000×100=40%

Table 34.21: PLS and BSK: gearing ratios, 2021

PLS is less dependent on bank (long-term) loans to finance its operations than BSK. This is a less risky business strategy. However, the directors of PLS could be missing some potentially profitable investment opportunities by this reluctance to increase debts. On the other hand, if company profits fell during a recession, the directors of BSK might regret their decision to raise finance from bank (long-term) loans to this extent.

Points to note:

- The ratio shows the extent to which the company's capital employed is financed from external long-term borrowing. A result of over 50%, using the ratio above, would indicate a highly geared business.
- The higher this ratio, the greater the risk taken by shareholders when investing in the business. This risk arises for two main reasons:
- Debts have to be repaid eventually and the need to pay back high debts could leave a business with low liquidity.
- A low gearing ratio is an indication of a safe business strategy. It also suggests that management are not borrowing to invest in, or to expand, the business. This could be disappointing for shareholders if they want rapidly increasing returns on their investment. The returns to shareholders will not increase by as great a proportion as they could for a highly geared business following a growth strategy. Shareholders in a company which follows a successful growth strategy financed by high debt will find their returns increasing much faster than in a slower-growth company with low gearing.

Methods of improving gearing

A highly geared business may want to reduce its dependence on debt when economic conditions are difficult or interest rates are high. Table 34.22 evaluates methods to improve gearing.

Method

Evaluation

Sell more shares and use the capital raised to pay back loans.

• This dilutes the control of existing shareholders.

• Dividend payments will have to increase to maintain dividend yield (see Section 34.5).

• Poor economic conditions might mean that additional shares are sold at a low price.

Reduce dividends, retain more profit and use this finance to repay loans.

• Profit may be very low and some of this is used to pay dividends.

• If dividends are reduced, returns to shareholders will fall.

Sell assets to raise finance which is then used to repay loans.

• If assets have to be sold quickly, a high price might not be achieved.

• This reduces the value of the business, and limits its ability to expand unless the assets sold are no longer required (for example, an empty office building).

Table 34.22: Evaluating methods of improving gearing

34.5 Investment ratios

Shareholders and potential shareholders will analyse company accounts very carefully to assess whether continued, or additional, investment in the company is worthwhile.

The meaning and importance of return to investors

Investment ratios are of particular interest to existing shareholders and prospective investors in a business. Returns to investors (or shareholders) are important. Buying shares in a company has the potential for two kinds of financial return. Capital gains can be made by the share price rising. In addition, companies pay annual dividends to shareholders unless profits are too low or losses are being made. The investor ratios give an indication of the prospects for financial gain from both of these sources.

==share price:== the quoted price of one share on the stock exchange.

==dividends:== the share of the company profits paid to shareholders.

Dividend yield ratio

The dividend yield ratio measures the percentage rate of return a shareholder receives from the dividend per share at the current share price. The dividend yield ratio is measured by the formula:

==dividend yield ratio:== a ratio that measures the annual return from dividends as a percentage of current market share price.

==dividend per share:== the financial amount received in dividends on one share.

The dividend per share is calculated by the formula:

Now, comparing the dividend yield ratios of PLS and BSK (see Table 34.23):

Dividends, 2021 ($ millions)

Number of issued shares ($ millions)

Dividend per share () < /td >< tdclass = "borh" > Marketshareprice(endof2021financialyear)()

Dividend yield %

PLS

21

140

0.15

1.50 < /p >< /td >< tdclass = "bor" >< pclass = "noindent" >< mathxmlns = "http : //www.w3.org/1998/Math/MathML" >< mfrac >< mstyledisplaystyle = "true" >< mo >0.15×100$1.50=10%

BSK

140

200

0.70

10.00 < /p >< /td >< tdclass = "bor" >< pclass = "noindent" >< mathxmlns = "http : //www.w3.org/1998/Math/MathML" >< mfrac >< mstyledisplaystyle = "true" >< mo >0.70×100$10.00=7%

Table 34.23: PLS and BSK: dividend yield ratios

Shareholders in PLS are earning a higher return on their investment than if they had bought shares in BSK. Before a judgement can be made about which company to invest in, potential shareholders need to consider other ratios as well as the result for the dividend yield.

Points to note:

- If the share price rises, perhaps due to improved prospects for the business, then with an unchanged dividend, the dividend yield will fall.
- If the directors propose an increased dividend but the share price does not change, then the dividend yield will increase.
- Shareholders compare this rate of return with other investments, such as bank interest rates and dividend yields from other companies.
- The result needs to be compared with previous years and with other companies in a similar industry to allow effective analysis.
- Potential shareholders might be attracted to buy shares in a company with a high dividend yield if the share price is not expected to fall in coming months.
- Directors may decide to pay a dividend from reserves even when profits are low or a loss has been made in order to keep shareholder loyalty.
- Directors may decide to reduce the annual dividend even if profits have not fallen to increase retained earnings. This makes more finance available for expanding the business and reducing the gearing ratio.
- A high dividend yield may not indicate a good investment. The yield could be high because the share price has recently fallen. The stock market may be concerned about the long-term prospects of the company.

Dividend cover ratio

The dividend cover ratio is the number of times the ordinary share dividend could be paid out of current profits after tax and interest: the profit for the year. The higher this ratio, the more able the company is to pay the proposed dividends. A high ratio leaves a considerable margin for re-investing profits back into the business.

==dividend cover ratio:== a ratio that measures how many times dividends could be paid from profit for the year.

The dividend cover ratio is measured by:

For PLS and BSK (see Table 34.24), the calculations are:

Dividends, 2021 $(m) < /td >< tdclass = "borh" > Profitfortheyear,$ 2021(m)

Dividend cover

PLS

21

30

2021=1.3

BSK

140

400

400140=2.9

Table 34.24: PLS and BSK: dividend cover ratios

The dividend cover ratio indicates to shareholders that the directors of BSK could have paid out a substantially higher dividend. Perhaps they are retaining a high level of profit to expand the business, from which shareholders could benefit in future.

Points to note:

- If directors decided to increase dividends to shareholders, with no increase in profits, then the dividend cover ratio would fall. Potential investors might start to query whether this level of dividend can be sustained in future.
- A low result means the directors are retaining low profits for future investment and this could raise doubts about the company's future expansion.

Price/earnings ratio

The price/earnings ratio (P/E ratio) is a vital ratio for shareholders and potential shareholders. It reflects the confidence that investors have in the future prospects of the business. In general, a high P/E ratio suggests that investors are expecting higher earnings growth in the future compared with companies with a low P/E ratio. A ratio result of 1, for example, would mean that investors had very little confidence in the future earnings power of the company.

==price/earnings ratio (P/E ratio):== the number of years it would take at the current earnings per share to purchase one share at the current market price.

The price/earnings ratio is measured by:

The earnings per share is calculated by the formula:

==earnings per share:== the amount of profit after tax and interest earned per share.

Returning to the two businesses, PLS and BSK (see Table 34.25):

Current share price () < */td* >< *tdclass* = "*borh*" > *Earningspershare*()

Price/earnings ratio

PLS

1.50

0.21

7.1

BSK

10.00

2.00

5.0

Table 34.25: PLS and BSK: earnings per share and price/earnings ratios

Points to note:

- The results show investors' relative level of confidence in these two companies. Investors seem to be slightly more confident about PLS's future prospects. The results measure how much investors are currently willing to pay for each $1 of earnings. PLS currently has a P/E of 7.1. This means investors are willing to pay $7.10 for $1 of current earnings. Another way of considering the result is that shareholders in this company will wait 7.1 years at present earnings levels to receive payback on their investment in shares.
- The ratio should only be compared with other companies in the same industry as investors may have different levels of optimism about the prospects for different industries.
- It would not be useful for investors using the P/E ratio as a basis for their investment decisions to compare the P/E of a technology company (possibly a high P/E) to that of a utility company (possibly a low P/E). Each industry has different growth prospects.

Methods of improving investor returns

The most effective way to improve returns to investors is to increase profits. Higher profit levels allow for increased dividends, which raise the dividend yield. The prospect of business growth and increased profitability is likely to increase the share price of the company. Shareholders will therefore benefit from higher dividends and a higher share price.

There might be a short-term trade-off, however:

- To increase profit might require investment in the business to buy more assets.
- If the company directors decided to reduce dividends to increase retained profit, this will increase internal finance for the company.
- However, this will obviously reduce returns to shareholders in the short term.

- If the new investment in expanding the business is successful, then profit should rise in the long term. So, dividends and share price will benefit shareholders, but only in the long term.

Image Image

35.1 What is meant by investment appraisal?

Investment means purchasing capital goods, such as equipment, vehicles and new buildings, with the expectation of earning future profits. All businesses make investment decisions. Many of these involve significant strategic issues, such as relocation of premises or the adoption of computer-assisted engineering methods.

Investment appraisal means assessing the profitability of an investment decision. This is usually undertaken by using quantitative techniques. Managers use investment appraisal methods to assess whether the likely future returns on projects will be greater than the costs and by how much. Non-financial issues can also be important and therefore qualitative appraisal of an investment project is often undertaken too.

==Investment appraisal:== evaluating the profitability or feasibility of an investment project.

All business investments involve capital expenditure as a cash outflow. Investment projects are undertaken because the business expects there to be a return from them, in the form of cash inflows. These are received over the useful life of the assets purchased. Quantitative methods of appraisal make comparisons between the cash outflows or costs of the project and the expected future cash inflows.

Quantitative investment appraisal: what information is necessary?

When appraising the profitability of investment projects using quantitative techniques, the following information will be required:

- initial capital cost of the investment such as the cost of buildings and equipment
- estimated life expectancy or the 'useful life' of an asset
- residual value of the investment – at the end of their useful lives, the assets will be sold, leading to a further cash inflow
- forecasted net cash flows from the project. These are the expected returns from the investment less its annual operating cost. Very little of this financial data can be said to be certain. Therefore, the quantitative techniques rely heavily on the reliability of financial estimates and forecasts.

Forecasting cash flows in an uncertain environment

All of the techniques used to appraise investment projects require forecasts to be made of future cash flows. These figures are referred to as forecasted net cash flows.

==forecasted net cash flows:== forecast cash inflows less forecast cash outflows.

It is assumed that the:

- cash inflows are the same as the annual revenues earned from the project
- cash outflows are the initial capital cost of the investment and the annual operating costs. Forecasting these cash flows is not easy and is rarely likely to be 100% accurate. With long-term investments, forecasts have to be made several years ahead. There will be the risk of external factors reducing the accuracy of the figures. For example, when appraising the construction of a new airport, forecasts of cash flows many years ahead are likely to be required. The possible external factors affecting the revenue forecasts include:
- An economic recession could reduce both business and tourist traffic through the airport.
- Oil price rises could lead to higher prices for air travel reducing demand levels.
- The construction of a new high-speed rail link might encourage some travellers to switch to this form of transport. Future uncertainties cannot be removed from investment appraisal calculations. The possibility of uncertain and unpredicted events making cash flow forecasts inaccurate must, however, be constantly considered by managers. All investment decisions involve some risk due to this uncertainty. The question is: Will the future profits from the project compensate for these risks?

35.2 Quantitative techniques: payback and accounting rate of return

The basic quantitative methods of investment appraisal are:

- payback periodlength of time it takes for the net cash inflows to pay back the original capital cost of the investment.
- accounting (or average) rate of return.

Payback method

If a project costs $2 million and is expected to pay back $500 000 per year, the payback period will be four years. This can then be compared with the payback on alternative investments. It is normal to refer to 'year 0' as the time period in which the investment is made. The cash flow in year 0 is therefore negative, shown by a bracketed amount (see Table 35.1).

Table 35.1 shows the forecast annual net cash flows and cumulative cash flows. This latter figure shows the running total of net cash flows. It becomes less and less negative as further cash inflows are received. Notice that in year 3 it becomes positive, so the initial capital cost has been paid back during this third year. But when during this year? If we assume that the cash flows are received evenly throughout the year (this may not be the case, of course), then payback will be at the end of the fourth month of the third year.

How do we know this? At the end of year 2, $50 000 is needed to pay back the remainder of the initial investment. A total of $150 000 is expected during year 3; $50 000 is one-third of $150 000, and one-third of a year is the end of month 4. To find out this exact month, use this formula:

Additional months to payback

The payback period is therefore two years and four months.

Year	Annual net cash flows ()	Cumulative cash flows ()
0	(500 000)	(500 000)
1	300 000	(200 000)
2	150 000	(50 000)
3	150 000	100 000
4	100 000 (including residual value)	200 000

Table 35.1: Forecast cash flows of an investment

Why is the payback of a project important?

Managers can compare the payback period of a particular project with other alternative projects so as to put them in rank order. The payback period can be compared with a cut-off time period that the business may have laid down. For example, they may not accept any project proposal that pays back after five years. The decision for a cut-off time period may include the following reasons:

- A business may have borrowed the finance for the investment and a long payback period will increase interest payments.
- Even if the finance was obtained internally, the capital has an opportunity cost of other purposes for which it could be used. The speedier the payback, the quicker the capital is made available for other projects.
- The longer the payback period, the more uncertain the whole investment becomes. The changes in the external environment that could occur to make a project unprofitable are likely to be much greater over ten years than over two.
- Some managers are risk averse. They want to reduce risk to a minimum, so a quick payback reduces uncertainties for these managers.
- Cash flows received in the future have less real value than cash flows today, owing to inflation. The more quickly money is returned, the higher is its real value.

Evaluation of the payback method

The payback method is often used as a quick check on the viability of a project or as a means of comparing projects. However, it is rarely used in isolation from the other investment appraisal methods (see Table 35.2).

Advantages of payback method

Disadvantages of payback method

• It is quick and easy to calculate.

• The results are easily understood by managers.

• The emphasis on speed of return of cash flows gives the benefit of concentrating on the more accurate short-term forecasts of the project's profitability.

• The result can be used to eliminate or identify projects that give returns too far into the future.

• It is particularly useful for businesses where liquidity is of greater significance than overall profitability.

• It does not measure the overall profitability of a project. Indeed, it ignores all the cash flows after the payback period. It may be possible for an investment to give a very rapid return of capital, but then to offer no other cash inflows.

- This concentration on the short term may lead businesses to reject very profitable investments just because they take some time to repay the capital.
- It does not consider the timing of the cash flows during the payback period. This will become clearer when the principle of discounting is examined in the final two appraisal methods (see Section 35.3).

Table 35.2: Payback method: advantages and disadvantages

Accounting rate of return

The accounting rate of return (ARR) may also be referred to as the average rate of return. If it can be shown that Project A returns, on average, 8% per year while Project B returns 12% per year, then the decision between the alternative investments will be an easier one to make.

==accounting rate of return (ARR):== measures the annual profitability of an investment as a percentage of the average investment (average capital cost).

The ARR (%) is measured by this formula:

where the average investment =

Table 35.3 shows the expected net cash flows from a business investment in a fleet of new fuel-efficient vehicles. They cost $8 million. The inflows for years 1–3 are the annual cost savings made. In year 4, the expected residual value of the vehicles is included.

Year	Net cash flow
0	($8 million)
1	$3 million
2	$3 million
3	$3 million
4	$3 million (including $2m residual capital value)

Table 35.3: Net cash flows for fleet investment

The five stages in calculating ARR are shown in Table 35.4.

1Add up all positive net cash flows.

= $12 million

2Subtract the cost of investment.

= $12 million – $8 million = $4 million (this is total profit or total net cash flow)

3Divide by the lifespan.

= $4 million/4 = 1million(thisistheaverageannualprofit) < /p >< /td >< /tr >< tr >< tdclass = "bor" >< pclass = "tlist" >< spanclass = "hang1" > 4 < /span > Calculatetheaverageinvestment. < /p >< /td >< tdclass = "bor" >< pclass = "noindent" >< mathxmlns = "http : //www.w3.org/1998/Math/MathML" >< mfrac >< mstyledisplaystyle = "true" >< mo > (< /mo >< mo >8m+$2m)2=5 < /mn >< mimathvariant = "normal" > m < /mi >< /math >< /p >< /td >< /tr >< tr >< tdclass = "bor" >< pclass = "tlist" >< spanclass = "hang1" > 5 < /span > TocalculatetheARR1m$5m×100=20%

Table 35.4: The five stages in calculating ARR

Why is the ARR of a project important?

What does this result mean? It indicates to the business that, on average over the lifespan of the investment, it can expect an annual return of 20% on its investment. This could be compared with:

- the ARR on other projects
- the minimum expected return set by the business. This is called the criterion ratethe minimum accounting rate of return that a business would accept before approving an investment. (In the example above, if the business refused to accept any project with a return of less than 18%, the new vehicle fleet would satisfy this criterion.)
- the annual interest rate on loans. If the ARR is less than the interest rate, it will not be worthwhile taking a loan to invest in the project.

Evaluation of average rate of return

ARR is a widely used measure for appraising projects, but it is best considered together with payback results. The two results then allow consideration of both profits and cash flow timings (see Table 35.5).

Advantages of ARR

Disadvantages of ARR

• It uses all of the cash flows, unlike the payback method.

• It focuses on profitability, which is the central objective of many business decisions.

• The result is easily understood and easy to compare with other projects that may be competing for the limited investment funds available.

• The result can be quickly assessed against the predetermined criterion rate of the business.

• It ignores the timing of the cash flows. This could result in two projects having similar ARR results, but one could pay back much more quickly than the other.

• As all cash inflows are included, the later cash flows, which are less likely to be accurate, are incorporated into the calculation.

• The time value of money is ignored as the cash flows have not been discounted.

Table 35.5: Advantages and disadvantages of ARR

35.3 Quantitative techniques: discounted cash flow

You should by now understand that managers may be uncertain which project to invest in if the two basic methods of investment appraisal give conflicting results. If project A is estimated to pay back at the end of year 3 at an ARR of 15%, should this be preferred to project B with a payback of four years but an ARR of 17%?

Managers need another investment appraisal method that solves this problem of trying to compare projects with different ARR and payback periods. The third method considers both the size of net cash flows and the timing of them. It does this by calculating discounted cash flows.

==discounted cash flows:== the present-day value of a future cash flow

If the effects of inflation are ignored, a rational person would rather accept a payment of $1 000 today instead of a payment of $1 000 in one year's time. Ask yourself which you would choose. The payment today is preferred for three reasons:

- It can be spent immediately and the benefits of this expenditure can be obtained immediately. There is no waiting involved.
- The $1 000 could be saved at the current rate of interest. The total of cash plus interest will be greater than the offer of $1 000 in one year's time.
- The cash today is certain, but the future cash offer is always open to uncertainty. This is taking the time value of money into consideration. Discounting is the process of reducing the value of future cash flows to

give them their value in today's terms. How much less is future cash worth compared to today's money? The answer depends on the rate of interest. If $1 000 received today can be saved at 10%, then it will grow to $1 100 in one year's time. Therefore, $1 100 in one year's time has the same value as $1 000 today given interest rates at 10%. This figure of $1 000 is called the present-day value of $1 100 received in one year's time. Discounting calculates the present-day values of future cash flows so that investment projects can be compared with each other by considering today's value of their returns.

Discounting: how is it done?

The present-day value of a future sum of money depends on two factors:

- The higher the interest rate, the less value future cash has in today's money.
- The longer into the future cash is received, the less value it has today. These two variables, interest rates and time, are used to calculate discount factors. They are available in discount tables and an extract of one is given in Table 35.7. To use the discount factors to obtain present-day values of future cash flows, multiply the appropriate discount factor by the cash flow.

For example, $3 000 is expected in three years' time. The current rate of interest is 10%. The discount factor to be used is 0.75 (see 10%, Year 3 in Table 35.7). This means that $1 received in three years' time is worth the same as 75 cents today. This discount factor is multiplied by $3 000 and the present-day value is $2 250.

Year

6%

8%

10%

12%

16%

20%

1

0.94

0.93

0.91

0.89

0.86

0.83

2

0.89

0.86

0.83

0.79

0.74

0.69

3

0.84

0.79

0.75

0.71

0.64

0.58

4

0.79

0.74

0.68

0.64

0.55

0.48

5

0.75

0.68

0.62

0.57

0.48

0.40

6

0.71

0.63

0.56

0.51

0.41

0.33

Table 35.7: Extract from discounted cash flow table

Net present value (NPV)

This investment appraisal method uses discounted cash flows. It is calculated by subtracting the capital cost of the investment from the total discounted cash flows. The three stages in calculating NPV are:

1. Multiply net cash flows by discount factors. Cash flows in year 0 are never discounted, as they are present-day values already.
2. Add the discounted net cash flows.
3. Subtract the capital cost to give the NPV. The working is clearly displayed in Table 35.8. The initial cost of the investment is a current cost paid out in year 0. Current cash flows are not discounted.

NPV is now calculated:

total discounted cash flows=$11 940original investment=($10 000)net present value=$1 940

Year

Net cash flow

Discount factors @ 8%

Discounted cash flows

0

($10 000)

1

($10 000)

1

$5 000

0.93

$4 650

2	$4 000	0.86	$3 440
3	$3 000	0.79	$2 370
4	$2 000	0.74	$1 480

Table 35.8: Discounted cash flows

What does this result mean? The project earns $1 940 in today's money values. So if the finance needed can be borrowed at an interest rate of less than 8%, the investment will be profitable. What would happen to the NPV if the discount rate was raised? If interest rates increased, the business would be advised to discount future cash flows at a higher rate. This will reduce the NPV, as future cash flows are worth even less when they are discounted at a higher rate. The choice of discount rate is crucial to the assessment of projects using this method of appraisal.

Usually, businesses will choose a rate of discount that reflects the interest cost of borrowing the capital to finance the investment. Even if finance is raised internally, the rate of interest should be used to discount future returns. This is because of the opportunity cost of internal finance as it could be used to gain interest if left on deposit in a bank. An alternative approach to selecting the discount rate is for a business to adopt a cut-off or criterion rate. The business would use this to discount the returns on a project and, if the NPV is positive, the investment could go ahead.

Figure 35.4 shows how NPV declines as the rate of discount used increases.

Figure 35.4: NPV as a function of discount rate Figure 35.4: NPV as a function of discount rate

> TIP When calculating investment appraisal methods, you are advised to lay out your working carefully, using the forms of table used in this chapter.

Evaluation of the NPV

Advantages of NPV

Disadvantages of NPV

• It considers both the timing of cash flows and the size of them in arriving at an appraisal.

• The rate of discount can be varied to allow for different economic circumstances. For instance, the rate of discount could be increased if there was a general expectation that interest rates were about to rise.

• It considers the time value of money and takes the opportunity cost of money into account.

• It is reasonably complex to calculate and to explain, especially to non-numerate managers.

• The final result depends on the rate of discount used, and expectations about interest rates may be wrong.

• NPVs can be compared with other projects, but only if the initial capital cost is the same. This is because the method does not provide a percentage rate of return on the investment.

Table 35.9: Advantages and disadvantages of NPV

35.4 Investment appraisal decisions

Major investment projects will always be appraised in quantitative and financial terms but there are other factors which will influence these important decisions too.

Quantitative results and their impact on investment decisions

Sections 35.2 and 35.3 examined the three main quantitative appraisal methods. They focus on the speed with which the capital investment is returned and the profit on an investment. Most businesses will establish investment criteria for these three techniques which future projects must satisfy before approval for a project is given. For example:

- Payback within three years.
- Accounting rate of return of at least 15%.
- Net present value of at least 15% of the original capital invested. Even when these criteria are satisfied, a project might be rejected by senior managers if there are non-quantitative reasons for not proceeding with it. These are called qualitative factors.

Qualitative factors and their impact on investment decisions

Investment appraisal techniques provide numerical data, which are important in taking decisions. However, no manager can afford to ignore the other factors that cannot be easily expressed in a numerical form but have a crucial impact on a decision. These qualitative factors include:

- Impact on the environment and the local community. Environmental pressure groups may force businesses to consider carefully plans for developments in sensitive areas. Bad publicity stemming from a proposed investment plan may dissuade managers from going ahead with a project because of the long-run impact on brand image and sales. Corporate social responsibility objectives may take priority over profit targets.
- Refusal of planning permission. This would prevent continuation of the scheme. It is the duty of local planning officers to weigh up the costs and benefits of a planned undertaking and to act in the best interests of the community. The plans for an investment project might have to be heavily revised before they are acceptable to local planning authorities.
- Aims and objectives of the business. For example, the decision to close bank branches and replace them with internet- and telephone-banking services involves considerable capital expenditure, as well as the potential for long-term savings. Managers may, however, be reluctant to pursue these investment policies if the objective of giving excellent and personal customer service could be threatened.
- Impact on the workforce. A decision to replace large numbers of employees with automated machinery may be reversed if employer–employee relations could be badly damaged.
- Acceptability of risk. Different managers are prepared to accept different degrees of risk. No amount of positive quantitative data will convince some managers, perhaps as a result of previous experience, to accept a project that involves a considerable chance of failure.

  TIP Unless the question asks only for an analysis of quantitative (numerical) factors, your answers to investment appraisal questions should include an assessment of qualitative factors too.

  KEY CONCEPT LINK The investment of a business may involve innovative projects which might allow a business to re-invent itself. The cash flows from these projects could be particularly difficult to estimate accurately.

Comparison of investment appraisal methods

Table 35.12 summarises the main differences between the quantitative investment appraisal methods.

Payback

ARR

NPV

What is being measured

- time period to pay back the initial capital cost
- annual profit as a percentage of the average capital cost
- present-day value of all net cash flows

Situations when the result is most useful

- when finance is limited
- when interest rates are high
- comparing with the criterion rate
- comparing with the return from other projects
- comparing with the cost of finance (rate of interest)
- to assess whether the project makes a return when cash flows are discounted
- for comparing other projects with a similar capital cost

Major limitations

- does not calculate the profit from an investment
- does not give a present-day value to cash flows
- does not take the timing of cash flows into account
- does not give a present-day value to cash flows
- choice of an appropriate discount rate may be difficult, for example in times of fluctuating interest rates
- difficult to compare projects with very different initial capital costs

Table 35.12: Comparison of payback, ARR and NPV methods

Image Image

36.1 The use of accounting data in strategic decision-making

Strategic decision-making requires detailed information from several sources. Accounting data is essential for making strategic decisions.

The use of financial statements in developing strategies

A business cannot develop or decide on a new strategy unless:

- The current profitability and financial performance of the business are analysed. Chapter 34 explains how the financial statements and ratios allowed this analysis to be undertaken.
- The availability of sources of finance is assessed. Section 34.1 explains how liquidity ratios assess current liquidity and Section 34.4 explains how the gearing ratio could help in finance decisions.
- The relative success of the company's current strategies can be compared with those of other similar businesses. Section 36.2 explains the importance of comparing financial statement data and ratio results with other businesses in the same industry.

The contents of an annual report

- Financial statements. The contents and importance of both the statement of profit or loss and statement of financial position are examined in Chapters 33 and 34.
- Chairman's statement. This is a general report on the major achievements of the company over the past year and the future prospects of the business. It also explains how the political and economic environment might affect the company's prospects.
- Chief executive's report. This is a more detailed analysis of the last financial year, often broken down by area or main product divisions. Major new projects are explained. Any mergers or takeovers, closures or rationalisations that have occurred during the year are briefly referred to.
- Auditors' report. This is the report by an independent firm of accountants on the accuracy of the accounts and the validity of the accounting methods used. If there are no problems with the accounts, the auditors state that the accounts give a 'true and fair view' of the business's performance and current position. If there are real concerns, then the auditors include in their report details of disagreements between themselves and the management over the reliability of the accounts.
- Notes to the accounts. The main accounts contain only the basic information needed to assess the position of the company. They do not contain

precise details, such as the types of individual fixed assets, the main long-term loans or the depreciation methods used. These and other details are contained at the end of the annual report and accounts in the notes to the accounts.

Usefulness of an annual report

The annual report and published accounts of a company are useful to all stakeholder groups. The main uses of this information and the stakeholders who need this information are shown in Table 36.1.

Stakeholders

Information in annual reports is used to…

Managers

• measure the performance of the business to compare against targets, previous time periods and competitors

• help take strategic decisions

• control and monitor the operation of each department and division

• set budgets for the future and review these against actual performance

Banks

• decide whether to lend money to the business

• assess whether to allow an increase in overdraft facilities

• decide whether to continue an overdraft facility

Suppliers

• see if the business is liquid enough to pay off its debts

• assess whether the business is a good credit risk

• decide whether to demand early repayment of outstanding debts

Customers

• assess whether the business is secure

• determine whether they will be assured of future supplies of the goods they are purchasing

• establish whether there will be security of spare parts and service facilities

Government and tax authorities

• calculate how much tax is due from the business

• determine whether the business is likely to expand and create more jobs, and be of increasing importance to the country's economy

• assess whether the business is in danger of closing down, creating economic problems

• confirm that the business is staying within the law in terms of accounting regulations

Shareholders and potential shareholders

• assess the value of the business and their investment in it

• establish whether the business is becoming more or less profitable

• determine what share of profit the shareholders are receiving

• decide whether the business has potential for growth

• compare performance with that of other businesses before making a decision to buy shares

• decide whether to consider selling shares in the company

Employees

• assess whether the business is secure enough to pay wages and salaries

• determine whether the business is likely to expand or be reduced in size

• determine whether jobs are secure

• find out whether a wage increase can be afforded

• find out how the average wage in the business compares with the salaries of directors

Local community

• assess whether the business is profitable and likely to expand, which could be good for the local economy

• determine whether the business is making losses and whether this could lead to closure

Table 36.1: The main uses of information in annual reports to business and other stakeholders

36.2 The use of accounting data and ratio analysis

Strategic decisions are difficult to reverse and can involve significant resources. To improve the chances of these decisions being successful, a thorough analysis of accounting data and ratio results is usually essential.

> KEY CONCEPT LINK Decision-making, in order to choose between alternative strategies, is most likely to lead to a successful outcome when a full analysis of all available information is undertaken.

Assessment of business performance over time and against competitors

One accounting ratio result alone is of very limited value. Ratios give a much clearer picture of relative business performance when they are compared with:

- Ratios for previous time periods. This is called trend analysis. It allows managers and other stakeholders to assess:
- Ratios from other companies in a similar industry. This is called inter-firm comparison. It allows managers and other stakeholders to assess:

The impact of accounting data and ratio analysis on business strategy

Developing new business strategies often starts with a detailed analysis of the company's accounts, using ratio analysis to highlight particular issues. Some examples illustrate the usefulness of this.

Example 1

Study the ratios in Table 36.2.

Company A	2019	2020	2021
Gross profit margin	23%	18.5%	18%
Operating profit margin	7.8%	5%	3.5%
RoCE	8%	6%	4%

Table 36.2: Selected Company A ratios

Ratio analysis over time has indicated the problem of declining profitability for Company A. Directors of the business have also made ratio comparisons with competitors. Company A is the only large business in the industry with declining profitability. The directors identify two strategies for the business to adopt:

- Reduce overhead expenses by delayering the organisation.
- Increase promotional spending to improve brand identity and customer loyalty and increase prices. Example 2

Study the data in Table 36.3.

Company B	2019	2020	2021
Gearing ratio	45%	50%	60%
Dividend per share	\$0.50	\$0.60	\$0.65
Trade payables turnover (days)	10	10	8

Table 36.3: Selected Company B accounting data

Directors of Company B are worried about the high gearing ratio. This is higher than those of most competitors. They identify two strategies for the business to adopt:

- Reduce dividend payments next year to retain more profit. The reduced cash outflow can be used to repay some debt.
- Delay payment to some suppliers as eight days is a short credit period to be offered by suppliers. This will slow down cash outflows and may allow some repayment of debt. Example 3

Study the ratios in Table 36.4.

Company C	2019	2020	2021
Rate of inventory turnover	8.5	7	6.5
Trade receivables turnover (days)	34	32	35
Trade payables turnover (days)	9	12	10

Table 36.4: Selected Company C ratios

Company C manufactures home office furniture and sells to retailers. The directors want to take action to improve financial efficiency. They have identified two strategies the business could adopt:

- Introduce a just-in-time system and only order supplies from businesses prepared to guarantee small shipments of supplies.
- Only sell products online so that consumers have to pay before goods are distributed. These three examples illustrate that accounting data and ratio results can help managers identify future strategic decisions. In each case, though, the final strategic decision could not be made before:
- further analysis of the problems that ratios have highlighted
- assessment of the resources available to pay for a new strategy
- the likely impact of the strategy on achieving the objectives of the business is evaluated.

The impact of debt or equity decisions on ratio results

Sources of finance impact on ratio results in different ways. The two main external long-term sources of finance available to companies are bank (long-term) loans (debt) or sales of new shares (equity). How will decisions to raise finance from these two sources impact on ratio results?

Example

Company D plans to build an additional factory making wind turbines. Demand for renewable energy is increasing. The economy is growing rapidly with high rates of inflation. The new factory will use the latest technology to achieve high labour productivity. This strategy will cost \$14m. Before the finance decision is taken, a summary of the current company accounts was produced (see Table 36.5).

Non-current liabilities

Capital employed

Shareholders' equity

\$65m

\$120m

\$55m

Table 36.5: Accounting data for Company D

The gearing ratio is currently 54.2%.

If the additional \$14m required is all borrowed, the new gearing ratio becomes:

If the additional \$14m is raised from the sale of shares, the gearing ratio becomes:

Points to note:

- Higher debt raises gearing but increasing equity reduces it.
- High interest rates make a highly geared strategy costly and risky.
- If the new factory is very profitable, shareholders would benefit from high gearing as the profit of the factory does not have to be distributed to a greater number of shareholders.

The impact of changes in dividend strategy on ratio results

Shareholders in public limited companies expect regular dividend payments from the companies they have bought shares in. Dividends are the return for investing funds into the business. Company directors decide the level of dividends each year. The level of dividends paid out to shareholders each year will depend on the profit after tax, liquidity of the business, and the need to keep share prices from falling if a new share issue is planned.

Example

The directors of Company E have paid high dividends in recent years. They did not want the share price to fall as they have issued new shares over this period to raise finance. Profit after tax has fallen for each of the last three years. Some ratios calculated from the latest annual accounts and share price are shown in Table 36.6.

Dividend per share	\$0.50
Market share price	\$12
Price/earnings ratio	6
Dividend yield	4.17%
Earnings per share	\$2

Table 36.6: Accounting data for Company E

Twelve months ago, the price/earnings (P/E) ratio was 9 and the dividend yield was 3.5%.

The directors predict that the earnings per share will fall to \$1 next year. They plan to reduce the dividend next year to \$0.35 per share.

- If the share price remains unchanged, this would result in a dividend yield of 2.9%.
- If the share price remains unchanged, the P/E ratio would become 12.

The impact of business growth on ratio results

Business growth is a common corporate objective. The rate of growth, the resulting economies of scale and whether growth is financed from debt or equity will all impact on ratio results.

Example

The directors of Company F have a growth objective for the business. They plan to take over another business which also produces recyclable plastic. This acquisition would nearly double the size of Company F. There would be great economies of scale. Some factories will be closed to rationalise production. Reducing operating expenses in this way will result in a lower fixed cost per unit. The redundant factory assets will be sold off. Some of the money raised will be used to pay back a proportion of the debt that will be used to finance the takeover.

The impact of other business strategies on ratio results

There are, of course, many different strategies that businesses can adopt. Each one is likely to impact on the published accounts and ratio analysis of these accounts in different ways. Each strategy may also impact on ratios in different ways depending on whether the short-term or long-term effect is being considered.

Table 36.7 summarises some further business strategies and their possible impact on ratio results. This cannot be a complete list but it will help you to understand the different impacts that different strategies have on ratio results.

Business strategy

Possible impact on ratios

Rationalisation

• Reductions in operating expenses should increase the operating profit margin and RoCE.

New product development

• Short term: profit and liquidity may fall due to the expenses and cash needs of new product research and development. RoCE and liquidity ratios could fall. Returns to shareholders might fall in the short term.

• Long term: if the product is successful, higher profit margins, higher RoCE and improved liquidity ratios should result. Returns to shareholders should increase.

Market development

• Short term: costs of entering the new market can be high, reducing operating profit margin and RoCE.

• Cash outflows for developing the new market could reduce liquidity.

• Long term: if a new market leads to higher sales, especially at high prices, then profit margins should increase, and RoCE should increase, as well as returns to shareholders.

Low price strategy

• This reduces gross profit and operating profit margins unless higher output reduces fixed costs per unit and leads to greater economies of scale. These cost reductions could increase profit margins and RoCE.

Table 36.7: Further business strategies and possible impact on ratios

TIP An excellent way to demonstrate evaluation is to make a clear distinction between the impact of a new business strategy on ratios in the short term compared to the long term.

Limitations of ratio analysis

- One ratio result is not very helpful. To allow meaningful analysis to be made, a comparison needs to be made with:
- Inter-firm comparisons are most effective when companies in the same industry are being compared. Financial years end at different times for different businesses. A rapid change in the economic environment could have an adverse impact on a company publishing its accounts in June compared with a January publication for another company.
- Trend analysis needs to take into account changing circumstances over time that could have affected the ratio results. These factors may be outside the company's control, such as an economic recession.
- Some ratios can be calculated using slightly different formulae, and care must be taken to only make comparisons with results calculated using the same ratio formula.
- Companies can value their assets in rather different ways, and different depreciation methods can lead to different capital employed totals, which will affect certain ratio results. Deliberate manipulation or window dressing of accounts would make a company's key ratios look more favourable, at least in the short term.
- Ratios can only be measured from numerical data. Analysts of company performance are becoming more concerned with non-numerical aspects of business performance. These include customer loyalty, environmental policies and approaches to human rights in developing countries that the business may operate in.
- Ratios are very useful analytical tools, but they do not solve business problems of underperformance. Ratio analysis can highlight problems that need to be tackled, such as falling profitability or liquidity. These problems can be tracked back over time and compared with other businesses. However, ratios alone do not indicate the true cause of business problems. It is up to good managers to locate these causes and develop effective strategies to overcome them.

Figure 36.2: Trend analysis – Tesco's RoCE Figure 36.2: Trend analysis – Tesco's RoCE

Limitations of annual reports and published accounts

Companies will only publish the minimum of accounting information, as required by company law. Company directors want to avoid sensitive information being studied by competitors, or even pressure groups that could take action against the interests of the business. Information that does not have to be published in a company's annual report and accounts includes:

- details of the sales and profitability of each of the company's products and divisions
- research and development plans of the business and proposed new products
- details of future plans for expansion or rationalisation of the business
- evidence of the company's impact on the environment and the local community, although this social and environmental audit is sometimes included voluntarily by companies
- future budgets or financial plans. Other limitations include:
- Only historic data is included. This might not be a good indicator of future performance.
- Only two years of accounting data have to be included.
- Intangible assets are rarely fully valued in the accounts which could undervalue knowledge-based companies.
- The accounts are not always comparable with other companies if, for example, different methods of valuing or depreciating assets have been used.
- The accounts may not be accurate. This point needs to be analysed in further detail.

Are the published accounts really accurate?

Stakeholders are often concerned about the accuracy of the published accounts. Accounting is not quite as objective as some observers often believe. No company is allowed to publish accounts that it knows to be deliberately and illegally misleading. They have to be checked by an independent firm of accountants known as auditors. However, accounting decisions are not always based on exact concepts. There are several instances when, in compiling accounts, it is necessary to use judgement and estimations.

These judgements can often lead to a difference of opinion between accountants, for example over the precise value of unsold inventories or the value of other assets. Where companies make judgements that present their accounts in a very favourable way, then the accountants could be accused of window dressing the accounts.

This might be done to influence a bank to lend more money to the business or to encourage investors to buy shares in the business. There are several ways in which accountants might use window dressing to boost the short-term performance of a business without actually breaking the law regarding accounting disclosure. These include:

- selling assets, such as buildings, at the end of the financial year, to give the business more cash and improve the liquidity position
- reducing the amount of depreciation of fixed assets, such as machines or vehicles, in order to increase declared profit and increase asset values
- ignoring the fact that some trade receivables which have not paid for goods delivered may, in fact, never pay: they are bad debts
- giving inventory levels a higher value than they may be worth
- delaying paying bills or incurring expenses until after the accounts have been published. For these reasons, published accounts of companies, and the ratios based on them, need to be analysed with considerable caution by stakeholders. They are a useful starting point for investigating the performance of a business. One annual report and set of accounts, on its own, will never provide the answers to all the questions that stakeholders should be asking.

Figure 36.3: Valuing assets such as inventory and shop premises is difficult following unforeseen events Figure 36.3: Valuing assets such as inventory and shop premises is difficult following unforeseen events

Image Image

Introduction

You can help yourself greatly in preparing for your final assessment by following some important steps. By preparing yourself thoroughly, you can look forward to this important stage of your course with a good level of confidence. Revision is, of course, one of the keys to success. However, just learning facts and figures is insufficient at AS Level and A Level. Before discussing revision strategies, it is important to recall the skills you have learned to use throughout your course and to think about how you will use these skills in your examinations and future studies.

Assessment objectives: what are they?

The four assessment objectives of the Cambridge International AS & A Level Business syllabus were explained in the 'Getting started' chapter at the front of this book. They are:

- AO1 Knowledge and understanding
- AO2 Application
- AO3 Analysis
- AO4 Evaluation.

How to use the key skills

Knowledge and understanding

You should always demonstrate knowledge and understanding. When the command words 'explain', 'analyse' or 'evaluate' are used, it is still important to demonstrate relevant subject knowledge and your understanding of that knowledge. For example, if you are asked to 'analyse two benefits of outsourcing' you should show your knowledge by stating two benefits. These two points then become the basis on which you build the rest of your answer, which should also demonstrate the skills of application and analysis.

The skill of demonstrating knowledge and understanding should only be your only focus when you are asked to 'identify' or 'define'. For example:

Application

Applying Business subject knowledge and understanding is an important skill. The ability to apply knowledge and understanding to different Business situations can be shown in the following ways:

Questions not based on case studies

In these questions, there is no detailed business context to read or incorporate into your responses. Application, therefore, must be shown by either:

- using the industry reference provided in the question and explaining an issue in the context of this industry. An example of such a question is: or:
- making clear reference to any business context that you can give in your answer, when there is no industry referred to in the question. An example of such a question and a sample answer are given below. The skill of application is shown in the sample answer in italics.

Questions based on case studies

When questions are based on case studies, the skill of application can be shown by making a direct and relevant reference to the business in the case study, the data provided about this business, or the decisions and issues that it is faced with.

Analysis

In the following example, the skill of analysis is shown in italics.

Evaluation

It is important to show the skill of evaluation in your responses to questions that use the command words ‘evaluate, ‘assess’, ‘advise’ and ‘justify’.

In the following example, the skill of evaluation is shown in italics.

AS Level Papers 1 and 2

- There are two AS Level papers.
- Paper 1 is called Business Concepts 1 and is worth 40% of the AS qualification (20% of the full A Level).
- Paper 2 is called Business Concepts 2 and is worth 60% of the AS qualification (30% of the full A Level).
- The two papers contain different types of questions.
- Paper 1 has two sections. Section A contains four compulsory short answer questions. Section B has a choice of two essay questions and you must answer just one of these.
- Paper 2 has two compulsory data response questions.
- AS Level Papers 1 and 2 form part of the full A Level assessment. These details are summarised in Table 37.1.

Paper

Duration

Type of questions

Number of questions

Maximum mark

% of total marks for the AS Level qualification

Business Concepts 1

1 hour 15 minutes

Short answer

4

20

20

Essay

1 from a choice of 2

20

20

Business Concepts 2

1 hour 30 minutes

Data response

2

60

60

Table 37.1: The two examination papers at AS Level

A Level Papers 3 and 4

- There are two A Level papers.
- Paper 3 is called Business Decision Making and is worth 30% of the A Level qualification.
- Paper 4 is called Business Strategy and is worth 20% of the A Level qualification. These details are summarised in Table 37.2.

Paper

Duration

Type of questions

Number of questions

Maximum marks

% of total marks for the A Level qualification

1

See Table 37.1

20

2

See Table 37.1

30

3

1 hour 45 minutes

Questions based on a case study

5

60

30

4

1 hour 45 minutes

Essay questions based on a case study

2

40

20

Table 37.2: The four examination papers at A Level

The relative % importance of the assessment objectives is shown in Table 37.3:

Business concepts 1

Business concepts 2

Decision making

Business strategy

Knowledge and understanding

Application

Analysis

Evaluation

Total

35

30

20

15

100

30

30

20

20

100

20

27

23

30

100

15

10

40

35

100

Table 37.3: Assessment objective weighting (%)

The guidance in this chapter has been written by the author. References to assessment and/or assessment preparation are the publisher's interpretation of the syllabus requirements and may not fully reflect the approach of Cambridge Assessment International Education.

Preparing for revision

For your revision to be effective you will need, as well as this coursebook, the following:

- a revision timetable to help allocate enough time to each topic
- well laid-out subject notes that you prepared during your course
- responses to activities and exam-style questions that you have attempted
- a copy of the syllabus to allow you to cross-check the progress you make with your revision against the precise requirements of this course. If you have a copy of the Cambridge International AS & A Level Business Workbook, you can use the worked examples there to help you construct and develop responses that demonstrate the key skills.

Revision techniques

You may already have your own preferred methods of revision, and there is no need to change them if you are happy with them and if they work. However, you may find that some of the approaches below are also useful.

Work in lots of short sessions

Psychology studies have shown that our learning abilities decline sharply after around 30 minutes of intensive study. Arrange your timetable so that in each day you have several 30-minute sessions with breaks in between – not just one session of several hours.

Use active-revision techniques

Reading notes and sections of this book has a place in revision but it is a passive form of revision. Active methods have been shown to be more effective. Try some of these active methods:

- Rewrite notes in a different style.
- Make new notes (e.g. from this book).
- Make spider diagrams or mind maps with key words and terms.
- Test yourself with simple written tests that you can mark yourself (e.g. lists of definitions – the glossary to this book is a good starting point).
- Revise with a friend and test each other.
- Make revision cards that are easy to refer to and contain a few key facts, figures or diagrams.

In the assessment room

Timing

Work out how long you have to complete each task, also allowing 15 minutes for reading any data or case studies at least once before starting any of your responses. Try to avoid spending too long on the first question. This is a common error and will mean that you will be rushed to complete all the tasks in the time available.

Planning

Without planning your answers to the longer responses, you can risk including irrelevant information. There is also the possibility that you overlook important issues. You should therefore spend a few moments writing a brief plan or list of key points that you intend to include in your response. If the task is an evaluative one, you could make a short list of points both for and against the issue you have been asked to make a judgement on.

Checking

If time allows, read through your answers. Make corrections where there are clear errors. Add further analysis and evaluation if you consider that your response is lacking in some element of these key skills.

And finally...

Your course is now completed and your assessments lie ahead. Take care in your final preparation and we hope that the outcome will meet your highest expectations.

The information in this section is based on the Cambridge International AS & A Level Business syllabus (9609) for examination from 2023. You should always refer to the appropriate syllabus document for the year of your examination to confirm the details and for more information. The syllabus document is available on the Cambridge International website at www.cambridgeinternational.org.