Cambridge University Press

Business Management

for the IB Diploma

SECOND EDITION

Peter Stimpson
and Alex Smith

Business Management

for the IB Diploma

SECOND EDITION

Peter Stimpson and
Alex Smith

Cambridge University Press's mission is to advance learning, knowledge and research worldwide.

Our International Baccalaureate Diploma resources aim to:

- encourage learners to explore concepts, ideas and topics that have local and global significance
- help students develop a positive attitude to learning in preparation for higher education
- assist students in approaching complex questions, applying critical-thinking skills and forming reasoned answers.

CAMBRIDGE
UNIVERSITY PRESS

CAMBRIDGE
UNIVERSITY PRESS

University Printing House, Cambridge CB2 8BS, United Kingdom

Cambridge University Press is part of the University of Cambridge.

It furthers the University's mission by disseminating knowledge in the pursuit of education, learning and research at the highest international levels of excellence.

www.cambridge.org
Information on this title: education.cambridge.org

First published 2011
Second edition 2015

Printed by Latimer Trend in the United Kingdom

A catalogue record for this publication is available from the British Library

ISBN 978-1-107-46437-7 Paperback

Contents

Introduction

Nature of the subject

The International Baccalaureate Diploma Programme Business Management is designed to develop an understanding of essential business theory and the ability to apply business principles, practices and skills. It encourages students to analyse the diverse range of business organisations and activities and the cultural and economic context in which businesses operate. The emphasis is placed on strategic decision-making and the business functions of marketing, production, human resource management and finance. Business Management is the study of both the way in which individuals and groups interact in an organisation and of the transformation of resources. It is, therefore, perfectly placed within the group 3 subject area (individuals and societies) of the IB Diploma Programme hexagon.

Who is this book for?

This book accurately and comprehensively follows the 2014 International Baccalaureate (IB) higher level (HL) and standard level (SL) syllabus for Business Management.

If you are a student preparing for the assessments based on this syllabus, or a teacher preparing students for the assessments, you can be confident that this book provides comprehensive coverage of the course. Other students of business management courses at equivalent levels could also greatly benefit from the subject content, activities and advice that this book contains.

What are the aims of the book?

Apart from providing the appropriate subject content for the IB Business Management course, this book aims to:

- introduce business management as a study of the ways in which individuals and groups interact in an organisation and of how resources are transformed by businesses
- explain that business management is a rigorous and rewarding subject that examines dynamic decision-making processes and assesses how these decisions impact on and are affected by internal and external environments
- help students to develop an understanding of business theory and the ability to apply business principles, practices and skills
- encourage students to consider the activities of business in a global market and appreciate cultural diversity
- evaluate the diverse range of business organisations and activities
- develop in students an awareness of the cultural and economic context in which businesses operate
- encourage the appreciation of ethical issues and the concept of social responsibility in the global business environment

- enable the development of decision-making skills through the use of case studies that enhance students' ability to make informed business decisions
- make a clear distinction between higher-level and standard-level content
- help students improve their performance on the internal and external assessments used in the Business Management syllabus
- show how the Business Management syllabus relates to the Theory of Knowledge part of the IB Programme.

The six key concepts that underpin the Diploma Programme are referred to throughout the book. These concepts are featured in the 'Setting the scene' case studies and a key concept question is included in all of the exam practice questions.

What are the key features of this book?

- **Learning objectives** – identifying the key syllabus-related topics and concepts covered in each chapter.
- **'Setting the scene' case studies** – raising important areas for discussion on business issues through case studies drawn from many different countries. These provide a context to the business applications of the material to be covered in each chapter.
- **Clearly laid-out text** – with easy-to-follow subsections and many tables of data and key advantages and disadvantages.
- **Exam tips** – helping to avoid common errors made by students in examinations.
- **Activities** – based on business case studies, these give practice at applying learning.
- **Revision checklists** – allowing monitoring of understanding of key issues.
- **Revision case studies and exam practice questions** – testing the skills of application, analysis and evaluation, using international business situations.
- **Theory of Knowledge assignments** – these reflect the very close relationship between Theory of Knowledge and Business Management.

Skills needed by Business Management students

The skills acquired and developed by successful students of Business Management interlink with the IB learner profile. In particular, decision-making, risk-taking and thinking skills are needed to weigh up and make judgements on a wide range of business strategies, and options will be transferable both to other disciplines and to higher-level undergraduate study at university.

The assessments used in the IB Business Management course will test the following skills:

- **Knowledge and understanding** of business terminology, concepts, principles and theories
- **Application** of skills and knowledge learned to hypothetical and real-business situations
- **Analysis and evaluation** of business decisions and business strategies and practices using critical thinking

- **Decision-making** by identifying the issue(s), selecting and interpreting data, applying appropriate tools and techniques, and recommending suitable solutions
- **Synthesise** knowledge in order to develop a framework for business decision-making.

Difference between higher and standard levels

The HL course in Business Management differs from the SL course in a number of important ways. These differences are reflected in this book by the clear distinction made between SL and HL material with several chapters specifically devoted to HL content. The HL material is supported by more evaluative questions and strategic decision-based tasks within the activities and exam practice questions.

IB assessment

The exam practice questions at the end of each chapter are IB-style questions designed to give students practice at answering examination questions.

The final chapter of the book gives clear guidance on the forms of assessment used at both SL and HL. It explains the requirements for the extended essay coursework, internal assessment and examination papers. Written by a senior IB examiner with many years' experience in preparing students for both levels of the IB Diploma, it is essential reading for all those preparing for the assessment in IB Business Management.

Peter Stimpson
Alex Smith
February 2015

Unit

1

BUSINESS ORGANISATION AND ENVIRONMENT

1.1

Introduction to business management

On completing this chapter you should be able to:

Analyse and apply:

- The role of business (AO2)
- The main business functions and their roles (AO2)
- Primary, secondary, tertiary and quaternary sectors (AO2)
- The nature of business activity (AO2)
- Reasons for starting up a business (AO2)
- Common steps in starting a business (AO2)
- Problems that a new business or enterprise faces (AO2)

Evaluate:

- The role of entrepreneurship and intrapreneurship in overall business activity (AO3)

Setting the scene

ENTERPRISE PAYS OFF

Sean Walsh knew that his retail job was at risk during the economic problems of 2009. He wanted to start his own business to give his family more security. Sean is a keen jet skier and power boater but he cannot afford to own these expensive leisure products. When he tried to hire a jet ski at a large lake in the USA he was surprised by the price – $400 a day – and the refusal of the renting company to offer insurance. Sean did not want to take any uninsured risks – he had a young family to think about – so he decided against renting. On the way home he noticed a large number of boats and jet skis lying idle in drives and parking lots and the idea occurred to him that these could be rented out to people who loved the sport but could not afford a boat. He did some market research and discovered what he considered to be a profitable gap in the market. He set up an online agency putting boat and jet ski owners in touch with people who wanted to rent – taking 25% commission when a rental was agreed. He also arranged insurance for both the renter and the boat owner. That was six years ago – he has since set up his own boatyard buying and selling second-hand power boats and jet skis, paid for from profits of the online rental agency.

Points to consider

- Why do you think Sean decided to own and run his own business?
- What resources (or inputs) does Sean need to run his business successfully?
- What problems do you think Sean experienced when starting up his business?

Key concept link

New enterprises need to differentiate themselves from rivals, many of whom will be well established. One way of achieving this is by innovation – providing either a different type of product or a service which is different from those of competitors or which is delivered in a distinct way.

Introduction – what is a business?

A business is any 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 semi-finished goods and making them more desirable to – and thus valued by – the final purchaser. Without business activity we would all still be entirely dependent on the goods that we could make or grow ourselves – as people in some communities still are. Business activity uses the scarce resources of our planet to produce goods and services that allow us to enjoy a much higher standard of living than would be possible if we remained entirely self-sufficient.

The role of businesses

Businesses identify the needs of consumers or other firms. They then purchase resources, which are the inputs of the business, or factors of production, in order to produce output. The 'outputs' of a business are the goods and services that satisfy consumers' needs, usually with the aim of making a profit. Business activity exists to produce goods or services, which can be classified in several ways: **consumer goods**, **consumer services** and **capital goods**.

What are business 'inputs'?

These are the human, physical and financial resources needed by business to produce goods or services. They are also known as factors of production. Firms will use different combinations of inputs, depending on the product being produced and the size of the business. There are four main inputs:

- **Land** – this general term not only includes land itself but all of 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. Some firms are labour-intensive, that is they have a high proportion of labour inputs to other factors of production, e.g. house-cleaning services.
- **Capital** – this consists of the finance needed to set up a business and pay for its continuing operations as well as all of the man-made resources used in production. These include capital goods such as computers, machines, factories, offices and vehicles. Some firms are capital-intensive, that is they have a high proportion of capital to other factors of production, e.g. power stations.
- **Enterprise** – this is the driving force of business, provided by risk-taking individuals, which combines the other factors of production into a unit that is capable of producing goods and services. It provides a managing, decision-making and coordinating role. Without this essential input, even very high-quality land, labour and capital inputs will fail to provide the goods and services that customers need.

Businesses have many other needs before they can successfully produce the goods and services demanded by customers. Figure 1.1.1 shows the wide range of these needs.

consumer goods: the physical and tangible goods sold to the general public. They include cars and washing machines, which are referred to as durable consumer goods. Non-durable consumer goods include food, drinks and sweets that can only be used once.

consumer services: non-tangible products that are sold to the general public and include hotel accommodation, insurance services and train journeys

capital goods: physical goods that are used by industry to aid in the production of other goods and services such as machines and commercial vehicles

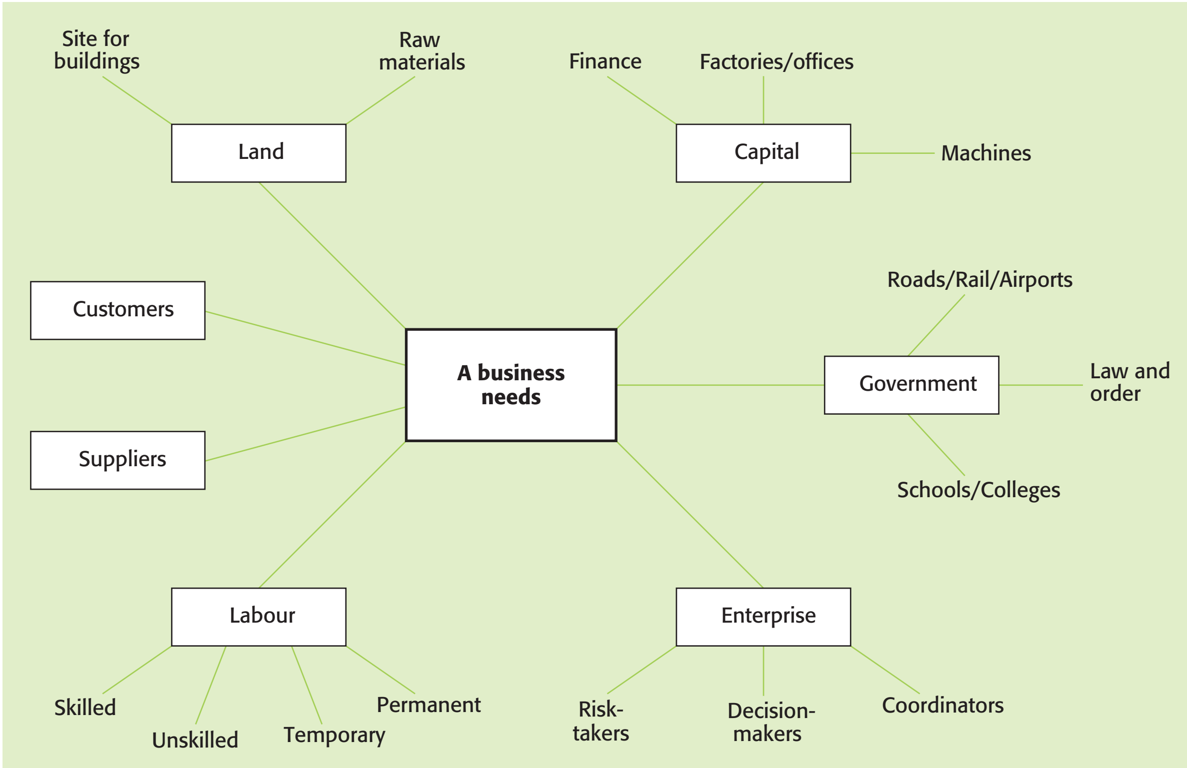


Figure 1.1.1 What businesses need

Business functions

Most businesses have four main functional departments. These will be staffed by people with specific qualifications and experience in the work of the functional areas.

Human resource management

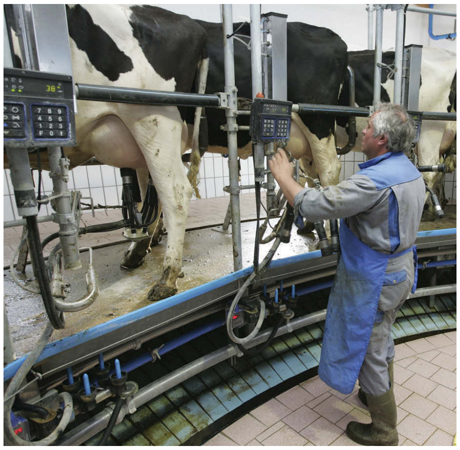
Human resource (HR) management identifies the workforce needs of the business, recruits, selects and trains appropriate employees and provides motivational systems to help retain workers and encourage them to work productively. It also draws up contracts of employment and covers the redundancy or redeployment of employees if these become necessary. The aim of this business function is to manage human resources to help the business achieve its overall objectives.

Finance and accounts

This function has responsibility for monitoring the flow of finance into and out of the business, keeping and analysing accounts and providing financial information to both senior management and other departments. Without adequate finance, no effective decisions can be made within the other functional areas, so finance is a key division of any business.

Marketing

This department is responsible for market research and for analysing the results of such research so that consumer wants can be correctly identified. This information will then be discussed with other departments of the business so that the right product decisions



Primary production – dairy cattle in France

Secondary production – clothing factory in India

Tertiary sector – the breathtaking Burj Al Arab hotel in Dubai

are made. Once a product is available for sale, the marketing function will have to make important decisions concerning its pricing, how and where to promote it and how to sell it and distribute it for sale.

Operations management

Once known simply as the 'production function', operations management has responsibility for ensuring adequate resources are available for production, maintaining production and quality levels and achieving high levels of productive efficiency. This function is important in service industries as well as traditional manufacturing. In service industries, operations management will have the objective of ensuring that the processes for the delivery of the service are well tested, consistent and understood by all employees.

Interrelationship of functions

It should not be assumed that all business decisions taken within these departments are separate and unconnected to the other parts of the business. Nothing could be further from reality! Effective strategic decision-making develops from the functions working closely together. Good communication, cooperation and close interrelationships between functions are essential before major decisions are taken. For example, the decision by BMW to develop and launch its first electric-powered sports car – the i8 – required interaction between:

- marketing – will consumers be prepared to buy this car and at what price?
- finance – do we have the capital needed to develop and produce it?
- HR management – do we need to recruit additional engineers before this project can be turned into a market-ready car?
- operations management – can we produce this product at a cost which allows the marketing department to set a profitable price level? Will quality of the vehicle be up to normal BMW standards?

ACTIVITY 1.1.1

Identify which business function is most likely to undertake the following roles:

Role	Function
Setting prices of new products	
Recruiting a new production manager	
Allocating resources to purchase capital equipment	
Deciding on the appropriate levels of stocks for raw materials	
Finding out if consumers prefer one product design to another	
Determining the level and number of employees the business needs for future operations	

Economic sectors

All production can be classified into four broad types of business activity, or economic sectors. These categories are the three stages involved in turning natural resources, such as oil and timber, into the finished goods and services demanded by consumers plus the 'knowledge-based' support services that businesses require. The four sectors are **primary**, **secondary**, **tertiary** and **quaternary**.

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

secondary sector business activity: firms that manufacture and process products from natural resources, including computers, brewing, baking, clothing and construction

tertiary sector business activity: firms that provide services to consumers and other businesses, such as retailing, transport, insurance, banking, hotels, tourism and telecommunications

quaternary sector business activity: is focused on information technology (IT) businesses and information service providers such as research and development, business consulting and information gathering

National economic data often makes no distinction between tertiary and quaternary sectors. The balance of the primary, secondary and tertiary sectors in the economy varies substantially from country to country. It depends on the level of industrialisation in each country. The balance between the sectors is often referred to as a country's 'economic structure'. Table 1.1.1 shows the different economic structures of three countries.

Country	Primary	Secondary	Tertiary
United Kingdom	2	17	81
China	42	26	32
Ghana	54	20	26

Table 1.1.1 Employment data 2013 – as percentage of total employment

Changes in economic structure – sectoral change

It is very important to recognise two features of this classification of business activity:

1. The importance of each sector in a country's economic structure changes over time. Industrialisation describes the growing importance of the secondary sector manufacturing industries in developing countries. The relative importance of each sector is measured in terms either of employment levels or output levels as a proportion of the whole economy. In many countries of Africa and Asia, the relative importance of secondary sector activity is increasing. This brings many benefits as well as problems.

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 simply exporting these as basic, unprocessed products.

Problems

- The chance of work in manufacturing can encourage a huge movement of people from the countryside to the towns, which leads to housing and social problems. It may also result in depopulation of rural areas and problems for farmers in recruiting enough workers.
- The expansion of manufacturing industries may make it difficult for a business to recruit and retain sufficient staff.
- Imports of raw materials and components are often needed, which can increase the country's import costs. Business import costs will vary with changes in the exchange rate.
- Pollution from factories will add to the country's environmental problems.
- Much of the growth of manufacturing industry is due to the expansion of multinational companies.

In more economically developed economies, the situation is reversed. There is a general decline in the importance of secondary sector activity and an increase in the tertiary sector. This is known as deindustrialisation. In the UK, the proportion of total output accounted for by secondary industry has fallen by 13% to 20% in 25 years. In South Africa, the relative importance of the secondary manufacturing sector fell from 20% to 17% between 1993 and 2012. The reasons for and possible impact of these changes on business 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 so on – yet spending on physical goods is rising more slowly.
- As the rest of the world industrialises, so manufacturing businesses in the developed countries face much more competition and these rivals tend to be more efficient and use cheaper labour. Therefore, rising imports of goods are taking market away from the domestic secondary sector firms and many have been forced to close.
- Employment patterns change – manufacturing workers may find it difficult to find employment in other sectors of industry. This is called structural unemployment.

2. The relative importance of each sector varies significantly between different economies. Table 1.1.1 above gives details of the differences that exist between the economies of different countries and the share of total employment accounted for by each sector of industry.

Exam tip: During your IB Business and Management course it is a good idea to read the business section of newspapers regularly – don't forget that these are often available free online. This will help you to apply the work you have done in class to the world outside. What, for example, was the major business story in your country this week?

ACTIVITY 1.1.2

Business	Primary	Secondary	Tertiary	Quaternary	Description of main activities
Coca-Cola					
HSBC					
FAW (China)					
RTZ					
Wyndham Worldwide					
RR plc					
Capco					

1. Copy out this table. Use the internet or other means of research to:
   a. identify these well-known international companies
   b. identify the main sector of industry that they operate in
   c. give details of their main activities.
2. Research **five** businesses that operate in your country and identify which sector of industry they mainly operate in and what their main activities are.

ACTIVITY 1.1.3

BP OPERATES IN THREE ECONOMIC SECTORS

BP is the third-largest oil company in the world. Here are extracts from three recent newspaper articles about the company:

BP announces another huge oil find
BP has just released details of its third major oil reserve discovery in the US Gulf of Mexico. This will enhance BP's position as one of the largest crude oil suppliers in the USA.

BP Castillon refinery
BP's Castillon refinery is the only oil refinery in this region of Spain. It has the capacity to convert 110,000 barrels of crude oil each day into a range of products used by road vehicles, the aviation industry, chemical manufacturers and the plastic industry.

BP now operates 800 petrol stations in China
BP is a familiar petrol and diesel brand to car and truck drivers in China. The company co-owns over 800 petrol station sites – mainly with PetroChina. BP has a leading position in the petrol retail market.

10 marks, 20 minutes

1. Define the term 'economic sector'. [2]
2. Using examples from these articles, explain the statement that 'BP operates in all economic sectors'. [4]
3. Explain why a decision by BP to open new petrol stations in China will involve effective cooperation between all four business functions. [4]

Starting a business

Why start a business?

Reasons for starting a new business include some or all of the following:

- Losing a job encourages many people to set up a business by themselves, either providing their former employer's product or another product, perhaps based on an interest or skill they have.

- Desire for independence – some people do not like the idea of being told what to do! By creating their own business, they have work flexibility and control over their working lives.
- By talking to friends or family, it might become clear that a business opportunity exists that an entrepreneur could take advantage of.
- A wish to make more money than in the current job – many people setting up their own business believe that they will earn a higher income working for themselves.

Role of the entrepreneur

New business ventures started by **entrepreneurs** can be based on a totally new product or customer service idea or a new way of offering a service. People who set up their own new business show skills of 'entrepreneurship'. People who are given responsibility to develop and market a product within a large corporation show skills of 'intrapreneurship'.

entrepreneur: someone who takes the financial risk of starting and managing a new venture

intrapreneur: someone within a large corporation who takes direct responsibility for turning an idea into a profitable finished product through using 'entrepreneurial talents' such as risk-taking and innovation

Entrepreneurs have:

- had an idea for a new business
- invested some of their own savings and capital
- accepted the responsibility of managing the business
- accepted the possible risks of failure.

Intrapreneurs do not risk their own capital and the consequences of failure are accepted by the organisation that they work for. They can drive forward a new product idea and help make the organisation that they work for more innovative and able to cope with change.

THEORY OF KNOWLEDGE

'The Entrepreneurial Instinct profoundly reveals that exceptional success has more to do with thoughtful risk-taking and agility than school pedigree, I.Q. and even decades of experience. Fear keeps us small, but following your instinct with stamina and passion can lead to greatness.'

Ajay Banga, President and CEO, MasterCard Worldwide

What does Ajay Banga's statement tell us about the importance of sense perception when making business decisions?

The personal qualities and skills needed for entrepreneurs or intrapreneurs to make a success of a new business venture are described below.

Innovative

The entrepreneur may not be a 'product inventor', but they must be able to carve a new niche in the market, attract consumers in innovative ways and present their business as being 'different'. This requires original ideas and an ability to do things innovatively.

Commitment and self-motivation

It is never an easy option to set up and run your own business. It is hard work and may take up many hours of each day. A willingness to work hard, a keen ambition to succeed, energy and focus 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 count the money. These different business tasks require a person with many different qualities such as being keen to learn technical skills, an ability to get on with people and being good at handling money and keeping accounting records.

Leadership skills

An entrepreneur has to lead by example and must have a personality that encourages people in the business to follow them and be motivated by them.

Belief in oneself

Many business start-ups fail, yet this would not discourage a true entrepreneur who would have such self-belief in their abilities and business idea that they would bounce back from any setbacks.

Risk-taker

Entrepreneurs must be willing to take risks in order to see results. Often the risk they take involves investing their own savings in a new business. Intrapreneurs may also have to take risks but the financial consequences – other than the risk of losing their jobs – are borne by the organisation.

LEARNER PROFILE

Risk-takers

According to Bloomberg, eight out of ten entrepreneurs who start businesses fail within the first 18 months. Predicting the success of a business is an incredibly difficult thing to do. People who start businesses and then see them fail can lose large sums of money and suffer what can be the significant emotional pain associated with business failure.

To what extent do new entrepreneurs have to be risk-takers?

Start-up businesses

New business start-ups can be found in nearly all industries. However, there are some industries and sectors of industry where there is a much greater likelihood of new entrepreneurs becoming established. These include:

- primary sector – fishing, market gardening (producing cash crops to sell at local markets)
- secondary sector – jewellery making, dressmaking, craft manufacture, e.g. batik cloth, building trades
- tertiary/service sector – hairdressing, car repairs, cafés and restaurants, childminding
- quaternary sector – IT support, website design, consultancy.

It would be unusual for entrepreneurs to successfully establish themselves in, say, the steel-making industry or car manufacturing because of the vast amount of capital equipment and financial investment that would be required.

Impact of enterprise (and intrapreneurship) on business activity

All governments around the world are following policies that aim to encourage more people to become entrepreneurs. What are the claimed benefits to the economy and business activity of enterprise?

- **Employment creation** In setting up a new business an entrepreneur is employing not only themselves ('self-employment'), but, very often, will employ other people too. Often these are members of their family or friends, but in creating such employment, the national level of unemployment will fall. If the business survives and expands, then there may be additional jobs created in the businesses that supply them.
- **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, and if enough small businesses are created, it will lead to increased living standards for the population. In addition, increased output and consumption will also lead to increased tax revenues for the government.
- **Firms' survival and growth** Although a high proportion of new firms fail, some survive and a few expand to become really important businesses. These will employ large numbers of workers, add considerably to economic growth and will take the place of declining businesses that may be forced to close due to changing consumer tastes or technology. So, in Trinidad and Tobago, the relative decline of the sugar industry has been balanced out by the growth of the tourist industry, which has itself been boosted by small guesthouse businesses operating as sole traders.
- **Innovation and technological change** New businesses tend to be innovative and this creativity adds dynamism to an economy. This creativity can 'rub off' on other businesses and help to make the nation's business sector more competitive. Many new business start-ups are in the technology sector, e.g. website design. The increased use of IT by these firms, and the IT services they provide to other businesses, can help a nation's business sector become more advanced in its applications of IT, and therefore more competitive.

Common steps in starting a business or enterprise

Identifying market opportunities

Many people say that they want to work for themselves, but they then do not make the leap into entrepreneurship successfully because they have not been able to identify a market opportunity that will generate sufficient demand for their product or service to enable the business to be profitable. The original idea for most new businesses comes from one of several sources including:

- own skills or hobbies, e.g. dressmaking or car bodywork repairer
- previous employment experience, e.g. learning hairdressing skills with an established business
- franchising conferences and exhibitions offering a wide range of new business start-up ideas, e.g. fast-food restaurants
- small-budget market research – the use of the internet allows any user to browse business directories to see how many businesses there are in the local area offering certain goods or services. This low-cost research might indicate gaps in local markets that could be profitably filled by the entrepreneur.

Sourcing capital (finance)

Once the entrepreneur has decided on the business idea or opportunity, the next task is to raise the necessary capital. This will come from various sources but the business owner/entrepreneur will almost certainly have to use some of their own savings in setting up the business. Friends and family might also be asked for financial support. Banks may provide loan finance or an overdraft facility – but bank officials will want to check the business plan contents very rigorously. Venture capitalists may be prepared to invest if the business idea is novel, can be protected or patented and offers significant profit potential. Government grants might be available – perhaps as part of a policy to reduce unemployment by encouraging people to set up new businesses.

Determining a location

A suitable location is vital if the start-up business intends to sell directly to consumers. This raises the problem of costs. Perhaps the most important consideration when choosing the location for a new business is the need to minimise fixed costs. When finance is limited, it is very important to try to keep the break-even level of output – the output level that earns enough revenue to cover all costs – as low as possible. This will greatly increase the chances of survival. Operating from home is the most common way for entrepreneurs to establish their business. This has the great advantage of keeping 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 prestigious premises tends to generate confidence.
- It may cause family tensions.
- It may be difficult to separate private life from working life.

The cost and position of these locations could have a big impact on the business entrepreneur's chance of success.

New businesses that offer a consumer service need to consider location very carefully. Whereas a website designer could operate from home very effectively, as communication with customers will be by electronic means, a hairdresser may need to consider obtaining premises in an area with the biggest number of potential customers. An alternative is to visit customers in their own homes – this way, the entrepreneur may avoid the costs of buying or renting their own premises altogether.

Building a customer base

To survive, a new firm must establish itself in the market and build up customer numbers as quickly as possible. The long-term strength of the business will depend on encouraging customers to return to purchase products again and again. Many small businesses try to encourage this by offering a better service than their larger and better-funded competitors. This better service might include:

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

Problems faced by start-ups

Even if an entrepreneur has all the qualities listed above, success with a new business can never be guaranteed. Many businesses fail during their first year of operation. The most common reasons for this are discussed below.

Competition

This is nearly always a problem for new enterprises unless the business idea is unique. More generally, a newly created business will experience competition from older, established businesses with more resources and market knowledge. The entrepreneur may have to offer better customer service to overcome the cost and pricing advantages of bigger businesses.

Lack of record-keeping

Accurate records are vital to pay taxes and bills and chase up debtors. Many entrepreneurs fail to pay sufficient attention to this as they either believe that it is less important than actually meeting customers' needs or they think they can remember everything, which they could not possibly do after a period of time. For example, how can the owner of a new, busy florist's shop remember:

- when the next delivery of fresh flowers was booked for?
- whether the flowers for last week's big wedding have been paid for?
- if the cheque received from an important customer has been paid into the bank yet?
- how many hours the shop assistant worked last week?

Lack of finance and working capital

In an International Labour Organisation (ILO) survey of new business start-ups, the problem of finance came at the top of the list of replies from entrepreneurs regarding the main difficulty. Why is obtaining finance such a major problem for entrepreneurs?

- Lack of sufficient own finance – many entrepreneurs have very limited personal savings, especially if they are setting up their own business because they were previously made redundant.
- Lack of awareness of the financial support and grants available.
- Lack of any trading record to present to banks as evidence of past business success – a trading record would tend to give a bank confidence when deciding whether to lend money for a new venture.
- A poorly produced business plan that fails to convince potential investors of the chances of a business's success. Running short of capital to run day-to-day business affairs is the single most common reason for the failure of new businesses to survive in the first year. Capital is needed for day-to-day cash, for the holding of stocks and to allow the giving of trade credit to customers, who then become debtors. Without sufficient working capital, the business may be unable to buy more stocks or pay suppliers or offer credit to important customers.

Serious working capital shortages can usually be avoided if businesses take several important steps:

- Construct and update a cash flow forecast so that the liquidity and working capital needs of the business can be assessed, month by month.
- Inject sufficient capital into the business at start-up for the first few months of operation when cash flow from customers may be slow to build up.
- Establish good relations with the bank so that short-term problems may be, at least temporarily, overcome with an overdraft.
- Use effective credit control over customers' accounts – do not allow a period of credit which is too long, and quickly chase up late payers.

Poor management skills

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

- leadership skills
- cash handling and cash management skills
- planning and coordinating skills

- decision-making skills
- communication skills
- marketing, promotion and selling skills.

Entrepreneurs may be very keen, willing to work hard and with undoubted abilities in their chosen field – for example, a new restaurant owner may be an excellent chef but may be lacking management skills. Some learn these skills very quickly once the business is up and running, but this is a risky strategy. Some entrepreneurs buy in the experience by employing staff with management experience, but this is an expensive option.

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

Changes in the business environment

Setting up a new business is risky. Not only are there the problems and challenges referred to above but there is also the risk of change, which can make the original business idea much less successful. New businesses may fail if any of the following changes occur, turning the venture from a successful one to a loss-making enterprise:

- new competitors
- legal changes, e.g. outlawing the product altogether
- economic changes that leave customers with much less money to spend
- technological changes that make the methods used by the new business old-fashioned and expensive.

This list of changes could, no doubt, be added to, but even these four factors indicate that the business environment is a dynamic one, and this makes owning and running a business enterprise very risky indeed.

Business plans

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

The contents of a typical **business plan** are:

- the executive summary – an overview of the new business and its strategies
- description of the business opportunity – details of the entrepreneur; what is going to be sold, why and to whom
- marketing and sales strategy – details of why the entrepreneur thinks customers will buy what the business plans to sell and how the business aims to sell to them
- management team and personnel – the skills and experience of the entrepreneur and the staff he/she intends 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.

Table 1.1.2 shows a typical business plan summary for a new business venture.

Name of business	Pizza Piazza Ltd
Type of organisation	Private limited company
Details of business owners	Peter Chun – chef with 15 years' experience Sabrina Singh – deputy manager of restaurant for three years
Business aim	To provide a high-class takeaway pizza service including home delivery
Product	High quality home-cooked pizzas
Price	Average price of \$10 with \$2 delivery charge
Market aimed for	Young people and families
Market research undertaken and the results	Research in the area conducted using questionnaires Also, research into national trends in takeaway sales and local competitors Results of all research in the appendix to this plan
Human resources plan	Two workers (the business owners) to be the only staff to be employed initially
Production details and business costs	Main suppliers – R and R Wholesalers Fixed costs of business – \$70 000 per year Variable costs – approximately \$2 per unit sold
Location of business	Site in shopping street (Brindisi Avenue) just away from the town centre. Leasehold site (ten years)
Main equipment required	Second-hand kitchen equipment – \$6000 Second-hand motorbike – \$2000
Forecast profit	See financial appendix to this plan Summary: In the first year of operations the total costs are forecast to be \$55 000 with revenue of \$85 000. Predicted profit = \$30 000 Level of output to break even – 8750 units per year
Cash flow forecast	See financial appendix to this plan Due to the high set-up and promotion costs there will be negative cash flow in the first year
Finance	\$10 000 invested by each of the owners Request to bank for a further \$10 000 plus an overdraft arrangement of \$5000 per month

Table 1.1.2 Business plan for Pizza Piazza Ltd

Importance of business plans

- Business plans are most important when setting up a new business, but they should be referred to and updated when important strategic choices are being made too. 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 clear details about the business proposal have been written down.
- The planning process is very important too. If an entrepreneur went into a new business – even if no external finance was required – without a clear sense of purpose, direction, marketing strategies and what employees to recruit, the chances of success would be much reduced.
- The financial and other forecasts contained in the plan can be used as the targets that the business should aim for.

Users of business plans

Business plans may be of real benefit to the stakeholders of new businesses:

- The plan allows potential investors in the new business – and the bank – to make a judgement about the viability of the idea and the chances of the owners making a success of it. Potential shareholders will not invest without seeing a plan first.
- The financial forecasts in a business plan can act as budgets and control benchmarks for the internal stakeholders such as business managers.
- Updated versions of the plan can be used to apply for additional funding, to attract additional partners or to supply data for the experts if a stock market flotation becomes an option.
- Employees will find that planning helps identify specific objectives and targets and gives focus to their work, which aids motivation.
- Suppliers may be able to tell from the parts of the business plan that are communicated externally whether it is worthwhile establishing a long-term trading relationship with the business.

OVER TO YOU

Revision checklist

1. What is a 'business'?
2. What is a 'business input'?
3. Give **two** examples of primary sector businesses, explaining why they are classified in this sector.
4. Give **two** examples of secondary sector businesses, explaining why they are classified in this sector.
5. Give **two** examples of tertiary sector businesses, explaining why they are classified in this sector.
6. Give **two** examples of quaternary sector businesses, explaining why they are classified in this sector.
7. Allocate each of these decisions into the appropriate business functional department:
   a. deciding on stock levels for an important raw material
   b. deciding between using shops or a website to sell a new range of clothing
   c. deciding whether to promote a manager from within the business or to recruit from another firm
   d. deciding on how to raise $3 million for a factory expansion.
8. Explain why, for a recent major business decision of your choice, it was important for all four business functions to work closely together.
9. Using data from your own country:
   a. How has total output or employment in the secondary sector changed over recent years?
   b. Consider **two** effects of this change on any business in your country.
10. Differentiate between entrepreneur and intrapreneur.
11. Comment on the similar skills needed by both entrepreneurs and intrapreneurs.
12. Explain **two** steps in the process of starting up a business.
13. Explain **two** problems commonly experienced by new business start-ups.
14. Comment on the importance of any two features of a business plan for a start-up enterprise to a potential investor.

Exam practice question

RECESSION SPARKS NEW BUSINESS IDEAS

Disney, McDonald's, Burger King, Procter & Gamble, Johnson & Johnson, Microsoft – what do they all have in common? They all started during a recession or depression.

The message, delivered to around 40 would-be entrepreneurs at a workshop in Stratford, East London, is clear: don't let bad economic headlines put you off. Most of the people at this session are not aiming to create new multinational corporations. But during the coffee break, they seem pretty confident that their ideas can prosper even in the current climate. 'I'm here to find out about starting up a business providing CVs to school leavers,' says Jessica Lyons, wearing a lapel badge with My First CV, the name of the future business, written on it. 'For my particular business idea I think this is the ideal time, because there are more people than ever out there looking for work.'

The recession is causing a spike in interest in setting up small businesses. Another interesting example was from a gym instructor who wants to take his equipment to companies around London, giving people a lunchtime workout without their having to leave their offices. Most of the would-be entrepreneurs in Stratford are looking at potential opportunities in the tertiary sector which don't require large amounts of start-up finance to purchase capital equipment and which rely more on their own skills and interests.

20 marks, 40 minutes

1. Define the term 'tertiary sector'. [2]
2. Outline the factors of production needed to set up the business providing CVs to school leavers. [4]
3. Explain **two** reasons why new businesses might start up in the tertiary sector. [4]
4. Discuss the advantages and disadvantages of setting up a business in a recession. [10]

Key concept question

20 marks, 40 minutes

With reference to one or two organisation(s) that you have studied, evaluate the importance of innovation in starting a new business. [20]

1.2

Types of organisations

On completing this chapter you should be able to:

Analyse and apply:

- The distinction between the private sector and public sector (AO2)

Evaluate:

- The main features of the following types of for-profit (commercial) organisations: sole traders, partnerships and companies/corporations (AO3)
- The main features of the following types of for-profit social enterprises: cooperatives, microfinance providers, public–private partnerships (PPP) (AO3)
- The main features of the following types of non-profit social enterprises: non-governmental organisations, charities (AO3)

Setting the scene

FRENCH TxCELL GOING PUBLIC

TxCell, a French private limited company that specialises in cell immunology, has taken the first steps to converting to a public limited company. Based in Valbonne, France, this company has 105 patents already and has developed a new generation of cell therapy for the treatment of inflammatory diseases. The finance raised from the Initial Public Offering (IPO) of shares to the general public will be used to continue the development and marketing of this important new product.

The first stage for planning of the IPO has already been completed. TxCell has announced the registration of its '*document de base*' (full analysis of the company's activities and finances) with the French *Autorité des marchés financiers* (AMF). Converting to a public limited company will not only allow access to additional capital but will increase the status and prestige of the business, may make it easier to attract the best employees and will allow the original owners to sell some of their share in the business to make money from their initial investments.

Source: Adapted from www.european-biotechnology-news.com

Points to consider

- Why are the owners of TxCell planning to sell shares to the public for the first time?
- Why is it important for potential investors to have a full 'analysis of the company's activities and finances'?
- Would the ownership by TxCell of 105 patents make potential investors more likely to buy shares in the company?

Key concept link

Is the culture of a business organisation partly dependent on its legal form of ownership? It could be the culture of a small sole-trader business is likely to be different from that of a large public limited company, owned by thousands – perhaps millions – of shareholders. The cultural difference could be even greater between 'for-profit' organisations and 'non-profit' social enterprises. The values, attitudes and beliefs of senior management and other employees of a social enterprise will not be the same as those of managers and employees in a profit-centred organisation.

Introduction

The first chapter looked at the classification of business into different economic sectors. This chapter further classifies business activity into:

- the **private sector** and **public sector**
- profit-based and non-profit-based organisations.

Profit-based or for-profit businesses in the private sector can take different legal forms and the advantages and disadvantages of these are very important. The growing importance of non-profit-based and non-governmental organisations is also analysed in this chapter.

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

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

Private sector and public sector organisations

Industry may be classified by sector: either public or private, and by type of legal organisation. These two types of classification are interlinked as some types of legal structure are only found in the private sector.

The relative importance of the private sector compared to the public sector is not the same in all **mixed economies**. Those economies that are closest to **free-market** systems 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 economy: economic resources are owned largely by the private sector with very little state intervention

command economy: economic resources are owned, planned and controlled by the state

Distinctions between the sectors

In most mixed economies, certain important goods and services are provided by state-run organisations – they are in the public sector. It is argued that they are too significant to be left to private sector businesses. They include health and education services, defence and law and order (police force). In some countries, important 'strategic' industries are also state-owned and -controlled, such as energy, telecommunications and public transport. These public sector organisations therefore provide essential goods and services for individual citizens and organisations in the private sector, and they often have objectives other than profit – for example:

- ensuring supplies of essential goods and services – perhaps free of charge to the user, e.g. health and education services in some countries
- preventing private monopolies – single firms that dominate an industry – from controlling supply
- maintaining employment
- maintaining environmental standards.

In recent years, there has been a trend towards selling some public sector organisations to the private sector – **privatisation** – and this means that they put profit-making as one of their main objectives.

privatisation: the sale of public sector organisations to the private sector

Private sector organisations are owned and operated by individuals or groups of people. These organisations are usually operated for a profit but not all are. For example, charities are non-profit-making organisations in the private sector; they are not owned and controlled by the government or state.

Public sector enterprises

public corporation: a business enterprise owned and controlled by the state – also known as nationalised industry or public sector enterprise

Exam tip: Public limited companies are in the private sector of industry – but public corporations are not.

The term 'public' is used by business organisations in two different ways, and this often causes confusion. We have already identified public limited companies as being owned by shareholders in the private sector of the economy. Thus, public limited companies are in the private sector. However, in every country there will be some enterprises that are owned by the state – usually central or local government. These organisations are therefore in the public sector and they are referred to as **public corporations**.

Public sector organisations do not often have profit as a major objective. In many countries the publicly owned TV channels have as their main priority the quality of public service programmes. State-owned airlines have safety as a priority. Selling off public corporations to the private sector, known as privatisation, often results in changing objectives from socially orientated ones to profit-driven goals. A summary of the potential advantages and disadvantages of public corporations is given in Table 1.2.1.

Advantages	Disadvantages
• 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 raised mainly from the government so not subject to limitations from banks or shareholders	• Tendency towards inefficiency due to lack of strict profit targets • Subsidies from government can encourage inefficiencies • Government may interfere in business decisions for political reasons, e.g. by opening a new branch in a certain area to gain popularity

Table 1.2.1 Public sector organisations – advantages and disadvantages

For-profit organisations

Figure 1.2.1 shows the main types of private sector businesses that are operated for profit.

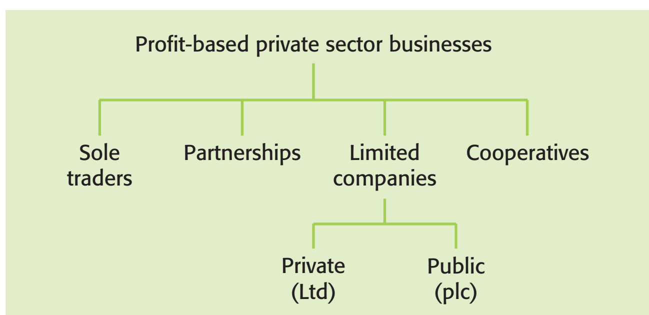


Figure 1.2.1 Private sector businesses

THEORY OF KNOWLEDGE

The personal loan market in many economies has seen the emergence of a huge number of so-called 'payday' lenders. These organisations provide very short-term loans (up to 30/40 days) to borrowers who urgently need cash to cover their living costs or a particular expense until, in theory, they get paid.

One of the most well-known payday lenders is a company called Wonga which started in the UK but is expanding internationally. You can, for example, borrow £111 from Wonga for 33 days and you will be charged interest and fees of £43.95, which means you will end up paying back £154.95. This has a headline interest rate of 5853%!

Payday lenders are for-profit organisations.

Discuss these questions in your class:

- What sort of people take out payday loans?
- What are the aims of payday loan organisations?
- What does this tell us about the 'values' of people who run payday loan organisations?

Sole trader

This is the most common form of business organisation. Although there is a single owner in this business organisation, there may be employees but the firm is likely to remain very small. Although they are great in number, **sole traders** account for only a small proportion of total business turnover. 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 their own businesses.

sole trader: 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

Another problem faced by sole traders involves 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 that they have 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 is dependent on their own savings, profits made and loans for injections of capital.

This type of business organisation is most commonly established in construction, retailing, hairdressing, car servicing and catering. The advantages and disadvantages of sole traders are summarised in Table 1.2.2.

Advantages	Disadvantages
• Easy to set up – no legal formalities • Owner has complete control – not answerable to anyone else • Owner keeps all profits • Able to choose times and patterns of working • Able to establish close personal relationships with staff (if any are employed) and customers • The 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 owner's assets are potentially at risk • Often faces intense competition from bigger firms, e.g. 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 often necessary to make business pay • Lack of continuity – as the business does not have separate legal status, when the owner dies the business ends too

Table 1.2.2 Sole traders – advantages and disadvantages

Partnership

A **partnership** agreement does not create a separate legal unit; a partnership is just a grouping of individuals. Partnerships are formed in order to overcome some of the drawbacks of being a sole trader. 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 them all. 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. It is usual, although not a legal requirement, to draw up a formal 'Deed of Partnership' between all partners. This would provide agreement

partnership: a business formed by two or more people to carry on a business together, with shared capital investment and, usually, shared responsibilities on issues such as voting rights, the distribution of profits, the management role of each partner and who has authority to sign contracts.

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 form of organisation and this is considered next. The advantages and disadvantages of partnerships are summarised in Table 1.2.3.

Advantages	Disadvantages
• Partners may specialise in different areas of business management • Shared decision-making • Additional capital injected by each partner • Business losses shared between partners • Greater privacy and fewer legal formalities than corporate organisations (companies)	• Unlimited liability for all partners (with some exceptions) • Profits are shared • As with sole traders, no continuity and the partnership will have to be reformed in the event of the death of one of the partners • All partners bound by the decisions of any one of them • Not possible to raise capital from selling shares • A sole trader, taking on partners, will lose independence of decision-making

Table 1.2.3 Partnerships – advantages and disadvantages

ACTIVITY 1.2.1

Helene owns a computer repair business – ITfix. She employs three skilled workers. The business operates from rented premises. It owns some machines but leases testing equipment. ITfix is very busy but there is no room for further employees in the small workshop. Helene is proud of her success in starting up and expanding such a profitable business. Despite its success, ITfix has insufficient finance to buy its own premises – Helene believes that this would be a wise investment for the future.

10 marks, 20 minutes

1. Define the term 'sole trader'. [2]
2. Explain **one** advantage and **one** disadvantage for Helene of being a sole trader. [4]
3. Analyse **two** benefits the introduction of a partner would bring to Helene's business. [4]

Limited company

There are three important differences between companies – private limited and public limited companies – and sole traders and partnerships: **limited liability**, legal personality and continuity.

Limited liability

The ownership of companies is divided into small units called **shares**. People can buy these and become '**shareholders**' – they are part-owners of the business. It is possible to buy just one share, but usually these 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. 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.

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

share: a certificate confirming part ownership of a company and entitling the shareholder to dividends and certain shareholder rights

shareholders: individuals or institutions that buy/own shares in a limited company

- The greater risk of the company failing to pay its debts is now transferred from investors to creditors (those suppliers/lenders who have not been paid). Creditors, as a result, are very interested in both ensuring that the word 'limited' appears in the company name and scrutinising the company's accounts for signs of potential future weakness.

Legal personality

A company is legally recognised as having an identity separate from that of its owners. This means, for example, that if the products sold by a company are found to be dangerous or faulty, the company itself can be prosecuted but not the owners, as would be the case with either a sole trader or a partnership. A company can be sued and can sue others through the courts.

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 the 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 therefore substantial. Small firms can gain this protection when the owner(s) create(s) a **private limited company**.

private limited company: a small to medium-sized business that is owned by shareholders who are often members of the same family; this company cannot sell shares to the general public

The word 'Limited' or 'Ltd' ('Pte' in some countries) indicates that the business is a private company. Usually, the shares will be owned by the original sole trader (who may hold a majority of the shares to keep control of the company), relatives, friends and employees. New issues of shares cannot be sold on the open market and existing shareholders may only sell their shares with the agreement of the other shareholders.

Legal formalities must be followed in setting up a private limited company and these can be expensive and time-consuming in some countries. The advantages and disadvantages of private limited companies are summarised in Table 1.2.4.

Advantages	Disadvantages
• Shareholders have limited liability • Separate legal personality • Continuity in the event of the death of a shareholder • Original owner is still often able to retain control • Able to raise capital from sale of shares to family, friends and employees • Greater status than an unincorporated business	• Legal formalities involved in establishing the business • Capital cannot be raised by sale of shares to the general public • Quite difficult for shareholders to sell shares • End-of-year accounts must be sent to Companies House (in UK) – available for public inspection there (less secrecy over financial affairs than sole trader or partnership)

Table 1.2.4 Private limited companies – advantages and disadvantages

Public limited companies

Public limited companies can be recognised by the use of 'plc' or 'Inc.' (Incorporated) after the company name. It is the most common form of legal organisation for large businesses, for the very good reason that they have access to very substantial funds for expansion. Converting a private limited company to public limited company (plc) status is referred to as a stock market flotation.

public limited company (plc): a limited company, often a large business, with the legal right to sell shares to the general public; its share price is quoted on the national stock exchange

A plc has all the advantages of private company status plus the right to advertise its shares for sale and have them quoted on the stock exchange. Public limited companies have the potential to raise large sums from public issues of shares. Existing shareholders may quickly sell their shares if they wish to. This flexibility of share buying and selling encourages the public to purchase the shares in the first instance and thus invest in the business.

The other main difference between private and public companies concerns the 'divorce between ownership and control'. The original owners of a business are usually still able to retain a majority of shares and continue to exercise management control when it converts to private company status. This is most unlikely with public limited companies, due to the volume of shares issued and the number of people and institutions as investors. These shareholders own the company, but they appoint, at the annual general meeting, 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 over the objectives to be set and direction to be taken by the business. The shareholders might prefer short-term maximum-profit strategies, but the directors may aim for long-term growth of the business, perhaps in order to increase their own power and status. Many private limited companies convert to plc status to gain the benefits referred to in Table 1.2.5. It is also possible for the directors or the original owners of a business to convert it back from plc to private limited company status. Richard Branson and the Virgin group are one of the best-known examples. The reasons for doing this are largely to overcome the divorce between ownership and control – in a private limited company it is normal for the senior executives to be the major, 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.

A summary of the advantages and disadvantages of public limited companies is given in Table 1.2.5.

Advantages	Disadvantages
• Limited liability • Separate legal identity • Continuity • Ease of buying and selling of shares for shareholders – this encourages investment in plcs • Access to substantial capital sources due to the ability to issue a prospectus to the public and to offer shares for sale	• Legal formalities in formation • Cost of business consultants and financial advisers when creating a plc • Share prices subject to fluctuation – sometimes for reasons beyond business's control, e.g. state of the economy • Legal requirements concerning disclosure of information to shareholders and the public, e.g. annual publication of detailed report and accounts • Risk of takeover due to the availability of the shares on the stock exchange • Directors influenced by short-term objectives of major investors

Table 1.2.5 Public limited companies – advantages and disadvantages

Legal forms of business organisation

Businesses often change their legal form as they expand and as the objectives of the owners change. Many newly formed businesses are sole traders and then accept partners if the aim of the original owner is to expand and share management responsibilities. Conversion to company status is often caused by owners wishing to protect their personal wealth and encourage new shareholder investors. When further expansion is very expensive, perhaps because of the nature of the business activity as with the development of new technology products, conversion to public limited company status is common. However, much depends on the desire for control of the original owners/shareholders. There is often the desire of the original owners to get back overall control from 'short-term-minded' investors by converting a plc back into a private limited company.

ACTIVITY 1.2.2

TWITTER 'GOES PUBLIC'

Twitter founders Evan Williams and Jack Dorsey became multimillionaires overnight when Twitter sold 70 million shares at US$26 each. The decision to convert the business into a public limited company was mainly to allow directors to spend capital on expanding the 'microblogging' business with expensive purchases of other internet businesses.

10 marks, 20 minutes

1. Define the term 'public limited company'. [2]
2. Analyse **two** potential advantages to Twitter of becoming a public limited company. [4]
3. Analyse **two** potential disadvantages to Twitter of becoming a public limited company. [4]

THEORY OF KNOWLEDGE

1. 'All countries have organisations that are part of the private sector; they come in the form of business organisations that exist to create a profit for their owners. All countries also have public sector organisations that exist to improve the welfare of all people in society. As a consequence of this, governments should look to expand the proportion of countries' organisations that are owned by the state.'
   a. Analyse the evidence you would use to prove or disprove this statement.
   b. In the light of this statement, discuss some of the reasons why so many countries have privatised former public sector organisations.
2. 'Organisations always run more efficiently when they are free of government control.'
   In groups, discuss to what extent you agree or disagree with this statement.

For-profit social enterprises

1. Social enterprises

Social enterprises are not charities, but they do have objectives that are often different from those of an entrepreneur who is only profit-motivated. Making a profit may be one of the objectives of a social enterprise, but it is usually much less important than the organisation's social objectives.

social enterprise: a business with mainly social objectives that reinvests most of its profits into benefiting society rather than maximising returns to owners

In other words, a social enterprise is a proper business that makes its money in socially responsible ways and uses most of any surplus made to benefit society. Social entrepreneurs are not running a charity, though – they can and often do keep some of any profit made for themselves.

Social enterprises 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 surplus or profit to survive as they cannot rely on donations as charities do.

Objectives of social enterprises

Social enterprises often have three main aims:

- Economic – to make a profit or surplus to reinvest back into the business and provide some return to the owners.
- Social – to provide jobs or support for local, often disadvantaged, communities.
- Environmental – to protect the environment and to manage the business in an environmentally sustainable way.

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

These aims are often referred to as the **triple bottom line**. This means that profit is not the sole objective of these enterprises.

Below are two examples of social enterprises:

- SELCO in India provides sustainable energy solutions to low-income households and small businesses. In one scheme, solar-powered lighting was provided by SELCO to a silkworm farmer who depended on dangerous and polluting kerosene lamps. The farmer could not afford the upfront cost, so SELCO helped with the finance too.
- The KASHF Foundation in Pakistan provides microfinance (very small loans) and social support services to women entrepreneurs who traditionally find it very difficult to receive help. This enables the women to set up their own businesses in food production, cloth making and other industries. The loans have to be repaid with interest, but the interest rates are much lower than a profit-maximising international bank would charge.

2. Cooperatives

cooperative: a group of people acting together to meet the common needs and aspirations of its members, sharing ownership and making decisions democratically

Cooperatives are not about making big profits for shareholders, but creating value for customers and secure employment for workers – this is what gives cooperatives a unique character, and influences their values and principles.

Cooperatives tend to fall into one of these three groups:

- Retail cooperative – also called consumers' cooperatives. This is a cooperative business owned by customers for their mutual benefits. It is a private sector enterprise that is oriented towards service rather than financial profit. It often takes the form of retail outlets operated and owned by their consumers. The consumers or customers are the people who have provided the capital required to launch or purchase the enterprise and profits are shared either by discounts on products or by a payout to customer owners each year.
- Agricultural cooperative – this exists when farmers pool resources for mutual benefit, for example, in the buying of fertiliser or the marketing of key food products.
- Worker cooperative – often engaged in manufacturing. Workers collectively own the business and make the important decisions.

ACTIVITY 1.2.3

The MONDRAGON Corporation is one of the world's best examples of successful cooperative organisation. It is a federation of worker cooperatives based in the Basque region of Spain. It was founded in the town of Mondragón in 1956 by graduates of a local technical college. Its first product was paraffin heaters. It is the seventh-largest Spanish company in terms of asset turnover and the leading business group in the Basque Country. It employs over 70 000 people in 257 companies and organisations in four areas of activity: finance, industry, retail and IT.

Cooperatives tend to operate much like modern businesses, aiming for improved efficiency, productivity and transparency. Cooperatives are not the ideal business model in all situations. For example, highly democratic procedures can slow down decision-making and reaction times to market developments and, in agricultural cooperatives, women are often underrepresented in decision-making. In other ways however, cooperatives can be more robust than private enterprises: driven by a combination of long-term social, economic and ethical interests rather than high-risk short-term profits; and many have proven particularly resilient in the recent global financial crisis. MONDRAGON cooperatives made virtually no compulsory redundancies between 2010 and 2014 – at a time when the Spanish economy shrank and profit-seeking businesses lost thousands of jobs.

10 marks, 20 minutes

1. Define the term 'cooperative'. [2]
2. Explain **two** reasons why a cooperative like mondragon might be at an advantage compared to a private enterprise. [4]
3. Analyse **two** disadvantages Mondragon might face as a cooperative compared to those of a private enterprise. [4]

3. Microfinance institutions

The **microfinance** approach to providing small capital sums to entrepreneurs 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. Not only did they repay this loan in full after their business ideas had been successful, but 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 over six million Asian people, many of whom have set up their own very small enterprises with the capital.

microfinance: the provision of very small loans by specialist finance businesses, usually not traditional commercial banks

Many business entrepreneurs in Bangladesh and other Asian countries have received microfinance to help start their business. In some of these countries over 75% of successful applicants for microfinance are women. Females have, in some traditional societies, 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. Empirical evidence shows that, among the poor, those participating in microfinance programmes who had access to financial services were able to improve their well-being – both at the individual and household level – much more than those who did not have access to financial services.

- In Bangladesh, Bangladesh Rural Advancement Committee (BRAC) clients increased household expenditures by 28% and assets by 112%. The incomes of Grameen members were 43% higher than incomes in non-programme villages.
- In El Salvador, the weekly income of FINCA (microfinance provider) clients increased on average by 145%.
- In India, half of SHARE (microfinance provider) clients graduated out of poverty.
- In Ghana, 80% of clients of Freedom from Hunger had secondary income sources, compared to 50% for non-clients.
- In Lombok, Indonesia, the average income of Bank Rakyat Indonesia (BRI) borrowers increased by 112% with 90% of households moving out of poverty.

However, interest rates can be quite high as the administration costs of many very small loans is 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. Microfinance may be inappropriate where conditions pose severe challenges to loan repayment. For example, populations that are geographically dispersed or have a high incidence of disease may not be suitable microfinance clients. In these cases, grants, infrastructure improvements or education and training programmes are more effective. For microfinance to be appropriate, the clients must have the capacity to repay the loan under the terms by which it is provided.

ACTIVITY 1.2.4

Mibanco in Peru plays an important role in the Latin American microfinance sector. The bank issues working capital and loans to micro-entrepreneurs and small and medium-sized businesses. Besides this, it offers current accounts, savings, deposit accounts and insurance products to private individuals – many of whom find it difficult to gain support from traditional commercial banks. In 2014 Mibanco's profit margin fell to under 1% and 12% of its loans to small businesses had not been repaid within one month of the required date; and 61% of its customers had also taken out loans with other banks.

KEY INDICATORS Mibanco at year-end 2013:
- number of loan clients: over 400 000
- percentage female clients: 55%
- percentage rural clients: 23%
- average loan amount: $2800

16 marks, 32 minutes

1. Describe **two** features of the microfinance loans provided by Mibanco. [4]
2. Explain **two** advantages of microfinance to small businesses in a country such as Peru. [4]
3. Assess why microfinance providers such as Mibanco might struggle to be profitable. [8]

Public–private partnership (PPP)

There are three main types of **public–private partnership (PPP)**:

- Government-funded – these are privately managed schemes. In this type of venture, the government provides all or part of the funding, but the organisation is managed by a private business that uses private sector methods and techniques to control it as efficiently as possible. For example, the Hope Clinic Lukuli in Kampala, Uganda, receives government funding for its malaria prevention and HIV-testing services. These are managed efficiently and successfully by this private sector, but non-profit-making, clinic. Analysts believe that the clinic operates the health services more efficiently than a government department would with many officials becoming involved.
- Private sector-funded – these are government or state-managed schemes. In this type of venture, which often involves large sums of capital investment, the government is released from the financial burden of finding taxpayers' money to pay for the project. Once the assets have been paid for and constructed, they are then managed and controlled by a government department, which pays rent or a leasing charge to the private sector business that constructed the project. This form of PPP started in Australia and the UK and is known as the **private finance initiative** (PFI).
- Government-directed but with private sector finance and management – this type of PPP encourages both private sector funding and some private sector management control of public projects. For example, a new London hospital has been built using private sector finance – it is leased to the state-controlled health authority which manages and controls the hospital's health services; in Australia, the international bank HBOS has invested in several PFI schemes for public sector projects such as new prisons in Victoria and the new toll road into Melbourne City Centre.

The potential costs and benefits of public–private partnerships are shown in Table 1.2.6.

public–private partnership (PPP): involvement of the private sector, in the form of management expertise and/or financial investment, in public sector projects aimed at benefiting the public

private finance initiative (PFI): investment by private sector organisations in public sector projects

Costs	Benefits
• The private sector business, if asked to manage the project, could try to increase profits by cutting staff wages and benefits. In effect, workers would no longer have the security of being employed by the public sector. • PFI schemes have been criticised for earning private sector businesses large profits from high rents and leasing charges – these must be paid for by taxpayers. • Private sector organisations may lack the experience needed to operate large public sector projects – such as social housing schemes – and failure of the scheme could leave vulnerable groups in society at risk.	• Many schools, roads, prisons and hospitals have been built through PPP/PFI schemes – it is argued that these would not have been constructed unless the private sector had been involved. • Private sector businesses aim to make profits; their managers will therefore operate services as efficiently as possible. This could mean that costs to the public sector are lower than if the projects were operated by government/public sector managers. • By using private sector business finance, the government can claim that public services are being improved, without an increase in taxes (at least in the short run as the capital cost is not paid for by the government).

Table 1.2.6 Potential costs and benefits of PPPs

ACTIVITY 1.2.5

WASTE – A GOOD CASE FOR PUBLIC–PRIVATE PARTNERSHIP?

Capital Waste Disposal plc was created five years ago when the capital city's rubbish collection service was privatised. As a public sector enterprise, the organisation had been overstaffed and inefficient, but charges for collecting waste were low and the service was popular with local residents. The city government subsidised the waste services and this helped to keep charges down. Shortly after privatisation, the directors announced substantial job cuts to save on costs. The waste collection service was reduced to once a week, yet charges were increased. The city government also announced that the city's rubbish collection services would be opened up to competition.

The business started to make big profits. It invested in new equipment and paid dividends to its shareholders. Last year, for the first time since privatisation, profits fell. This was due to competition from a newly formed waste disposal business. Many of Capital Waste's shareholders wanted the directors to be replaced. The biggest shareholders demanded to be on the board of directors. The chief executive discussed with the bank whether a loan could be obtained to enable him to buy out most of the shares to convert the business into a private limited company. He told the bank manager, 'If I turn the business into a private company, I can run it without any interference from big shareholders and publish less data about the company.'

The government still owns and manages the old and inefficient waste recycling plant in the city. It now wants to involve Capital Waste in a public–private partnership to build a new, environmentally friendly waste recycling plant. The business would be asked to invest capital in the new facility and to use its private sector managers to help manage the new plant. A PPP would help to make sure that it was built quickly. However, some local residents are worried that private sector managers would try to cut costs, and that difficult-to-recycle waste would simply be dumped in the local river.

20 marks, 40 minutes

1. Define the term 'public–private partnership'. [2]
2. Explain **two** possible reasons why the city government decided to create Capital Waste Disposal plc as a privatised business. [4]
3. Analyse **two** disadvantages of the city government privatising waste disposal. [4]
4. Discuss the advantages and disadvantages of the proposed public-private partnership for the building and operation of a new waste recycling plant. [10]

Non-profit social enterprises

Not all organisations in the world aim to make profits. There are many thousands of **non-profit organisations** that have objectives other than profit – for example, charities and pressure groups. Many of these are also termed **non-governmental organisations** (NGOs).

non-profit organisation: any organisation that has aims other than making and distributing profit and which is usually governed by a voluntary board

non-governmental organisation (NGO): a legally constituted body with no participation or representation of any government which has a specific aim and purpose, e.g. supporting disadvantaged groups in developing countries or advocating the protection of human rights

Non-governmental organisations (NGOs)

A non-governmental organisation (NGO) is a not-for-profit group, independent from government, which is organised on a local, national or international level to tackle issues that support the public good. They are task-focused and made up of people sharing a common interest. NGOs perform a variety of services and humanitarian functions, bring public concerns to governments and encourage participation of society's stakeholders at the community level. The objectives of NGOs are not profit-based but are specifically focused on social, environmental or humanitarian objectives. In Russia, the GLOBUS group aims to 'stimulate an effective national response to the HIV/AIDS epidemic'. Also in the humanitarian field, the International AIDS Alliance in Ukraine aims to 'reduce HIV incidence and death rates from AIDS'.

Other examples of NGOs include the following:

- Amnesty International is a worldwide campaigning movement that works to promote internationally recognised human rights for all. It undertakes research and action focused on preventing and ending grave abuses of human rights to physical and mental integrity, freedom of conscience and expression, and freedom from discrimination.
- Article 19 is a human rights organisation with a specific mandate and focus on the defence and promotion of freedom of expression and freedom of information worldwide.
- Avocats Sans Frontières ('Lawyers Without Borders' – ASF) is mostly made up of lawyers, solicitors and magistrates, aiming to contribute, completely independently, to the establishment of a fair, equitable and united society.
- Médecins Sans Frontières (MSF) is an international humanitarian aid organisation that provides emergency medical assistance to populations in danger in more than 80 countries. According to its Charter, MSF 'offers assistance to populations in distress, to victims of natural or man-made disasters and to victims of armed conflict, without discrimination and irrespective of race, religion, creed or political affiliation.'

Médecins Sans Frontières (MSF) is an international humanitarian aid organisation

- Ford Foundation is a resource for innovative people and institutions worldwide, with a view to strengthening democratic values, reducing poverty and injustice, promoting international cooperation, and advancing human achievement.
- MacArthur Foundation supports creative people and effective institutions committed to building a more just, verdant and peaceful world. Among other things, it seeks to further the development of an international system of justice and advance human rights around the globe.
- International Committee of the Red Cross (ICRC) is an impartial, neutral and independent organisation whose exclusively humanitarian mission is to protect the lives and dignity of victims of armed conflict and other situations of violence and to provide them with assistance.

LEARNER PROFILE

Médecins Sans Frontières or Doctors Without Borders is a not-for-profit NGO that provides medical aid and support to developing countries in conflict situations and humanitarian crisis situations. When Typhoon Haiyan hit the Philippines in 2013 MSF was very quickly on the scene with help and support. It has also teams of medical professionals to provide medical support in the Syrian Civil War.

MSF's actions are based on the principles of medical ethics, independence and impartiality. Their primary aim is to go to the most difficult places and situations around the world and provide support to sick and injured people.

'They act with integrity and honesty, with a strong sense of fairness, justice and respect for the dignity of the individual, groups and communities. They take responsibility for their own actions and the consequences that accompany them'.

To what extent can the people of Médecins Sans Frontières be described as principled?

Find another example of an organisation that you would describe as principled and explain to your class why you think your choice of organisation is principled.

Charities

charities: an organisation set up to raise money to help people in need or to support causes that require funding

Most countries have laws about what constitutes charitable work as **charities** are usually allowed tax benefits. The following list is typical of activities accepted as being for 'charitable purposes':

1. prevention or relief of poverty
2. advancement of education
3. advancement of religion
4. advancement of health or the saving of lives
5. advancement of citizenship or community development
6. advancement of the arts, culture, heritage or science
7. advancement of human rights conflict resolution or reconciliation or the promotion of religious or racial harmony or equality and diversity
8. advancement of environmental protection or improvement
9. relief of those in need, by reason of youth, age, ill health, disability, financial hardship or other disadvantage
10. advancement of animal welfare.

Charities often perform useful social and environmental functions that would not be undertaken by private businesses or government-funded organisations. They are dependent on private contributions and these can vary in amount, making it difficult for charity managers to plan. Some charitable work is duplicated – for example, in social care or medical research – and it is argued that such situations can lead to wasteful duplication.

OVER TO YOU

Revision checklist

1. What is the difference between private sector and public sector organisations?
2. State **three** differences between a sole trader and a private limited company.
3. Who (a) owns and (b) controls a public limited company? Explain why this distinction might lead to conflict.
4. Why might the directors of a public limited company decide to convert the business back into a private limited company by buying a majority of the shares?
5. Explain how legal personality and continuity help businesses and companies to operate effectively.
6. In what way does limited liability make it easier for companies to raise finance?
7. Using the examples of a sole-trader business and a public limited company, explain how the relationship between ownership and control differs in these two types of organisations.
8. Using the examples of a partnership and a public limited company, explain how the legal structure of a business affects its ability to raise finance.
9. List **two** organisations in your own country that are in the public sector.
10. Analyse **one** impact of the distinction between ownership and control for:
    a. shareholders of a plc
    b. employees of a plc.
11. Explain **two** potential advantages to a country's economy from microfinance providers.
12. Explain **two** potential advantages and **two** potential disadvantages to a country when its government uses public–private partnerships to pay for and manage health clinics.

Exam practice question

THE GOOGLE™ PHENOMENON

In 1995, Larry Page and Sergey Brin met at Stanford University. The following year they formed a partnership and began collaborating on a search engine called BackRub. In 1997, they decided to rename BackRub and came up with Google (derived from 'googol', a mathematical term for the number represented by the numeral 1 followed by 100 zeros).

With $100 000 support from a backer, Google Inc. was set up in 1998 in a garage in California. Later that year, *PC Magazine* recognised Google's search engine as one of the top 100 websites. In 2000, Google became available in many languages including French, German, Italian and Chinese. By 2004, the Google search index contained six billion items, including 4.28 billion web pages and 880 million images. It moved to an office in California called Googleplex with more than 800 employees and offices all over the world. In the same year, Google became a public limited company offering for sale 19 605 052 shares at an opening price of $85 a share.

Over the next five years, Google refined and added to its search engines a range of products such as Google News, Google Earth, Google Maps and Google Video. Today, Google is a huge multinational corporation worth around $160 billion and its share price is over $500 a share.

20 marks, 40 minutes

1. Define the term 'partnership'. [2]
2. Outline **two** possible benefits to Larry Page and Sergey Brin of starting Google as a partnership. [4]
3. Analyse **two** possible problems Larry Page and Sergey Brin might encounter by starting Google as a partnership. [4]
4. Discuss the advantages and disadvantages to Google of its conversion to a public limited company in 2004. [10]

Key concept question

20 marks, 40 minutes

With reference to one or two organisation(s) that you have studied, evaluate the impact different types of organisational ownership have on business strategy. [20]

1.3

Organisational objectives

On completing this chapter you should be able to:

Know and understand:

- Ethical objectives and corporate social responsibility (AO1)

Analyse and apply:

- Vision statement and mission statement (AO2)

Evaluate:

- Aims, objectives, strategies and tactics and their relationships (AO3)
- The need for organisations to change objectives and innovate in response to changes in internal and external environments (AO3)
- The reasons why organisations set ethical objectives and the impact of implementing them (AO3)
- The evolving role and nature of CSR (AO3)
- SWOT analysis of a given organisation (AO3)
- Ansoff's matrix for different growth strategies of a given organisation (AO3)

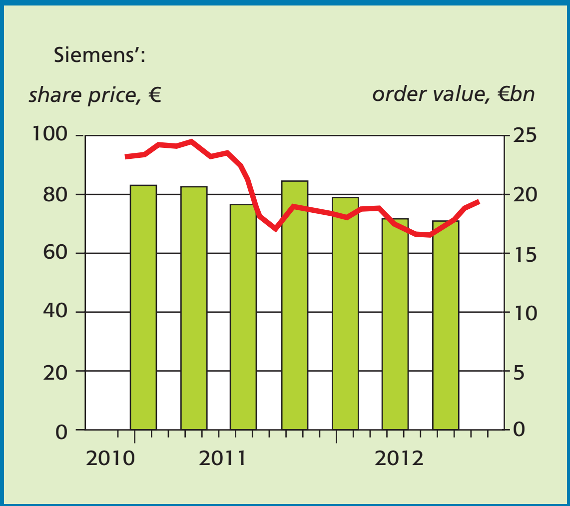
Prepare/construct:

- SWOT analysis of a given organisation (AO4)
- Ansoff's matrix for different growth strategies of a given organisation (AO4)

Setting the scene

SIEMENS' STRATEGY FOR HIGHER PROFITABILITY

Poor planning in recent years is blamed for Siemens' low levels of customer orders and a weak share price performance.



Siemens is now targeting a profit margin of at least 12%. To reach this corporate objective, the company plans to reduce its costs by €6 billion, increase competitiveness and reorganise its structure to become less bureaucratic.

Two stages of this new 'Siemens 2014' strategy have already been decided upon and are being implemented. First, it has acquired LMS International for around €680 million. LMS sells simulation software in 15 countries for evaluating mechatronic systems in aeroplanes and cars. With the acquisition of LMS, Siemens will hold a top position in this software segment and can improve the innovative strength of its customers.

Second, Siemens will restructure its water technology business. In the future, the water business will focus on Siemens' core competencies in automation and advanced equipment, while activities involved in processing and treating water and wastewater will be sold. Other elements of the new strategy include:

- Cost reduction – Cost savings of around €3 billion are expected from the improved integration of the key processes of design, development and production. Around €1 billion is to be saved by increasing global capacity utilisation.

- Go-to-market – The sales setup will be more flexibly adapted to regional circumstances.
- Optimised structure and management – The company's worldwide structure will be further optimised and redundant functions and duplicate processes will be eliminated. The complexity of processes and regulations will be reduced in order to give the company's business units greater entrepreneurial freedom and optimise their work with customers.

Source: www.siemens.com

Points to consider

- What do you understand by the terms 'business objective' and 'strategy' from this case study?
- What are likely to be the benefits to Siemens of having a clear and specific corporate objective?
- Why might Siemens have to change its objectives if there are changes in the external environment?

Key concept link

The objectives of an organisation will reflect its culture. Social enterprises will not focus on profit alone because the people who operate and control them have different values, attitudes and beliefs from those who control and operate profit-seeking organisations. Objectives of any organisation may have to change over time – for example, to reflect a major change in the external environment.

Introduction

Businesses of any size can benefit from setting clear objectives. In small businesses, such as sole traders, these objectives are often not written down or formalised in any way, but the owners will usually have a clear idea of what they are trying to achieve. In partnerships, it is important for partners to agree on the direction their business should take to avoid future disagreements. Limited companies must state the overall objectives of the business in their Memorandum and Articles of Association, but this often lacks much strategic detail. This chapter focuses on the importance of business objectives, the different forms that these can take, including ethical and social objectives, and how they can be used to direct the work of employees in an organisation.

Mission statements and vision statements

Mission statements outline the overall purpose of the organisation. A **vision statement**, on the other hand, describes a picture of the 'preferred future' and outlines how the future will look if the organisation achieves its mission. It is a clear statement of the future position that offers the ideal of what owners and directors want their business organisation to become.

mission statement: a statement of the business's core aims, phrased in a way to motivate employees and to stimulate interest by outside groups

vision statement: a statement of what the organisation would like to achieve or accomplish in the long term

A mission statement is an attempt to condense the central purpose of a business's existence into one short paragraph. It is not concerned with specific, quantifiable goals but tries to sum up the aims of the business in a motivating and appealing way. It can be summed up as a statement about 'who we are and what we do'.

Here are some examples of mission statements:

- College offering IB and A Level qualifications – 'To provide an academic curriculum in a caring and supportive environment'
- BT – 'To be the most successful worldwide telecommunications group'
- Nike, Inc. – 'To bring inspiration and innovation to every athlete in the world'
- Microsoft – 'To enable people and businesses throughout the world to realise their full potential'
- Google – 'To organise the world's information and make it universally accessible and useful'
- Merck – 'Provide society with superior products and services by developing innovations and solutions that improve the quality of life and satisfy customer needs, to provide employees with meaningful work and advancement opportunities and investors with a superior rate of return'.

An effective mission statement should answer three key questions:

- What do we do?
- For whom do we do it?
- What is the benefit?

Table 1.3.1 compares the vision and mission statements of three organisations.

Organisation	Vision statement	Mission statement
Nokia	Our vision is a world where everyone is connected	Nokia exists to connect people with each other and the information that is important to them with easy-to-use and innovative products. Nokia aims to provide equipment, solutions and services for consumers, network operators and corporations.
Minnesota Health Department (USA)	Keeping all residents healthy	To protect, maintain and improve the health of all residents
McDonald's Restaurants	Where the world buys more McDonald's than any other fast food	McDonald's aims to be the world's best quick service restaurant experience. Being the best means providing outstanding quality, service, cleanliness and value so that we make every customer in every restaurant smile.

Table 1.3.1 Comparing vision and mission statements

So what is the link between vision statements, mission statements and strategies? It is simple. Without the direction and focus brought to an organisation by vision and mission statements, planning new strategies will be like trying to steer a ship with no idea of either where it is or the direction it is meant to be heading in. Vision and mission statements give the organisation a sense of purpose and can prevent it from drifting between the tides and currents of powerful events.

THEORY OF KNOWLEDGE

Hewlett-Packard 'loses its way'

Hewlett-Packard has lost its way. The company is in the midst of an existential crisis. It continues to be a large and powerful organisation. It is one of America's largest companies with $127 billion in sales and $7 billion in profits. However, its future trajectory is ominous. Those profits, for example, were 19% lower than the previous year's. HP's business is under siege on almost every front, losing market share and facing declining profit margins.

HP is a traumatised organisation. Morale amongst its employees has hit 'rock bottom'. One top executive says that creativity has been stifled to the point that very little meaningful innovation is possible – 'We don't know who we are or what we do any more'.

The company has not produced a single hit consumer product in recent years. Apple has shown the riches awaiting those who invent hit devices. However, there were no iPhones or iPads in HP's bland array of products. Apple was not the only rival for HP, whose diverse businesses meant it also competed with enterprise hardware and software companies such as IBM and Oracle and consultants such as Accenture.

Work in small groups to research the business of Hewlett-Packard.Prepare a presentation that answers the following questions:

a. What role do reason, self-perception and emotion play in Hewlett-Packard's employees knowing what the mission of the organisation is?

b. How important is 'knowing who you are' in determining the success of an organisation?

Effectiveness of these statements

In recent years, virtually every organisation of any size has devised a vision statement and a mission statement. Do they perform a useful function or are they just another management fad? Below are some arguments in favour of these statements:

- They quickly inform groups outside the business what the central aim and vision are.
- They help to motivate employees, especially where an organisation is looked upon, as a result of its mission statement, as a caring and environmentally friendly body. Employees will then be associated with these positive qualities.
- Where they include ethical statements, they can help to guide and direct individual employee behaviour at work.
- They help to establish in the eyes of other groups 'what the business is about'.

On the other hand, these statements are often criticised for being:

- too vague and general so that they end up saying little which is specific about the business or its future plans
- based on a public relations exercise to make stakeholder groups 'feel good' about the organisation
- virtually impossible to analyse or disagree with
- rather 'woolly' and lacking in specific detail, so it is common for two completely different businesses to have very similar mission statements.

Communicating mission and vision statements is almost as important as establishing them. There is little point in identifying the central vision for a business and then not letting anyone else know about it. Businesses communicate their mission statements in a number of ways, for example in published accounts, communications to shareholders and the corporate plans of the business. Internal company newsletters and magazines may draw their title from part of the mission statement. Advertising slogans or posters are frequently based around the themes of the mission statements – The Body Shop is most effective in incorporating its mission into its eco-friendly campaigns.

On their own, mission statements are insufficient for operational guidelines. They do not tell managers what decisions to take or how to manage the business. Their role is to provide direction for the future and an overall sense of purpose, and in public relations terms, at least, they can prove very worthwhile. It is important that both vision and mission statements are applicable to the business, understood by employees and convertible into genuine strategic actions.

ACTIVITY 1.3.1

1. Use the website www.samples-help.org.uk/mission-statements to look up more mission statements for well-known corporations.
2. Comment on the usefulness of any **one** of these mission statements for planning of future strategies for this business.
3. Suggest how the statements might be communicated to **three** different stakeholder groups.
4. Find out if your school or college has a vision statement and a mission statement. By asking staff, students and parents, attempt to establish whether these statements have had any impact on their view of the school.

corporate aims: the long-term goals which a business hopes to achieve

divisional/operational objectives: short- or medium-term goals or targets – usually specific in nature – which must be achieved for an organisation to attain its corporate aims

Aims, objectives, strategies and tactics

Figure 1.3.1 shows the links between the different stages in the setting of aims and objectives.

Corporate aims

The core of a business's activity is expressed in its **corporate aims** and plans. A typical corporate aim is: 'To increase shareholder returns each year through business expansion'.

Figure 1.3.1 The hierarchy of objectives

This example demonstrates a typical corporate aim. It tells us that the company aims to give shareholders maximum returns on their investment by expanding the business. Other corporate aims tend to concentrate on customer-based goals, such as 'meeting customers' needs', or market-based goals, such as 'becoming the world leader'. Corporate aims are all-embracing, and are designed to provide guidance to the whole organisation, not just a part of it.

Establishing corporate aims has several benefits. They:

- become the starting point for **divisional/operational objectives** on which effective management is based; this is shown by the position of 'aim' at the top of the hierarchy of objectives in Figure 1.3.1

- can help develop a sense of purpose and direction for the whole organisation if they are clearly and unambiguously communicated to the workforce
- allow an assessment to be made, at a later date, of how successful the business has been in attaining its goals
- provide the framework within which the strategies or plans of the business can be drawn up.

A business without a long-term corporate plan or aim is likely to drift from event to event without a clear sense of purpose. This will become obvious to the workforce and customers, who may respond in adverse ways.

Operational objectives should be 'SMART'

Business aims and objectives help to direct, control and review the success of business activity.

The most effective business objectives usually meet the following SMART criteria:

- **S – Specific** Objectives should focus on what the business does and should apply directly to that business. For example, a hotel may set an objective of 75% bed occupancy over the winter period – the 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 – for example, to increase sales in the south-east region by 15% this year.
- **A – Achievable** Objectives must be achievable. Setting objectives that are almost impossible to achieve in a given time will be pointless. They will demotivate staff who have the task of trying to reach these targets.
- **R – Realistic and relevant** Objectives should be realistic when compared with the resources of the company, and should be expressed in terms relevant to the people who have to carry them out. For example, informing a factory cleaner about 'increasing market share' is less relevant than a target of reducing usage of cleaning materials by 20%.
- **T – Time-specific** A time limit should be set when an objective is established. For example, by when does the business expect to increase profits by 5%? Without a time limit it will be impossible to assess whether the objective has actually been met.

Exam tip: Remember the acronym: SMART.

Interlinking aims, objectives and strategies

Corporate aims relate to the whole organisation. They need to be broken down into specific tactical or operational objectives for separate divisions.

Divisional, operational objectives are set by senior managers to ensure:

- coordination between all divisions – if they do not work together, the focus of the organisation will appear confused to outsiders and there will be disagreements between departments
- consistency with strategic corporate objectives
- adequate resources are provided to allow for the successful achievement of the objectives.

Once divisional objectives have been established, these can be further divided into departmental objectives and finally budgets and targets for individual workers. This process is called management by objectives (MBO), as shown in Figure 1.3.2.

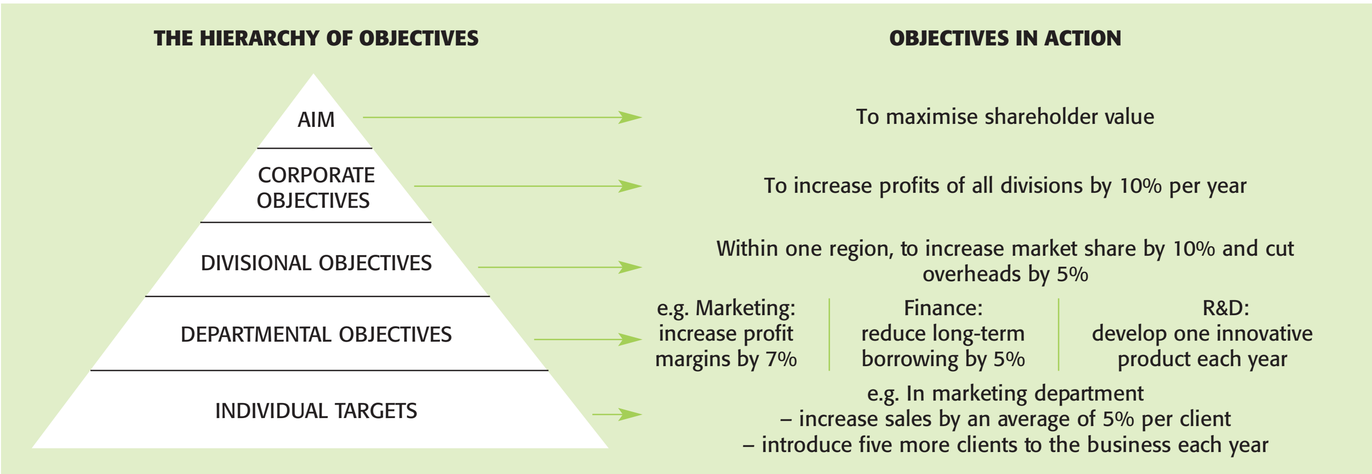


Figure 1.3.2 Management by objectives – how the corporate aim is divided at every level of the organisation

Relationship between aims, objectives, strategy and tactics

Aims and objectives provide the basis and focus for business strategies – the long-term plans of action of a business that focus on achieving its aims. Without a clear objective a manager will be unable to make important strategic decisions. For example, should a marketing manager decide to sell products in new markets or attempt to sell more in existing markets? Without a clear corporate objective, which is then translated into a marketing objective, decisions of this kind become very arbitrary.

For any corporate aim to be successfully achieved, there has to be an appropriate strategy – or detailed plan of action – in place to ensure that resources are correctly directed towards the final goal. This strategy should be constantly reviewed to check whether the business is on target to achieve its objectives. Both the aims of an organisation and the strategies it adopts will often change over time. Indeed, a change of objective will almost certainly require a change of plan too. A poor plan or strategy will lead to failure to reach the target.

These links between objectives and strategies are shown in Figure 1.3.3.

Figure 1.3.3 Links between objectives and strategies

Without clear objectives, decision-making will lack direction and a means of assessing success. Every stage of decision-making – collecting data about options, choosing a strategic option and reviewing success/failure – is made much more meaningful with specific business objectives to refer to.

strategy: a long-term plan of action for the whole organisation, designed to achieve a particular goal

tactic: short-term policy or decision aimed at resolving a particular problem or meeting a specific part of the overall strategy

Strategy and tactics – the key differences

Strategic decisions, e.g. to develop new markets abroad	Tactical decisions, e.g. to sell product in different-sized packaging
Long term	Short to medium term
Difficult to reverse once made – departments will have committed resources to it	Reversible, but there may still be costs involved
Taken by directors and/or senior managers	Taken by less senior managers and subordinates with delegated authority
Cross-functional – will involve all major departments of the business	Impact of tactical decisions is often only on one department

Table 1.3.2 Key differences between tactical decisions and strategic decisions

ACTIVITY 1.3.2

CORPORATE AIMS OF DOMESTIC DETERGENTS INC.

- To increase annual sales from $1 billion to $2 billion in five years
- To enter a new market every 18–24 months
- To achieve 30% of sales each year from products not in the company's product line five years earlier
- To be the lowest cost, highest quality producer in the household products industry
- To achieve a 15% average annual growth in sales, profit and earnings per share

20 marks, 40 minutes

1. Explain what is meant by the term 'SMART objectives'. [4]
2. To what extent are the corporate objectives for Domestic Detergents SMART objectives? [8]
3. Discuss the benefits and limitations to Domestic Detergents of setting specific and time-limited objectives. [8]

Common corporate aims

Profit maximisation

Profits are essential for rewarding investors in a business and for financing further growth, and are necessary to persuade business owners and entrepreneurs to take risks. Profit maximisation means producing at the level of output where the greatest positive difference between total revenue and total costs is achieved – see Figure 1.3.4.

It seems rational to seek the maximum profit available from a given venture. Not to maximise profit is seen as a missed opportunity, but there are limitations with this corporate objective:

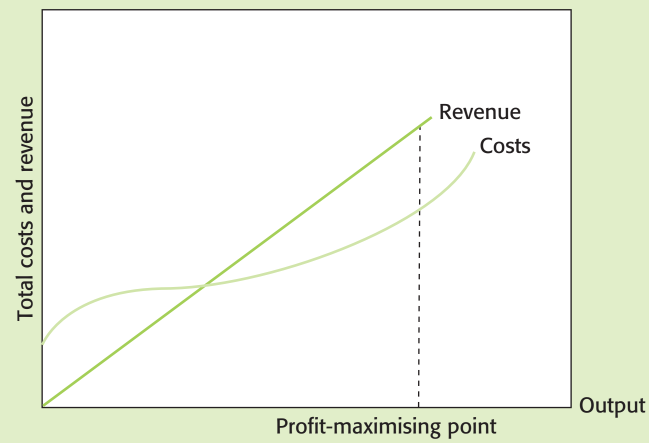


Figure 1.3.4 Profit maximisation – the greatest possible difference between total revenue and total cost

- High short-term profits may lead competitors to enter the market.
- Many businesses seek to maximise sales in order to secure the greatest market share possible, rather than maximise profits. The business would expect to make a target rate of profit from these sales.
- Owners of smaller businesses may be more concerned with issues of independence and keeping control – these may be of more importance than making higher profits.
- Most business analysts assess business performance through return on capital employed – the rate of profit returned on each dollar invested in the business – rather than through total profit.
- Profit maximisation may well be the preferred objective of the owners/shareholders, but other stakeholders will give priority to other issues. Managers cannot ignore these. Hence, the growing concern over job security for the workforce and the environmental concerns of local residents may force profitable business decisions to be modified, giving lower profit levels.
- In practice, it is very difficult to assess whether the point of profit maximisation has been reached, and constant changes to prices or output to attempt to achieve it may well lead to negative consumer reactions.

Profit satisficing

This means aiming to achieve enough profit to keep the owners happy but not aiming to work flat out to make as much profit as possible. This is often the objective of owners of small businesses who wish to live comfortably but do not want to work very long hours in order to earn more profit.

Growth

The growth of a business – in terms of sales or value of output – 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 may gain higher salaries and fringe benefits. Businesses that do not attempt to grow may cease to be competitive and, eventually, will lose their appeal to new investors. Business objectives based on growth have limitations:

- Over-rapid expansion 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 – retained profits – can lead to lower short-term returns to shareholders.
- Growth into new business areas and activities can result in a loss of focus and direction for the whole organisation.

Increasing market share

Closely linked to overall growth of a business is the market share it enjoys within its main market. It is possible for an expanding business to suffer a loss of market share if the market is growing at a faster rate than the business itself. Increasing market share indicates that the marketing mix of the business is proving to be more successful than that of its competitors. Benefits resulting from being the brand leader with the highest market share include:

- Retailers will be keen to stock and promote the best-selling brand.
- Profit margins offered to retailers may be lower than for competing brands as the shops are so keen to stock it – this leaves more profit for the producer.
- Effective promotional campaigns are often based on 'buy our product with confidence – 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.

Maximising short-term sales revenue

This could benefit managers and staff 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.

Maximising shareholder value

Management, especially in public limited companies, take decisions that aim to increase the company share price and dividends paid to shareholders. These targets might be achieved by pursuing the goal of profit maximisation. This shareholder value objective puts the interests of shareholders above those of other stakeholders.

Ethical objectives

Ethical objectives are targets based on a moral code for the business – for example, 'doing the right thing'. The growing acceptance of corporate social responsibility has led to businesses adopting an '**ethical code**' to influence the way in which decisions are taken.

ethics: moral guidelines that determine decision-making

ethical code (code of conduct): a document detailing a company's rules and guidelines on staff behaviour that must be followed by all employees

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

- Should a toy company advertise products to young children so that they 'pester' their parents into buying them?
- Is it acceptable to take bribes in order to place an order with another company?
- Should a bank invest in a company that manufactures weapons or tests new 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 directors receive substantial pay hikes and bonuses when other workers in the business might be 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 in a country, is it acceptable to pay very low wages for long hours of work since this policy will reduce the firm's costs?
- Should a business employ child labour to reduce costs compared with employing adults?
- Should a business continue to 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. To what extent should businesses take ethics into consideration when making decisions? 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.

Different people will have different answers to these dilemmas. 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 too. Other managers will operate their business according to strict ethical rules and will argue that, even if certain actions are not illegal, they are not right. Morally, they cannot be justified even if they might cut costs and increase sales.

Evaluating ethical objectives

Adopting and keeping to a strict ethical code in decision-making can be expensive in the short term. For example:

- Using ethical and Fairtrade suppliers can add to a business's costs.
- Not taking bribes to secure business contracts can mean losing out on significant sales.
- Limiting the advertising of toys and other child-related products to an adult audience to reduce 'pester power' 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 costs and may reduce a firm's competitiveness against businesses that exploit workers.

However, in the long term there could be substantial benefits from acting ethically. For example:

- Avoiding potentially expensive court cases can reduce costs of fines.
- While bad publicity from being 'caught' acting unethically can lead to lost consumer loyalty and long-term reductions in sales, ethical policies will lead to good publicity and increased sales.
- Ethical businesses attract ethical customers and, as global pressure grows for corporate social responsibility, this group of consumers is increasing.
- Ethical businesses are more likely to be awarded government contracts.
- Well-qualified staff may be attracted to work for companies that have ethical and socially responsible policies.

ACTIVITY 1.3.3

SIAM CEMENT GROUP (SCG)

The SCG has a strict ethical code of conduct. Its key features are shown in the table below.

Business ethics	Code of conduct
• Fairness to all who have business relationships with the company, including society and environment • Making business gains in a proper manner • No alliances with political parties • Non-discriminatory treatment of all staff and stakeholder groups	• Upholding the principles of honesty and fairness • Protecting the properties and reputation of SCG • Conducting business in the best interests of SCG and its stakeholders • Behaving appropriately at all times towards others

According to a report by Judith Ross, as SCG expanded beyond Thailand managers came under pressure to compromise on its corporate code of ethics. The company's standards on bribes and other improper payments, for example, made it difficult to compete in places where such unethical payments are a way of life. This example demonstrates the classic problem: should firms conform to the standards of the country they operate in or should they try to export their own high moral principles to other lands?

Source: Adapted from http://hbswk.hbs.edu

22 marks, 44 minutes

1. Explain what you understand by the term 'corporate code of ethics'. [4]
2. Discuss how SCG and its employees might benefit from a corporate code of ethics. [8]
3. Should a business such as SCG ever use unethical methods in a country where they are the 'norm' – for example, the giving and accepting of bribes? Justify your answer. [10]

Corporate social responsibility (CSR)

Objectives that focus on meeting social responsibilities are increasingly important for most business organisations.

To whom is business answerable? Should business activity be solely concerned with making profits to meet the objectives of shareholders and investors or should business decisions also be influenced by the needs of other **stakeholders**? When a firm fully accepts its legal and moral obligations to stakeholders other than investors, it is said to be accepting **corporate social responsibility** (CSR).

One important measure of a firm's attitude to its social responsibility is the way in which it deals with environmental issues. Our environment 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 can lead to global warming and the use of scarce non-renewable natural resources are all environmental issues that are of increasing concern to people and governments all over the world. How should business managers react to these concerns? Should they respond by adopting environmentally safe or green policies, even if these are expensive, or should they always take the cheapest option no matter what the consequences for the environment might be?

stakeholders: people or groups of people who can be affected by, and therefore have an interest in, any action by an organisation

corporate social responsibility: this concept applies to those businesses that consider the interests of society by taking responsibility for the impact of their decisions and activities on customers, employees, communities and the environment

Other issues connected with the concept of CSR cross over into ethical decisions. In fact, the two concepts are closely linked. Examples of recent CSR developments include:

- the growth in the number of firms that promote organic and vegetarian foods
- increasing numbers of retailers emphasising 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 action being taken because trade and reputation might be lost if it is not or because such action is increasingly profitable? Might businesses be criticised for paying lip service to CSR rather than praised for their genuine concern for society and the environment? Conceivably, firms are being ethical or environmentally conscious because they have an objective that Peter Drucker, a famous writer on management, calls 'public responsibility', because they want to behave in these ways. However, many consumer groups and pressure groups are still dubious as to whether these objectives are based on genuinely held beliefs.

Table 1.3.3 looks at the benefits and drawbacks for businesses of adopting CSR policies.

Benefits	Drawbacks
• The image of the business and its products can be improved with a green or socially responsible approach. This could become a major competitive advantage, attracting new customers and loyalty from existing customers. • Attracting the best-motivated and most efficient employees may become easier as many workers will prefer to work for and be associated with socially aware businesses. • Bad publicity and pressure group activity resulting from socially irresponsible behaviour should not arise.	• Short-run costs could increase, e.g. fitting anti-pollution equipment, paying workers above-poverty wage levels, paying suppliers promptly, not exploiting vulnerable groups in advertising. • Shareholders may be reluctant to accept lower short-run profits (even though long-run profitability might increase). • Loss of cost and price competitiveness if rival businesses do not accept social responsibilities and have lower costs as a result.
• The goodwill of other stakeholder groups, resulting from socially responsible behaviour, could lead to better relations with workers, suppliers, customers and the local community. • Higher long-term profitability should result from all of the factors above.	• Consumers may be prepared to pay higher prices for products made in a socially responsible manner, but during an economic recession, they might just prefer low prices and worry less about how products were made. • There could be a considerable social backlash against a business that *claims* to be socially responsible but is discovered to operate in socially irresponsible ways, e.g. a furniture maker claims to use sustainable timber but buys from rainforest suppliers – this is sometimes referred to as 'greenwash'.

Table 1.3.3 Benefits and drawbacks of corporate social responsibility

Changes in corporate responsibility

Attitudes towards corporate responsibility have changed over time. The standards that companies are expected to reach are determined by societal norms, and in most countries these now focus on stakeholders rather than shareholders.

The main reasons for changing corporate approaches to social responsibility include:

- increasing publicity from international pressure groups that use the internet to communicate, blog, raise funds and organise boycotts
- the United Nations Millennium Development Goals, agreed by more than 120 countries in 2000, which includes 'environmentally sustainable growth' – this

has forced many developing nations to insist that new company investment in their economy takes environmental concerns into consideration

- global concern over climate change and the impact this could have on social and economic development – this is forcing companies to confront the climatic consequences of their actions and investments, e.g. the rapid increase in wind-power farms in Germany
- legal changes at local, national and European Union level – these have forced businesses to refrain from certain practices. In most countries, businesses can no longer pay staff very low wages or avoid legal responsibility for their products.

CSR and corporate strategy changes

The changing corporate strategies of the world's mining companies are an excellent example of how firms may adopt different strategies towards their social responsibilities in response to pressure. In the 1970s and 1980s, many mining companies signed mineral extraction deals with undemocratic political regimes. Environmental concerns were given very low priority and the interests of the local or indigenous peoples (displaced by the mine workings) ignored. The Grasberg (West Papua) and Bougainville (Papua New Guinea) gold and copper mines are useful case studies.

- In Bougainville, joint owners of the mine, RTZ and Freeport, allowed the government to use force to put down civil unrest caused by the displacement of people by the mine and its environmental damage. The company took a very tough line and military action took place next to the mine. Eventually, the company was forced to close it.
- The Grasberg mine, which opened later than Bougainville, benefited from a very different objective by RTZ towards its social responsibilities as a result of the poor publicity over its policy in Papua New Guinea. A trust fund has been set up to spend 1% of total mine revenue to fund village development. In addition, one quarter of the total workforce is drawn from local communities.
- RTZ went even further with the Jabiluka uranium mine in northern Australia. Publicity by the local Mirrar tribe and their supporters led to an unprecedented extraordinary general meeting of shareholders, which led to the mine being closed; it has never reopened.

Measuring CSR – social audits

Social audits report on a firm's 'social' performance and are becoming an important way for businesses to report on their corporate social responsibility record. They assess the impact a business has on society and how effectively its ethical behaviour matches up to its ethical objectives. Social audits can include an environmental audit (see above), but they give details of other impacts on society too. These include:

- health and safety record, e.g. number of accidents and fatalities
- contributions to local community events and charities
- proportion of supplies that come from ethical sources, e.g. Fairtrade Foundation suppliers
- employee benefit schemes
- feedback from customers and suppliers on how they perceive the ethical nature of the business's activities.

The social audit will also contain annual targets to be reached to improve a firm's level of social responsibility and details of the policies to be followed to achieve these aims. By researching and publishing these reports, firms are often able to identify potentially

social audit: an independent report on the impact a business has on society. This can cover pollution levels, health and safety record, sources of supplies, customer satisfaction and contribution to the community anti-social behaviour and take steps to root this out of the company's practices. Publishing detailed and independently verified social audits can improve a firm's public image, increase consumer loyalty and give the business a clear direction for future improvements in its social responsibility achievements. The benefits and limitations of social audits are considered in Table 1.3.4.

Benefits	Limitations
• Identifies what social responsibilities the business is meeting – and what still needs to be achieved. • Sets targets for improvement in social performance by comparing audits with the best-performing firms in the industry. • Gives direction to the action plans a business still needs to put into effect to achieve its social/ethical objectives. • Improves a company's public image and this can be used as a marketing tool to increase sales.	• If the social audit is not independently checked – as published accounts must be – will it be taken seriously by stakeholders? • Time and money must be devoted to producing a detailed social audit – is this really necessary if it is not legally required? • Many consumers may just be interested in cheap goods, not whether the businesses they buy from are socially responsible. • A social audit does not prove that a business is being socially responsible.

Table 1.3.4 Benefits and limitations of social audits

Evaluation of social audits

- Until social audits are made compulsory and there is general agreement about 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 make them of limited value to small businesses or those with very limited finance.

ACTIVITY 1.3.4

CORPORATE SOCIAL RESPONSIBILITY

Corporate social and environmental awareness has become essential for companies as they realise that they must listen to all stakeholders if they are to achieve their objectives.

The combination of environmental responsibility, **business ethics** and profits is one that is attracting increasing attention. Many chief executive officers of leading companies now disagree with the idea that the interests of shareholders and those of other stakeholders (employees, community, customers and so on) must always conflict. Increasingly, corporations seek to weld these two seemingly opposite forces so that 'doing good' and 'doing good business' become the same thing.

Social and environmental responsibility has moved from a 'nice to do' to a 'need to do'. The importance of the employee has been highlighted by the so-called 'war for talent'. Recruiting the brightest and best has become a key concern, says a human resources manager at PricewaterhouseCoopers: 'There is such a limited number of the right type of graduates, and they are choosy about the type of company they will work for. The cost of recruiting and retaining staff is likely to be higher if you are not seen to be an ethical employer and organisation.' A company's reputation also has significant implications for its financial performance. Analysts believe it is one of the key factors in the valuation of companies. One company could have a higher stock market valuation than another solely on account of its good social and environmental reputation.

Shell, a company with traditionally one of the worst reputations among environmental and social pressure groups, has made enormous efforts to reinvent itself as a **socially responsible business**. It has stated its aims as nothing less than to become 'the leading multinational in economic, environmental and social responsibility'. Shell's chairman has said that the reason for Shell's conversion to environmental protection is: 'We won't achieve our business goals unless we are listening to and learning from the full range of our stakeholders in society.'

32 marks, 64 minutes

1. Define the following terms highlighted in the article:
   a. business ethics [2]
   b. socially responsible business. [2]
2. Analyse **two** factors given in the article which could encourage a business to adopt ethical and socially responsible objectives and strategies. [8]
3. Discuss the likely costs and benefits for Shell of the company working towards being seen as 'the leading multinational in economic, environmental and social responsibility'. [10]
4. Examine whether businesses should change their strategies of corporate responsibility over time. [10]

ACTIVITY 1.3.5

VIRGIN'S ENVIRONMENTAL POLICIES – GREEN OR JUST 'GREENWASH'?

The Virgin Atlantic jumbo jet that flew between London and Amsterdam using a proportion of biofuel was a world first. This fuel was derived from Brazilian babassu nuts and coconuts and is much less polluting than ordinary jet kerosene. The airline's boss, Sir Richard Branson, hailed this as a 'vital breakthrough' for the industry. Other well-publicised fuel-saving measures used by the airline are the towing of aircraft to the runways for take-off instead of using their own engines and offering first-class passengers train tickets to travel to the airport in place of chauffeur-driven cars. Unfortunately, very few passengers have taken up this last offer, and towing of aircraft has been stopped as it causes damage to the undercarriage.

Greenpeace's chief scientist has labelled these efforts to make air travel more environmentally friendly 'high altitude greenwash' and said that 'less air travel was the only answer to the growing problem of climate-changing pollution caused by air travel'. A Friends of the Earth spokesperson said that biofuels do little to reduce emissions, and large-scale production of them leads to higher food prices.

18 marks, 36 minutes

1. Analyse why Virgin Atlantic is making efforts to reduce the amount of jet fuel (kerosene) used by its aircraft. [8]
2. To what extent will the company lose or benefit from these well-publicised attempts to reduce air pollution? [10]

LEARNER PROFILE

Africa is Big Tobacco's last frontier, and companies are conquering the continent stick by stick. Even the very poor can afford the cost of a single cigarette. So the world's leading tobacco companies are targeting Africa in the same strategic way any organisation would approach an expanding and profitable market.

Unlike many more developed countries the regulations on cigarette sales in African countries is relatively relaxed. The sale of packs, for example, with fewer than 20 cigarettes is prohibited in countries like the US, whereas selling cigarettes single, or 'one-one,' is allowed in African countries.

Tobacco use is declining in the developed world. It has reached a plateau in the strongest market, Asia. However, it is growing in Africa, because of the continent's booming population and rapidly expanding middle class.

Can you be principled and work for a tobacco company that targets markets in developing countries?

Issues relating to corporate objectives

Some important issues relating to corporate objectives include the following:

- They must be based on the corporate aim and should link in with it.
- They should be achievable and measurable if they are to motivate employees.
- They need to be communicated to employees and investors in the business. Unless staff are informed of the objectives and their own targets that result from these, then the business is unlikely to be successful.
- They form the framework for more specific departmental or strategic objectives – see below.
- They should indicate a time scale for their achievement – remember SMART!

Conflicts between corporate objectives

Conflicts between objectives can often occur. These conflicts will need to be resolved by senior managers and decisions taken on the most significant objective for the next time period. The most common conflicts that can occur are:

- growth versus profit – achieving higher sales by raising promotional expenditure and by reducing prices will be likely to reduce short-term profits
- short term versus long term – lower profits and cash flow may need to be accepted in the short term if managers decide to invest heavily in new technology or the development of new products that might lead to higher profits in the longer term
- stakeholder conflicts – these are covered in detail in Chapter 1.4.

ACTIVITY 1.3.6

IS STS PLC SUCCESSFUL?

STS plc collects waste from houses, offices and factories. Most of the waste is burned to produce heat and electricity for the company's own use. This saves costs and reduces the impact on the environment by not using areas of land to bury the rubbish. A recent increase in customers has meant that not all of the waste can be burned and the company has dumped it in old quarries where it causes smells and gas emissions. Investment in labour-saving equipment has allowed the business to save on wage costs. The company's new mission statement is 'to become the country's number one waste business and to protect the environment for our children's benefit'. This has been explained to all shareholders in a recent letter to them, but the workers of the company were not involved in helping create the mission statement and they have not been informed of it.

The latest company accounts stated: 'We aim to maximise returns to shareholders through a strategy of aggressive growth. Our objectives are to expand year on year.' These accounts contained the following data.

	2011	2012	2013	2014
Sales revenue ($m)	20	25	35	40
Net profit ($m)	3	8	10	20
Total value of country's waste market ($m)	120	140	160	180
Number of employees	1000	950	900	800

26 marks, 52 minutes

1. a. Define the term 'mission statement'. [2]

b. Explain **one** benefit STS might gain from its new mission statement. [4]

2. a. Explain what you understand by SMART objectives. [4]

b. STS's objectives are not completely SMART. Analyse **two** problems that might arise from this. [8]

3. STS's aim is 'to maximise returns to shareholders through a strategy of aggressive growth'. Using the data provided, evaluate the extent to which they are being successful in achieving this objective. [8]

Factors determining corporate objectives

There are several reasons why firms have different objectives.

Corporate culture

This can be defined as the code of behaviour and attitudes that influences the decision-making style of the managers and other employees of the business. Culture is a way of doing things that is shared by all those in the organisation.

If directors are aggressive in pursuit of their aims, keen to take over rival businesses and care little about social or environmental factors, then the objectives of the business will be very different from those of a business owned and controlled by directors with a more 'people'- or 'social'- orientated culture.

Size and legal form of the business

Owners of small businesses may be concerned only with a satisficing level of profit. 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 status and power of the managers. This is often a result of the divorce between ownership and control. Directors and managers may be more concerned about their bonuses, salaries and fringe benefits – which often depend on sheer business size – than on maximising returns to shareholders.

Public sector or private sector businesses

State-owned organisations tend not to have profit as a major objective. Quality of service targets are often set, however, such as the maximum days for a patient to wait for an operation. Even businesses earning revenue in the public sector, such as the postal service, may have among their objectives the target of maintaining services in non-profitable locations.

Well-established businesses

Newly formed businesses are likely to be driven by the desire to survive at all costs – 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.

Changing business objectives

Businesses can change their corporate objectives over time. These changes will be in response to internal factors, such as resource constraints, or external factors, such as changes in the social and economic environment.

Some of the most significant reasons for businesses changing their objectives include the following:

- A 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 internal resources of the business might have increased which will allow the objective of growth to be realistically established.
- An important senior manager responsible for international expansion might leave the business, which leads to focusing on growing the business in domestic markets until an effective replacement can be found.
- The external competitive and economic environment may change. The entry into the market of a powerful rival or an economic recession may lead a firm to switch from growth to survival as its main aim. The UK airline British Airways (BA) has responded to the dual impact of increased low-fare competition and the recession by focusing less on its objectives to increase business-class and first-class market share and more on cost-cutting and low fares. This has led to serious disputes with trade unions representing BA cabin staff.
- A short-term objective of growth in sales or market share might be replaced by a longer-term objective of maximising profits from the higher level of sales.

Business objectives need to be flexible enough to be adapted to reflect internal and external changes, but they should not be changed too dramatically or frequently as this may result in the loss of many of the benefits of setting SMART targets, including a loss of focus, sense of direction and specific measures to judge present performance. Before making a significant change to objectives, senior managers need to consider:

- Is the internal or external change significant and long-lasting enough to make a change in objectives necessary?
- What would be the risks of not adapting objectives to meet the new situation?
- What would be the cost and other consequences of new business objectives for the business and its staff?
- How can changed objectives – and the strategies needed to achieve them – be effectively managed within the business?

Air pollution is one way in which business activity can damage the environment: should companies be forced to use cleaner production methods?

ACTIVITY 1.3.7

PEUGEOT CITROËN SET CLEAR OBJECTIVES

The chairman of the car manufacturer Peugeot Citroën has set the company the aim of becoming the 'most competitive carmaker in Europe in 2015'. This overall aim is supported by more specific and measurable objectives. The profit margin of each car sold is targeted to increase from 2% to 7% by 2015. The overall sales objective was to reach four million car sales a year by 2010. One million car sales are aimed for in the emerging markets by 2015. In Europe, one of the most competitive car markets in the world, the target is to increase sales by 300 000 cars a year by the same date.

Departmental operating targets have also been established. For example, the human resources department must prepare for up to 8000 job losses and operations must aim to cut fixed manufacturing costs by 30% and costs of purchasing car parts by 4–6% a year. Marketing must plan to launch 12 new models in the Chinese market.

The chairman also announced his intention to take both car brands upmarket and establish them as premium car brands that increasing numbers of customers will want to own.

Source: www.timesonline.co.uk

26 marks, 52 minutes

1. Analyse whether Peugeot Citroën's objectives fit the SMART criteria. [6]
2. Analyse the importance of the chairman not only setting an overall aim for the company but also establishing departmental objectives. [10]
3. To what extent might the chairman's new objectives meet with the needs of the company's shareholders? [10]

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 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. It is, therefore, useful in strategy formulation and selection. It comprises:

- **S = strengths** These are the internal factors about a business that can be looked upon as real advantages. These could be used as a basis for developing a competitive advantage. They might include experienced management, product patents, loyal workforce and 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 and the effectiveness of each of its departments and major product ranges.
- **W = weaknesses** These are the internal factors about a business that can be seen as negative factors. In some cases, these can be the flip side of a strength. For example, whereas a large amount of spare manufacturing capacity might be a strength in times of a rapid economic upturn, if it continues to be unused it could add substantially to a firm's average costs of production. Weaknesses might include: poorly trained workforce, limited production capacity and ageing equipment. This information would also have been obtained from an internal audit.
- **O = 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 firm operates in and its major competitors. Examples include: new technologies, export markets expanding faster than domestic markets, and lower rates of interest increasing consumer demand.
- **T = 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 are: new competitors entering the market, globalisation driving down prices, changes in the law regarding the sale of the firm's products and changes in government economic policy.

This information is usually presented in the form of a four-box grid as shown in Table 1.3.5.

	Strengths	Weaknesses
Internal	• Specialist marketing expertise • A new, innovative product or service • Location of your business • Quality products and processes • Any other aspect of your business that adds value to your product or service	• Lack of marketing expertise • Undifferentiated products or services (i.e. in relation to your competitors) • Location of your business • Poor-quality goods or services • Damaged reputation
	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 your home market • Price wars with competitors • A competitor has a new, innovative product or service • Competitors have superior access to channels of distribution • Taxation of your product or service

Table 1.3.5 SWOT analysis – some common issues

SWOT and strategic objectives

The SWOT diagram focuses on the key issues under each heading. A brief outline of each of these could then accompany the grid to make it more useful to the managers responsible for strategic planning. This approach helps managers assess the most likely successful future strategies and the constraints on them. A business should not necessarily pursue the most profitable opportunities. It may stand a better chance of developing a competitive advantage by identifying a good 'fit' between the firm's strengths and potential opportunities. In many cases, a business may need to overcome a perceived 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.

SWOT evaluation

Subjectivity is often a limitation of a SWOT analysis as no two managers would necessarily arrive at the same 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 a prescription. Part of the value of the process of SWOT analysis is the clarification and mutual understanding that senior managers gain by the focus that SWOT analysis provides.

Exam tip: Some examination 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.

ACTIVITY 1.3.8

STRATEGIC ANALYSIS OF LVM LTD

LVM owns a major assembly plant for laptop computers. It supplies products to some of the major brand names in the computer industry but, at present, it does not sell any under its own name. Every six months the managers hold a key strategic review meeting to consider the current position of the business and the long-term plans. The following are extracts from the most recent of these meetings:

Imran Khan – marketing director: 'Sales of our latest TFT screen models have exceeded expectations and the switch towards laptops from desktop PCs is expected to continue. The chance for computer companies to break into the expanding Asian market when trade barriers are lifted should lead to increased orders too. We need to undertake some market research in Asia as this market has higher growth potential than Europe, where most of our computers are marketed. The uncertainty over the newest mobile phone technology and links with the internet remain a concern for us. We decided two years ago not to develop this technology, and, if our competitors succeed in getting a major breakthrough, then sales of our laptops will dive in some markets.'

Liz Collins – operations manager: 'The automation of the screen-assembly section is now complete. We managed to push this through while maintaining excellent staff relationships. This was helped by our continued expansion, which meant that no jobs were lost. We had to turn down a large order from a big-name brand last month due to too little factory capacity and shortages of skilled labour. I do urge you to agree to my plan to extend the factory space by 35% and to train more new recruits. Research into the lighter, faster computer model that was agreed on last year is making excellent progress and we will soon have to decide whether to proceed into the production stage.'

Lukas Klimas – finance director: 'Our profits are holding steady, but cash flow remains a concern due to the expenditure on automated machines and research costs. We would need to borrow substantially to finance a factory extension. We would be in trouble if interest rates increased – there is already some government concern about inflation rising. There is a new range of grants available for businesses relocating into areas of high unemployment. We must constantly be aware of exchange rate movements too – the recent depreciation helped our international competitiveness.'

30 marks, 60 minutes

1. Prepare a SWOT analysis based on your assessment of the internal and external factors that influence LVM's success. [10]
2. Evaluate the usefulness of SWOT to a business such as LVM. [10]
3. Evaluate **two** potential strategic options available to LVM Ltd by using the SWOT analysis prepared in question 1. [10]

Ansoff's matrix

This analytical tool is one of the most widely referred-to means of portraying alternative corporate growth strategies.

Ansoff popularised the idea that long-term business success was dependent upon establishing business strategies and planning for their introduction. His best-known contribution to strategic planning was the development of **Ansoff's matrix**, which represented the different options open to a marketing manager when considering new opportunities for sales growth.

Ansoff's 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

He considered that the two main variables in a strategic marketing decision are:

- the market in which the firm is going to operate
- the product(s) intended for sale.

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 on a matrix, these options can be presented as shown in Figure 1.3.5.

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:

Market penetration

In 2013 Samsung reduced the European prices of its range of 4K TV's by up to €200. This was in response to price cuts by other manufacturers – but Samsung's reductions were larger in an attempt to increase market share. **Market penetration** is the least risky of all the four possible strategies in that there are fewer 'unknowns' – the market and product parameters remain the same. However, it is not risk-free as, 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 development and sale of new products or new developments of existing products in existing markets

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 4G mobile (cell) phones – and these brand new products can offer a distinctive identity to the business.

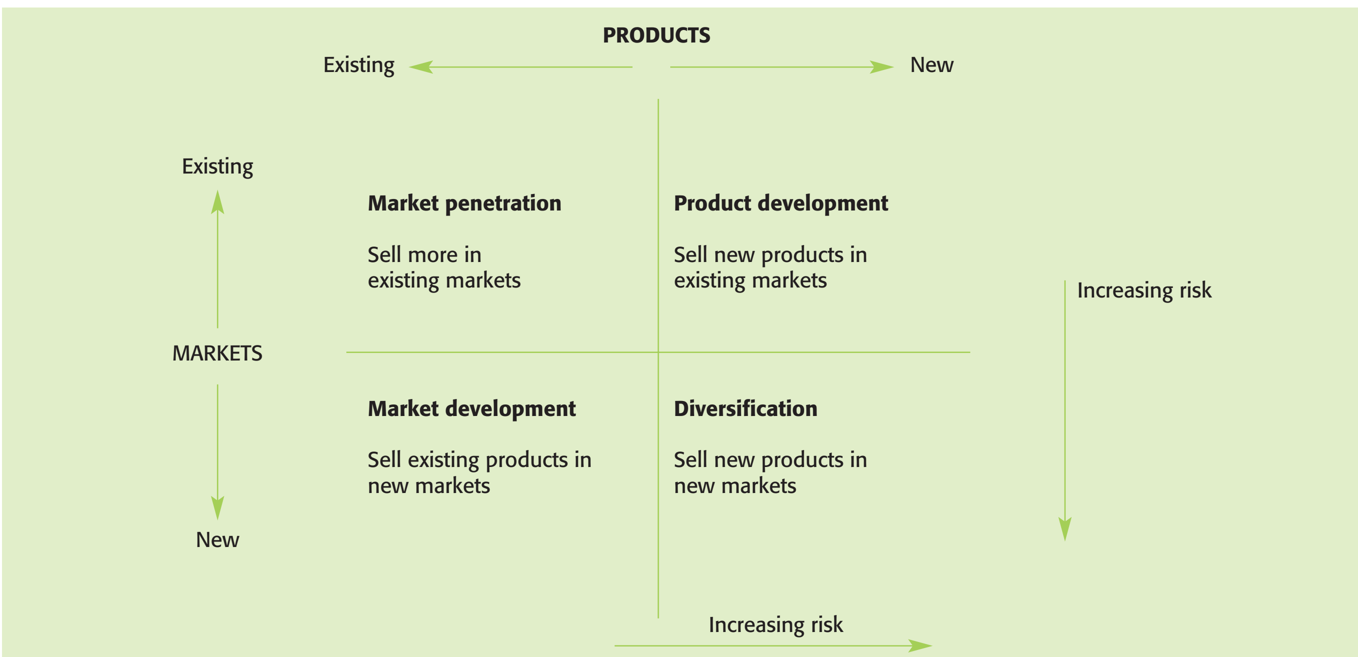


Figure 1.3.5 Ansoff's matrix

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 cold 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 expansion from a media empire to an airline and then a train operator, then into finance, is a classic

diversification: the process of selling different, unrelated goods or services in new markets

example of **diversification**, which was continued with the bid for the National Lottery in the UK. Tata Industries in India is another classic example of a very diversified business, making a huge range of products from steel to tea bags. Related diversification, e.g. backward and forward vertical integration in the existing industry, can be less risky than unrelated diversification, which takes the business into a completely different industry.

As the diversification strategy involves new challenges in both markets and products, it is the most risky of the four strategies. It may also be a strategy that is outside the core competences of the firm. However, diversification may be a possible option if the high risk is balanced out by the chance of a high profit. Other advantages of diversification include the potential to gain a foothold in an expanding industry and the reduction of overall business-portfolio risk.

Evaluation of Ansoff's matrix

Clearly, the risks involved in these four strategies differ substantially. By opening up these options, Ansoff's matrix does not direct a business towards one particular future strategy. However, by identifying the different strategic areas in which a business could expand, the matrix allows managers to analyse the degree of risk associated with each one. Managers can then apply decision-making techniques to assess the costs, potential gains and risks associated with all options. In practice, it is common for large businesses, in today's fiercely competitive world, to adopt multiple strategies for growth at the same time.

While Ansoff's analysis helps to map the strategic business options, it has limitations too. It only considers two main factors in the strategic analysis of a business's options – it is important to consider SWOT and STEEPLE (Chapter 1.5) analysis too in order to give a more complete picture. Recommendations based purely on Ansoff would tend to lack depth and hard environmental evidence.

Management judgement, especially based on experience of the risks and returns from the four options, may be just as important as any one analytical tool for making the final choice.

The matrix does not suggest – and to be fair to Ansoff, it was never intended to – actual detailed marketing options. For instance, market development may seem to be the best option but: which market/country and with which of the existing products produced by the business? Further research and analysis will be needed to supply answers to these questions.

ACTIVITY 1.3.9

CAFFÈ NERO AND ASDA – CONTRASTING STRATEGIES TO ACHIEVE GROWTH

Although both companies have similar objectives – sales growth, leading to profitability – Caffè Nero and Asda present an interesting contrast in business strategy. The coffee-bar operator is going for market development. Gerry Ford, Caffè Nero's chairman, has set a target of 100 branches to be opened in Turkey. He said that he was 'also looking around Europe and scouting out China'. He is confident of success in Turkey. He has appointed Isik Asur, a Harvard Business School graduate, who used to run the Starbucks operation in the country. He knows all about the changing consumer tastes in the country as well as the political, social and economic environment there.

Asda – the number-two supermarket chain in the UK – has decided on the strategies of market penetration and product development to build sales growth. New food stores will be opened in the next few years in an attempt to gain ground on Tesco. It aims to be the lowest-price supermarket to increase food sales further. In addition, it is expanding rapidly into non-food retailing. It plans to open ten new Asda Living stores, selling a huge range of items for the home – but not food.

Different businesses in different markets will often decide on different strategies for the future – even though overall objectives may be similar.

44 marks, 88 minutes

1. Analyse **two** reasons why companies like Caffè Nero and Asda need long-term plans to help them achieve their objectives. [8]
2. a. Identify **three** possible aspects of the Turkish consumer market that Caffè Nero might find useful in their strategic decision-making. [6]
   b. Analyse **two** reasons why an understanding of the Turkish consumer market would be useful to Caffè Nero. [8]
3. Using Ansoff's matrix, compare and contrast the different strategies being adopted by Caffè Nero and Asda. [10]
4. Discuss the factors that might influence the long-term plans or strategies adopted by businesses such as Caffè Nero and Asda. [12]

OVER TO YOU

Revision checklist

1. Differentiate clearly, with examples, between mission statements and vision statements.
2. What are often considered to be the practical limitations of mission statements?
3. State **four** factors that would help to ensure that corporate objectives are effective in assisting a business to achieve its aim.
4. Give an example of a SMART objective that could be set for your school or college.
5. Explain, with **two** examples, what corporate objectives a car manufacturing business could establish.
6. Why might short-term profit maximisation not be an appropriate objective for a car manufacturer?
7. Explain the meaning of the corporate objective 'increasing shareholder value'.
8. Why might the owners/directors of a small private limited company set a profit-satisficing objective?
9. Why might the objective of increasing shareholder value conflict with corporate social responsibility?
10. Why should departmental objectives be coordinated?
11. Why are more companies adopting objectives that include corporate social responsibility?
12. What do you understand by the term 'ethical code of conduct'?
13. Explain the possible benefits to a clothing retailer of strictly observing an ethical code when choosing and checking on its suppliers.
14. Why might some firms decide not to act ethically in a competitive market?
15. Using a business example from your own country, explain why its key corporate objectives might change over time.
16. Identify **two** factors under each of the SWOT headings for any business that operates in your country.
17. Select a business that operates in your country and give an example of how it could adopt a 'market penetration strategy'.
18. Select a business that operates in your country and give an example of how it could adopt a 'market development strategy'.
19. Select a business that operates in your country and give an example of how it could adopt a 'product development strategy'.
20. Select a business that operates in your country and give an example of how it could adopt a 'diversification strategy'.

Exam practice question

CORPORATE AND SOCIAL RESPONSIBILITY AT NIKE, INC.

The Nike 'Swoosh' logo is one of the most famous corporate symbols in the world. Nike, Inc. is an organisation that people look to as a leading sports brand and a business that encapsulates US corporate power and globalisation.

Nike, Inc.'s mission statement has two elements:

- To bring inspiration and innovation to every athlete in the world.
- If you have a body you are an athlete.

Much of Nike, Inc.'s success is based on the way it focuses on consumers in a sporting context and provides products which strongly support this. In recent years it has, like many multinational companies, suffered from adverse publicity on issues such as working conditions in its factories. It has tried to answer its critics by becoming a socially responsible organisation and communicating this to its stakeholders.

The following is a short extract from Nike, Inc.'s website (www.nikebiz.com) on its corporate social responsibility:

> Nike, Inc. shares the widely held view that climate change is a serious issue requiring immediate and meaningful action across government, industry, consumers and society. Nike, Inc. has made cutting greenhouse gas emissions across our operations, incorporating sustainability into the design of our products and reducing the overall environmental footprint a cornerstone of our environmental efforts.

Source: Adapted from www.nike.com

25 marks, 50 minutes

1. Explain the reason for Nike, Inc. having a mission statement. [4]
2. Analyse **two** strategic objectives that Nike, Inc. might try to achieve. [6]
3. Using Nike, Inc. as an example, outline the main components you might expect to see in its environmental audit. [6]
4. Evaluate the advantages and disadvantages to Nike, Inc. of aiming to be a socially responsible organisation. [9]

Key concept question

20 marks, 40 minutes

With reference to one or two organisation(s) that you have studied, discuss how organisational objectives may differ in two cultures that you are familiar with. [20]

1.4

Stakeholders

On completing this chapter you should be able to:

Analyse and apply:

- The interests of internal stakeholders (AO2)
- The interests of external stakeholders (AO2)

Evaluate:

- Possible areas of mutual benefit and conflict between stakeholders' interests (AO3)

Setting the scene

TATA NANO – WHICH STAKEHOLDERS BENEFIT FROM IT?

What makes the Nano so cheap?

It is three metres long, seats four, does 100 kilometres per hour and, when launched, aimed to revolutionise travel for millions. The 'People's Car' is also the cheapest in the world at 100 000 rupees (US$2600) – about the same price as a DVD player in a Lexus. When Ratan Tata, the company's chairman, unveiled the cute, snub-nosed car it was believed that it would allow millions of Asia's emerging middle classes to buy a car for the first time. 'This will change the way people travel in India and Asia. This is a car that will be affordable to millions of consumers for the first time,' he said when the car was launched. However, sales levels are currently way below those forecast – just 554 units in December 2013. Customers are being 'put off' by the car's poor safety record and the title of 'the world's cheapest car'. Tata plans to relaunch the car at a higher price with an improved specification under the advertising headline of 'celebrating awesomeness' – hoping to make the car profitable for shareholders once more.

The car is built in a factory in Sanand, Gujarat, offering relatively well-paid factory employment to many workers for the first time. India gains export revenue when the car is sold abroad. The steel and other materials used in the car are purchased from Asian suppliers, which help to boost local economies and suppliers.

The idea of millions of cheap cars such as the Nano on the road alarms environmental groups. Rajendra Pachauri, the UN's chief climate scientist, said that he was 'having nightmares' about the environmental impact. New Delhi, where air pollution levels are more than twice the safe limit, is registering 1000 new cars a day. Average speed of traffic at rush hour is 10 kilometres per hour and the government might be forced to spend much more on building new roads if Nano's ownership becomes more widespread. Bus operators also fear increased competition from private car users.

1.4

Points to consider

- List the groups of people who benefit from Nano's car production.
- List the groups who might be badly affected by the use of large numbers of small, cheap cars.
- Do you think Tata should attempt to reduce the potential conflicts between the interests of these groups?

Key concept link

Innovations such as 'the world's cheapest car' can have multiple impacts on stakeholder groups. Not all innovative products are commercially successful and the strategy of introducing the Tata Nano to the Indian market as a very cheap car seems to have failed. With the benefit of hindsight, how could this strategy have been implemented more successfully?

Introduction

The traditional view of business is often referred to as the shareholder concept. As the shareholders are the owners of the company, the firm has a legally binding duty to take decisions that will increase shareholders' value. Since directors and managers ultimately owe their position to shareholders, it is important to keep them satisfied. In recent times, this limited view of business responsibility has been extended to include the interests not just of the investors/owners but also of suppliers, employees and customers. This approach to business responsibilities does not end with these four groups, however. The **stakeholder concept** or theory is that there are many other parties involved and interested in business activity and that the interests of these groups – local communities, the public, government and pressure groups such as environmental lobbyists – should be considered by business decision-makers.

stakeholder concept: the view that businesses and their managers have responsibilities to a wide range of groups, not just shareholders

Who are the stakeholders?

Internal stakeholders

There are three main groups of internal stakeholders, each with their own set of interests in the business's activities. They include:

- employees
- managers
- shareholders.

External stakeholders

The external stakeholders and their interests include:

- customers
- suppliers
- government
- banks and other creditors

- special interest groups such as:
  - pressure groups that want to change a business's policy towards pollution or testing of chemicals on animals
  - community action groups concerned about the local impact of business activity
- competitors – fairness of competitive practices, strategic plans of the business.

Exam tip: Do not confuse the terms 'stakeholder' and 'shareholder'. Stakeholder is a much broader term that covers many groups, including shareholders.

Stakeholders' interests

Table 1.4.1 outlines specific interests that each stakeholder group has. It also outlines the responsibilities that businesses are often considered to have towards stakeholders.

Conflicting stakeholders' interests

Business decisions and activities can have both positive and negative effects on stakeholders, but it is rare for all stakeholders to be either positively or negatively affected by any one business activity. It is also possible for any one stakeholder group to experience both negative and positive effects from the same business decision. This is why conflicts of interest between stakeholder groups, with different objectives and interests, can arise. Table 1.4.2 outlines some business decisions and the conflict of stakeholders' interests that can result.

THEORY OF KNOWLEDGE

The fall of the Stanford Financial Group

In 2009 the world fell in on the billionaire Allen Stanford, owner of the Stanford Financial Group. It also fell in for the different stakeholders in Stanford Financial Group's organisation.

Stanford was one of the world's richest men. His $100 million fleet of private jets, the yacht off the coast of his adopted home of Antigua and the $10 million faux castle in Florida were certainly the trappings of a very rich man and owner of a successful (on the surface) finance business.

Antigua had become known as Stanford-land – he had a private terminal at the airport, had built a much-needed hospital, was so well-connected politically he was said to attend cabinet meetings and, with a fortune exceeding the island's GDP, was one of its biggest employers.

The 2008 financial crisis toppled his empire which was based on a giant Ponzi scheme. A Ponzi scheme is a fraudulent scheme where investors are offered very high return on their investments to attract in funds. The newly attracted funds are used to pay investors high returns and the owner (Stanford) even higher returns. The scheme works as long as new funds are attracted in but fails when this source of funds dries up.

Source: Adapted from www.telegraph.co.uk

1. Consider the different stakeholder groups affected by the Stanford Financial Group.
2. What role does knowledge play in establishing Ponzi schemes like Stanford's?
3. Discuss in your class the conflict between emotion and reason when individuals are offered financial rewards which are seen as 'too good to be true'.

Exam tip: Many examination questions involve the conflict of stakeholders' objectives. Remember that it is difficult for a business to meet all its responsibilities to all stakeholders at any one time. Compromise might be necessary – meeting as many stakeholders' objectives as possible or meeting the needs of the most important group in each situation.

	Stakeholders' interests	Business's responsibilities to stakeholders
Employees	• Employment security • Wage levels and benefits that compare well with similar jobs in other businesses • Good conditions of employment, e.g. health and safety • Some participation in decision-making within the business	• Adhere to country's laws that outline business responsibilities to workers – such laws are stricter in some countries than in others • Some businesses also provide training and job security, pay more than minimum wages, offer good working conditions, involve staff in some decision-making
Managers	• Employment security • Salary and benefits that compare well to similar posts of responsibility in other businesses • Responsibilities offered and status of the post • Opportunity for profit sharing or share purchase scheme	• Job security • Competitive salaries and other benefits • Opportunities for responsibility and career advancement
Shareholders	• Annual dividends at a level at least comparable to similar businesses • Share price rising over time • Security of investment • Ability to sell shares when required	• Incorporated businesses should be operated in accordance with company's law • Annual accounts presented to shareholders • Strategies taken to increase shareholders' value over time
Customers	• Value for money • Product quality and safety • Guarantees • Service levels • Long-term rewards for loyalty	• Not to break the laws on consumer protection and accurate advertising • Not taking advantage of vulnerable customers, such as the elderly, and not using high-pressure selling tactics • Giving customers assurances about quality, delivery dates, service levels and continued supplies of vital components and materials
Suppliers	• Speed of payment • Level and regularity of orders • Fairness of treatment, e.g. not being exploited by a very large customer business	• Establish effective two-way relationships that are of benefit to the business and suppliers • Avoid excessive pressure on smaller or weaker suppliers to cut prices • Pay fair prices and pay invoices promptly
Government	• Creation of jobs and incomes that boost the economy • Taxes paid, e.g. Profit tax • Value of output produced as this adds to GDP • Impact on wider society, e.g. is production environmentally sustainable?	• Pay profit tax • Keep accurate accounting records so true profit can be shown • Provide information to government as requested • Keep within all legal limits, e.g. on employment contracts and pollution levels
Banks and other creditors	• Security of their loans and the ability of the business to repay them • Prompt payment of interest and capital owed by the business	• Pay interest • Pay back capital owed
Special interest groups	• Pressure groups – campaigning to achieve a change in business decisions/activities • Local community – encouraging business to act in community's interests and to avoid harmful production methods	• Pressure groups – recognise genuine concern over business activity; business may respond by changing decisions or operations • Local community – avoid pollution and other damaging operations; support for local groups
Competitors	• Fairness of competitive practices • Strategic plans of the business	• To compete fairly and within the law • It is *not* a responsibility of business to provide details of its strategic plans to competitors

Table 1.4.1 Stakeholders' interests and business's responsibilities to stakeholders

ACTIVITY 1.4.1

MAJOR PALM OIL COMPANIES ACCUSED OF BREAKING ETHICAL PROMISES

Palm oil is one of the world's most versatile raw materials. It is estimated that it is an ingredient in 50% of all products sold by a typical supermarket. It is used in a wide range of products from margarine, cereals, crisps, sweets and baked goods to soaps, washing powders and cosmetics but it is often listed as just 'vegetable oil'. So, its production benefits customers of these products. In addition, an estimated 1.5 million small farmers grow the crop in Indonesia, along with about 500 000 people directly employed in the sector in Malaysia, plus those connected with related industries. The governments of these countries have encouraged production as it is a major export for these economies.

Destruction caused by palm oil production

However, the industry has a poor image. Palm oil production has led to deforestation with a resulting negative impact on climate change. There has been substantial loss of wildlife habitat, even endangering the orangutan. Palm oil companies have been accused by community groups of driving native people off their land which is then used for palm oil production. **Socially responsible businesses**, such as KL Kepong in Malaysia, have agreed to an ethical code which aims to make palm oil production 'sustainable' with fair treatment for all local populations affected by it. However, many companies have been accused of breaking the code as there is no strong world body to stop them behaving irresponsibly. In any case, food manufacturers want to **maximise profits** and final consumers want the cheapest raw materials possible.

27 marks, 54 minutes

1. Define the following terms highlighted in the article:
   a. socially responsible business [2]
   b. maximise profits. [2]
2. Explain the interests of any **two** of KL Kepong's stakeholder groups. [6]
3. Analyse the impact on these **two** stakeholder groups of a decision by KL Kepong to close one of its palm oil plantations. [8]
4. Discuss why an expansion of the palm oil industry in either Malaysia or Indonesia is likely to cause conflicting views between stakeholder groups. [9]

ACTIVITY 1.4.2

Business decision/ activity	Impact on:	
	Employees	**Local community**
Expansion of the business	✔ More job and career opportunities ✘ More complex lines of communication after expansion	✔ More jobs for local residents and increased spending in other local businesses ✘ External costs caused by increased traffic and loss of green fields for amenity use
Takeover of a competing firm (horizontal integration)	✔ The larger business may be more secure and offer career promotion opportunities ✘ Rationalisation may occur to avoid waste and cut costs – jobs might be lost	✔ If the business expands on the existing site, local job vacancies and incomes might increase ✘ Rationalisation of duplicated offices or factories might lead to closures and job losses
New IT introduced into production methods	✔ Training and promotion opportunities might be offered ✘ Fewer untrained staff will be required and those unable to learn new skills may be made redundant	✔ Local businesses providing IT services could benefit from increased orders ✘ Specialist workers may not be available locally, so more staff may need to commute

Table 1.4.2 Potential conflicts of interest between stakeholder groups

15 marks, 30 minutes

1. In the three examples in Table 1.4.2, analyse the likely positive and negative effects on **two** other stakeholder groups. [6]
2. State **two** other examples of business decisions. Try to use actual and recent examples from your own country. Analyse the potential conflicts of interest between any **three** stakeholder groups. [9]

Can all stakeholders benefit from business activity?

Is it misleading to suggest that business decisions or activities always lead to significant conflict between stakeholder groups? Possibly, yes. Read the following case study activity. It indicates that business can be operated in ways that lead to mutual benefits for most – if not all – stakeholders.

ACTIVITY 1.4.3

JLP – ARE ALL STAKEHOLDERS SATISFIED?

The success of the John Lewis Partnership (owning John Lewis department stores and Waitrose supermarkets) shows that giving all employees a substantial stake in the performance of a business and opportunities to influence management decisions has advantages. The 2013 annual employee profit share bonus was 17% of their salaries – up from the 14% of the previous year. This annual bonus is one reason why JLP has the lowest rate of labour turnover of any major UK business.

According to Charlie Mayfield, the chairman of the Partnership, the 'we're all in this together' spirit is central to the modern growth of John Lewis and Waitrose. Sales at JLP outlets are rising at a faster rate than for other competing retailers, showing that customers increasingly appreciate the 'never knowingly undersold' promise of the business and its huge range of quality, value for money products. Local communities and central government benefit from the huge investment programme of JLP – it spent £200 million on new stores and refitting existing ones even when the UK economy was in recession. Suppliers are competing strongly with each other to make sure that their products are displayed in the JLP stores as it gives brands additional prestige. JLP claims that all major strategies consider ethical and CSR issues as well as their potential profitability.

Perhaps only JLP's competitors might feel aggrieved at the success of this business. But some business analysts claim that even rival retailers can benefit from JLP's growth – for example, by copying some of its practices and business models. The performance of the Sports Direct stores has been transformed since the business introduced a generous employee share ownership scheme.

16 marks, 32 minutes

1. Explain how **two** internal stakeholder groups and **two** external stakeholder groups can benefit from rising sales and profits at JLP. [8]
2. Discuss whether stakeholders can gain mutual benefits in all business organisations. [8]

THEORY OF KNOWLEDGE

Imperial Tobacco to close factories in UK and France

Despite recently announcing a 16.7% rise in annual profit to £1.26 billion, Imperial Tobacco is closing two of its last cigarette-making factories in Western Europe – in the UK and France. Up to 1000 jobs will be lost at the two factories and trade unions have promised to oppose the closures. Union leaders accuse Imperial Tobacco management of putting shareholders first by relocating production to low-labour cost countries in Eastern Europe. An Imperial Tobacco spokesperson said that these decisions had been partly driven by falling cigarette sales in high-income countries as a result of government and pressure groups' campaigns against smoking which highlight the serious health risks. The lack of this kind of bad publicity in countries such as Turkey, Greece and Russia means that these are the markets Imperial Tobacco is targeting – and these are the countries in which cigarettes will, increasingly, be produced.

1. Comment on the conflict in stakeholders' interests that arises from the article.
2. Discuss the ethical questions businesses face when they make job cuts.

Evaluating stakeholder conflict

One way of reducing conflict is to compromise. For example, a business aiming to reduce costs may close one of its factories in stages rather than immediately to allow workers time to find other jobs but, as a result, 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, but the new site might be more expensive. The introduction of 24-hour flights at an airport – to the benefit of the airlines and passengers – may only be accepted if local residents are offered sound insulation in their homes, thereby increasing costs for the airport and airlines.

Clearly, senior management must establish its priorities in these situations. They need to decide who the most important stakeholders are in each case, what the extra cost of meeting the needs of each stakeholder group will be, and whether bad publicity resulting from failure to meet the interests of one group will lead to lost revenue – perhaps this will be greater than the cost savings of not satisfying this group.

Table 1.4.3 considers methods available to businesses to reduce stakeholder conflict, and the potential advantages and disadvantages of each.

Method of conflict resolution	Advantages	Disadvantages
Arbitration – to resolve industrial disputes between workers and managers	An independent arbitrator will hear the arguments from both sides and decide on what they consider to be a fair solution. Both sides can agree beforehand whether this settlement is binding, that is they have to accept it.	Neither stakeholder group will be likely to receive exactly what they wanted. The costs of the business might rise if the arbitrator proposes higher wages or better work conditions than the employer was originally offering.
Worker participation – to improve communication, decision-making and reduce potential conflicts between workers and managers, e.g. works councils, employee directors	Workers have a real contribution to make to many business decisions. Participation can motivate staff to work more effectively.	Some managers believe that participation wastes time and resources, e.g. in meetings that are just 'talking shops', and that the role of the manager is to manage, not the workers. Some information cannot be disclosed to staff other than senior managers, e.g. sensitive details about future product launches.

Table 1.4.3 Methods to reduce stakeholder conflict – advantages and disadvantages [*table continues over*]

Method of conflict resolution	Advantages	Disadvantages
Profit-sharing schemes – to reduce conflict between workers and shareholders over the allocation of profits and to share the benefits of company success	The workforce is allocated a share of annual profits before these are paid out in dividends to shareholders. Sharing business profits can encourage workers to work in ways that will increase long-term profitability.	Paying workers a share of the profits can reduce retained profits (used for expansion of the business) and/or profits paid out to shareholders, unless the scheme results in higher profits due to increased employee motivation.
Share-ownership schemes – to reduce conflict between workers, managers and shareholders	These schemes, including share options (the right to buy shares at a specified price in the future) aim to allow employees (at all levels including directors) to benefit from the success of the business as well as shareholders. Share ownership should help to align the interests of employees with those of shareholders.	Administration costs, negative impact on employee motivation if the share price falls, dilution of ownership – the issue of additional shares means that each owns a smaller share of the company. Employees may have to stay with the company for a certain number of years before they qualify, so the motivation effect on new staff may be limited.

Table 1.4.3 *Continued*

LEARNER PROFILE

Communicators

Communicators understand and express ideas and information confidently and creatively in more than one language and in a variety of modes of communication. – IB learner profile

Samsung is one of the world's biggest companies. It is a giant Korean conglomerate that produces everything from mobile phones to ships to televisions. It is even involved in services like insurance and theme parks. Its turnover is $268 billion and it employs 427 000 people.

Dr Oh-Hyun Kwon is the CEO of Samsung. Dr Kwon has a BSc in Electrical Engineering from Seoul National University, an MSc in Electrical Engineering from KAIST (Korea Advanced Institute of Science and Technology) and a PhD in Electrical Engineering from Stanford University, USA. He has been with the business since 1985.

Source: Adapted from www.samsung.com

Discuss with your class the importance of the chief executive officer (CEO) of a business being an effective communicator like Dr Oh-Hyun Kwon, the CEO of Samsung.

ACTIVITY 1.4.4

DAILY RECORD: 'MERGER RESULTS IN JOB LOSSES'

The merger of two of the largest airlines in the country will lead to job losses, reports the *Daily Record*. Special Air and Flights4U have announced a huge merger which will result in a business worth over $2 billion. The long-term plans are to offer more routes and cheaper prices to passengers. The merger has the support of the government as it is expected to keep inflation down and boost tourist numbers into the country.

Non-profitable routes to small regional airports are to be closed, together with Special Air's headquarters in New City. More than 500 staff are expected to lose their jobs, resulting in annual savings of over $10 million. Trade union leaders are threatening to take industrial action to support workers who will lose their jobs. The local governments in the towns which are losing routes are very worried about the impact on local suppliers of fuel and food to the airlines. The chief executive of Flights4U said: 'Sure, there will be losers from this merger, but there will be many more winners as we expand our operations from the major cities.'

32 marks, 64 minutes

1. Are the two airlines focused on shareholders' interests or other stakeholders' interests? Explain your answer. [10]
2. Why is it difficult in this case for the two merging companies to meet their responsibilities to all stakeholder groups? [6]
3. Why might the negative impact on some stakeholders mean that the merger will not turn out to be as profitable as expected? [6]
4. Discuss how the newly merged business could attempt to meet some of its responsibilities to the stakeholder groups worst affected by this decision. [10]

OVER TO YOU

Revision checklist

1. Distinguish between the shareholder concept and the stakeholder concept.
2. Explain why a business might experience lower profits by meeting its stakeholders' objectives.
3. Explain why a business might experience higher profits by meeting its stakeholders' objectives.
4. Outline the responsibilities a business in the oil industry might have towards **two** stakeholder groups.
5. Outline the responsibilities a tertiary sector business might have towards **two** stakeholder groups.
6. What do you understand by the term 'conflicts between stakeholders' interests'?
7. Explain an example, from your own country, of a business decision that involves a conflict of stakeholders' interests.
8. Explain **three** examples of potential stakeholder conflict of interests.
9. Evaluate how each of the conflicts you identified in question 8 might be resolved.

Exam practice question

FURY AT BANGLADESH MINE SCHEME

A huge open-cast coal-mining project by a British firm, which would involve moving the homes of up to 130 000 workers in Bangladesh, is at the centre of an international row. The company, GCM, plans to extract up to 570 million tonnes of coal in a project that will displace people from Phulbari, in north-west Bangladesh. A river will have to be diverted and the mangrove forest, which is a world heritage site, would be destroyed too.

The project has attracted widespread hostility. In protests against the scheme 18 months ago, three people were killed in an area now said to be controlled by the armed forces. Many international campaign groups have written to the Asian Development Bank demanding that it turns down a $200 million loan for the project. The World Development Movement is claiming that the social and environmental damage can never be repaired if the scheme receives government approval. A spokesperson for GCM, on the other hand, stressed the importance of jobs, incomes and exports to one of the world's poorest countries.

25 marks, 50 minutes

1. Using examples from the case study, explain the differences between internal and external stakeholders. [4]
2. Explain the benefits of any **two** stakeholder groups resulting from this mine project. [6]
3. Explain the disadvantages to any **two** stakeholder groups resulting from this mine project. [6]
4. Discuss the ways in which GCM could reduce the impact of the disadvantages it has created for stakeholder groups negatively affected by the mine. [9]

Protests in Dhaka over the mine project

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, examine the influence of culture and ethics on different stakeholder groups. [20]

1.5

External environment

On completing this chapter you should be able to:

Analyse, apply and prepare:

- STEEPLE analysis of a given organisation (AO2) and (AO4)

Evaluate:

- Consequences of a change in any of the STEEPLE factors for a business's objectives and strategy (AO3)

Setting the scene

US CREATES 288 000 JOBS IN JUNE AS UNEMPLOYMENT RATE DROPS TO 6.1%

Job creation data far exceeds analysts' expectations as US economy records fifth straight month of job growth. Pressure to increase interest rates rises. Dollar exchange rate weakens against pound sterling.

CHINA INTRODUCES NEW CONSUMER PROTECTION LAW

The new law introduces a number of important reforms to the Chinese retail environment: in allegations of counterfeiting, the onus of proof is now on the retailer to prove their innocence for the first six months after the sale, rather than on the consumer to prove wrongdoing all the time, as previously took place. Penalties for fraud and false advertising have been increased; retailers are now required to accept goods for return within seven days of purchase unless agreed otherwise; for online and other types of delivery purchases, consumers are not required to provide a reason for returns.

JAPAN'S POPULATION SUFFERS BIGGEST FALL IN HISTORY

The population across the Japanese archipelago dropped by around 284 000 to an estimated 127.5 million by October 2013, according to figures compiled by the government's Internal Affairs and Communications Ministry. The number of elderly people aged 65 or over surpassed 30 million for the first time, accounting for as much as 24% of the population – in contrast to children aged 14 and under which decreased to a record low of 13%.

Points to consider

- These three examples of external environmental factors were all reported on in 2014. Explain how each one might affect a retailing business operating in the countries concerned.
- Explain why businesses should analyse the external environment in which they operate.
- Give two further examples of recent changes in the external business environment in your country.

Key concept link

Business strategy should be centred on the objectives of the organisation but must also consider internal strengths, weaknesses, opportunities and threats (SWOT). A further important influence on strategy is the macro-environment – the external factors that can impact on business activities. STEEPLE analysis considers these external constraints and opportunities and business often adapts strategies or adopts new ones after this analysis.

Introduction

This chapter assesses the importance of external influences on business performance and decision-making. Businesses depend for their survival on understanding and responding to external factors that are beyond their control. Many of the factors are 'constraints' because they may limit the nature of decisions that business managers can take. The legal requirements imposed by governments, on environmental pollution for example, are one of the most obvious constraining influences on business activity. However, external influences can also create opportunities and enable a business to become even more successful – introducing new technology in advance of rival firms is one example.

STEEPLE analysis

STEEPLE analysis: an acronym standing for social, technological, economic, environmental, political, legal and ethical external factors that impact on business; it refers to a framework for analysing the external environmental factors affecting business objectives and strategies

This is an outline of the **STEEPLE** factors:

Social: Social factors include population size and structure, lifestyle, age groups and education levels

Technological: Factors include the state of the technological advancement and introduction of new technologies

Economic: Factors such as the GDP growth rate, inflation rates, interest rates, exchange rates

Environmental: Includes weather and climate of the region, the flora and fauna of the region, environmental pressure group activity

Political: Factors such as the type of government that exists and its ideology as shown by its attitude to free markets, imposition of tariffs, business incentives offered and the stability of the government

Legal: The legal factors include any law influencing business activity, e.g. competition law, health and safety at work, consumer protection, employee protection

Ethics: The general code of ethics followed by most people in the country, and the tendency of people to be ethical.

Managers undertake STEEPLE analysis to assess the importance of the major external influences and future changes in them on their organisation's future activities. It is particularly useful when a business is planning new strategies such as entering new markets or developing new products.

STEEPLE analysis may be conducted regularly to allow a business to review its objectives and strategies in the light of external changes. Some businesses may only do this form of analysis as a one-off instance when a major decision needs to be taken. This is likely to be less effective than regular STEEPLE reviews which monitor changes to the external environment. It is the responsibility of managers to decide which of the key STEEPLE factors are relevant to their business. The analysis itself can be undertaken by managers alone or with the participation of other workers. It is often combined with SWOT analysis which assesses internal factors that could influence future business objectives and strategies.

Preparing STEEPLE analysis

Table 1.5.1 shows the structure of a simplified STEEPLE analysis for McDonald's restaurants which the company would carry out when planning to enter a national market for the first time. The company would seek answers to all the following questions before judging the suitability of this country for expansion. Other businesses might consider different factors as being important.

internet: the worldwide web of communication links between computers

economic growth: increases in the level of a country's gross domestic product or GDP (total value of output)

recession: six months (two quarters) of falling GDP (negative growth)

unemployment: the number of people in an economy willing and able to work who cannot find employment

exchange rate: the value of one currency in terms of another currency

Social issues	**Technological issues**
• How are dietary trends changing and how different are customer tastes from those in other countries (e.g. cultural and religious factors)? • What proportion of couples both work – less time to prepare meals? • Growing health consciousness – is the demand for healthy foods increasing? • Is the population ageing? Do the elderly buy more or fewer fast-food meals than the young? • Is the population growing?	• Can the food production process be automated? Is technical support available? • Online selling – is full **internet**/broadband coverage available? Will customers order online? • Are IT support services available locally?
Economic issues	**Environmental issues**
• **Economic growth** – is this slowing or even negative (**recession**)? • **Unemployment** – is this rising and reducing consumer incomes? • Interest rates – are these high or low? • **Exchange rate** – is this likely to appreciate or depreciate? • Is the government's fiscal policy likely to lead to increases or reductions in consumer incomes?	• Environment – is environmentally friendly packaging technically possible and available in this country? • Are waste-recycling facilities available? • Is sustainable/renewable energy available in this country? • Are environmental pressure groups powerful in this country?
Political issues	**Legal issues**
• Is the government stable and are there likely to be any demonstrations against the government? • Are government grants available for setting up in the country? • Is the government committed to increasing or reducing taxes? • Does the country belong to a free-trade area or political unions? • Does the government put tariffs or quotas on imported goods? For example, supplies needed from the USA for McDonald's restaurants.	• Political stability of the country – is civil unrest likely? • Employee and consumer protection laws – how restrictive are these, e.g. health and safety laws? • Trade restrictions or membership of free-trade bloc – can food be imported without tariffs? • Environmental regulations – what forms of packaging of fast food are allowed? • Health concerns about fast food – could the government pass new laws about the contents of fast-food products?
Ethical issues	
• Are there high ethical standards in public and commercial life in this country? • Do suppliers treat workers ethically? • Is bribery and corruption widespread in this country?	

Table 1.5.1 Example of possible STEEPLE analysis for McDonald's restaurants

ACTIVITY 1.5.1

Prepare a STEEPLE analysis for a foreign fashion retailer planning to set up a chain of shops for the first time in your country.

Social and cultural influences

The structure of society is constantly evolving. The changes occurring in many countries include:

- an ageing population with reduced birth rates and longer life expectancy, although in some nations the average age is falling due to high birth rates
- changing role of women – increasingly seeking employment and posts of responsibility in industry
- improved education facilities – resulting in increasing literacy and 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 (in some countries) – creating increasing numbers of single-person households
- job insecurity, often created by the forces of globalisation – forcing more employees to accept temporary and part-time employment (some workers prefer this option)
- increased levels of immigration – resulting in changing and widening consumer tastes as different ethnic groups tend to have different preferences, e.g. for clothing and food.

This list is by no means complete. You could add to it from your knowledge of the changes occurring in your own society. How do these changes impact on business objectives and strategies? We will look at two of these changes – an ageing population and patterns of employment – but the analysis used can be adapted when considering the impact of the many other social changes.

An ageing population

The main effects associated with an ageing population are:

- a larger proportion of the population over the age of retirement
- a smaller proportion of the population in lower age ranges, e.g. 0–16 years old
- a smaller number of workers in the economy but a larger number of dependants, that is below working age or retired – this puts a higher tax burden on the working population.

Business objectives and strategy will need to adapt to:

- patterns of demand – there will be more 'grey' consumers than teenagers and they buy different products. Therefore, a construction company might switch from building large apartments for families to smaller units with special facilities for the elderly. Market research will be important for a business that believes the demand for its portfolio of products could change as the population ages.
- change in the age structure of the workforce – there may be reduced numbers of youthful employees available, and businesses may need to adapt their workforce planning to enable the employment of older workers, or to keep existing workers beyond retirement age. Although younger employees are said to be more adaptable and easier to train in new technologies, older workers may show more loyalty to a business and will have years of experience that could improve customer service.

Changing patterns of employment

The main features of changing patterns of employment include:

- an increase in the number of women in employment and in the range of occupations in which they are employed

- an increase in student employment on a part-time basis – some industries are substantially staffed by students and part-timers, e.g. McDonald's; most other fast-food shops and supermarkets are largely staffed in this way
- an increase in temporary, part-time and flexible employment contracts – these are introduced by employers to reduce the fixed costs of full-time and salaried posts and to allow for flexibility when faced with seasonal demand or uncertainties caused by increasing globalisation
- more women taking maternity leave and then returning to work.

Many countries are increasingly multicultural and this also has an effect on the pattern of women at work. In the UK, 33% of women of Pakistani origin and 20% of women of Bangladeshi origin seek full-time employment. In the UK as a whole, 75% of women seek full-time employment.

Many businesses employ mainly part-time staff – this can be beneficial for both the employer and the workers

Firms can make these changes work to their benefit, while accepting some of the cost implications. Part-time workers can offer a firm much greater flexibility by being available at peak times and this will help to keep down overheads. Yet part-time and temporary staff can be difficult to mould into a team and may not contribute as much as a result.

By employing more females and removing barriers to their progress and promotion, firms can benefit from a wider choice of staff and improved motivation among women workers. However, there will be the increased costs of maternity leave and of providing staff cover for this. As with all other external influences on business behaviour, the most successful firms will be those that adapt to changes the most quickly and attempt to turn them to their own competitive advantage.

ACTIVITY 1.5.2

Consider Table 1.5.2 and then answer the questions that follow.

	2000		2010		2020 (estimated)	
	(000s)	%	(000s)	%	(000s)	%
Total labour force	7042.0		9572.5		12 939.6	
Age distribution		**100.0**		**100.0**		**100.0**
15–24	2014.0	28.6	2498.4	26.1	3118.4	24.1
25–34	2204.1	31.3	2977.0	31.1	4114.8	31.8
35–54	2436.5	34.6	3608.8	37.7	4994.7	38.6
55–64	387.4	5.5	488.2	5.1	711.7	5.5
Educational attainment		**100.0**		**100.0**		**100.0**
Primary only	2380.2	33.8	2604.3	27.2	1643.3	12.7
Lower and middle secondary	4042.1	57.4	5624.5	58.8	6767.4	52.3
Tertiary (university)	619.7	8.8	1343.7	14.0	4528.9	35.0
Labour force participation rate		**65.3**		**65.5**		**68.1**
Male		85.6		85.4		86.4
Female		44.1		44.5		49.0

Table 1.5.2 Profile of a country's labour force, 2000–2020 (in 000s)

20 marks, 40 minutes

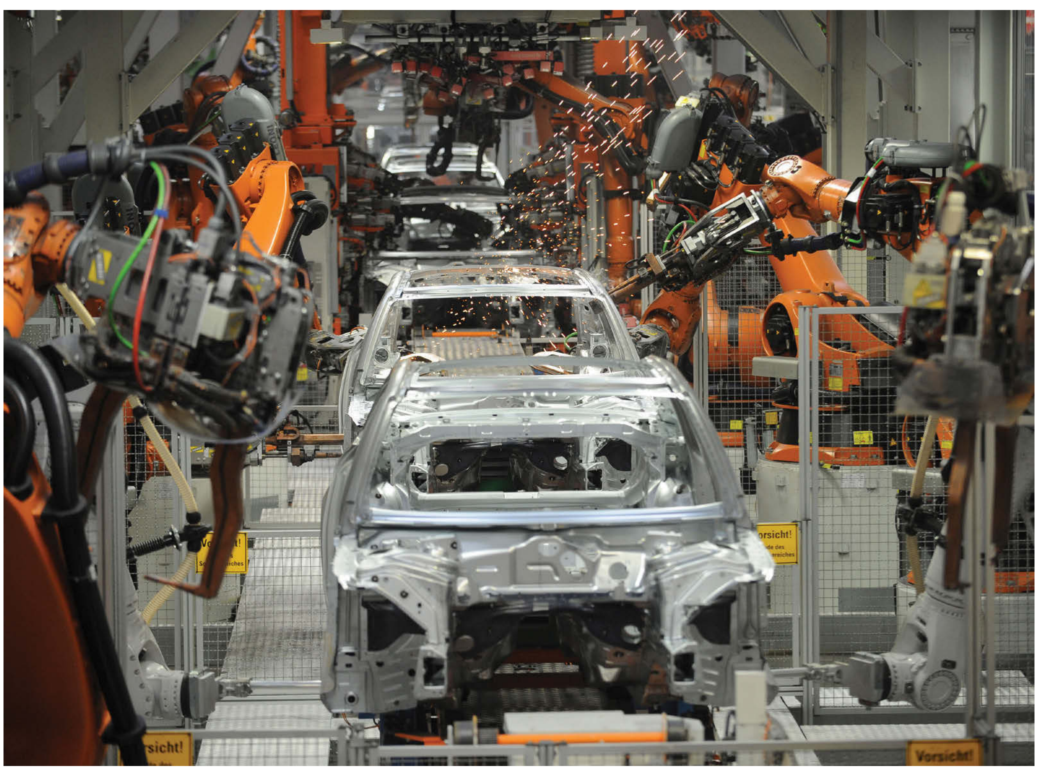
1. Calculate the forecasted percentage increase in the labour force between 2000 and 2020. [2]
2. Using the data in the table, describe the changes that are forecasted to take place in the age distribution of the working population of the country. [4]
3. Using the data in the table, describe the changes that are forecasted to take place in the educational attainment of the population of the country. [4]
4. Discuss the impact the changes in demography and educational attainment shown in the table might have on a business's human resource management. [10]

Impact of technology

In its simplest form, technology means the use of tools, machines and science in industry. This section assesses the impact on businesses of the relatively recent introduction of high-technology machines and processes that are based on **information technology** (IT).

Technological change is affecting all businesses and all departments within business. Table 1.5.3 explains some of the most common business applications of IT, the departments likely to benefit most from them and the potential advantages to be gained.

In addition to these uses of technology, advances in technical knowledge are opening up new product markets, such as hydrogen-powered cars and 'flexible' mobile phones. The use of technology to develop new products is part of the research and development function of businesses.



The use of computer-controlled robots has increased productivity in car manufacturing

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

Exam tip: It is wrong to assume that a business must always use the latest technology in all circumstances. There are substantial costs to be paid and some businesses thrive on using old-fashioned methods. For example, handmade designer furniture will sell because each piece is unique and computer-controlled robots might be completely impractical.

Impact on objectives and strategies

Technological developments have led to businesses focusing their objectives on IT-based capabilities and adopting new strategies to embrace and fully exploit new opportunities.

Focus on new product development

Information technology has reduced the time it takes new products to reach the market. Companies quickly establish new product requirements by gathering market information from databases, customers and sales representatives. Computer-assisted design and manufacturing software speed up manufacturing, while communication technologies allow global teams to work on different components of a product simultaneously. From innovations in microprocessors to efficient consumer payment systems, IT helps businesses respond quickly to changing customer requirements and this is now the focus of the objectives set by most businesses.

Improve stakeholder communication

Improving communication with all stakeholders is another important objective of information technology. Using global 24/7 interconnectivity, a customer service call originating in Paris, France, ends up in a call centre in Manila, Philippines, where a service agent could look up the relevant information on servers based in corporate headquarters in Auckland, New Zealand, or in Frankfurt, Germany. Public limited companies use their investor relations' websites to communicate with shareholders and financial analysts.

Developing new and better processes

Process improvement is another important IT business objective. Enterprise resource planning (ERP) systems allow managers to review sales, costs and other operating data on one integrated software platform and communicate with suppliers and customers about each order or contract. An ERP system may replace many old technology systems for finance, human resources and procurement making internal processes more efficient and cost-effective.

Cost benefits

Initial IT purchase and implementation costs can be substantial and there will be employee training costs – and possibly redundancy expenses too. However, the resulting long-term cost savings usually justify the investment. IT allows companies to reduce many operational costs. IT-based operational solutions, from word processing to email and the internet, have allowed companies to save on the costs of duplication, postage and promotion, while maintaining and improving product quality and customer service.

Competitive advantage

All of the preceding benefits could allow a business to improve its competitive advantage in the marketplace. If a smartphone developer announces a new device with innovative touchscreen features and a larger screen, the competitors must quickly follow suit with similar products or risk losing market share. Companies can use rapid software simulations and other IT-based systems to bring a product to market cost-effectively and rapidly.

Outsourcing and offshoring – the impact of globalisation

IT developments have been at the core of operating systems essential for globalisation, such as telecommuting and outsourcing. A company can outsource most of its non-core functions, such as human resources and call centres, to offshore companies and use network technologies to stay in contact with its overseas employees, customers and suppliers.

Information technology application	Common business applications	Impact on business
Spreadsheet programs	• Financial and management accounting records can be updated and amended. • Cash flow forecasts and budgets can be updated in the light of new information. • Changes in expected performance can be inputted to the spreadsheet and changes in total figures made automatically. • Income statements and balance sheets can be drawn up frequently.	• Flexibility and speed – changes to accounting records can be made quickly and the impact of these on total figures can be demonstrated instantly. • 'What-if' scenarios in budgeting and sales forecasting can be demonstrated, e.g. what would happen to forecasted profits if sales rose by 10% following a 5% cut in price?
Computer-aided design (CAD)	• Nearly all design and architectural firms now use these programs for making and displaying designs, e.g. cars, house plans, furniture, garden designs. • Designs can be shown in 3D and 'turned around' to show effect from all angles.	• Saves on expensive designer salaries as work can be done more quickly. • More flexibility of design as each customer's special requirements can be easily added. • Can be linked to other programs to obtain product costings and to prepare for ordering of required supplies.
Computer-aided manufacturing (CAM)	• Programs are used to operate robotic equipment that replaces many labour-intensive production systems. • Used in operations management in manufacturing businesses.	• Labour costs are reduced as machines replace many workers. • Productivity is increased and variable costs per unit are lower than in non-computerised processes. • Accuracy is improved – less scope for human error. • Flexibility of production is increased – modern computer-controlled machinery can usually be adapted to make a number of different variations of a standard product, and this helps meet consumers' needs for some individual features. • All of these benefits can add to a firm's competitive advantage.

Table 1.5.3 Impact of applications of technology on business [*table continues over*]

computer-aided design (CAD): using computers and IT when designing products

computer-aided manufacturing (CAM): the use of computers and computer-controlled machinery to speed up the production process and make it more flexible

Information technology application	Common business applications	Impact on business
Internet/intranet	• Marketing department – for promoting to a large market and taking orders online (see Chapter 4.8 for discussion of e-commerce). • Operations management – business-to-business (B2B) communication via the internet is used to search the market for the cheapest suppliers. • Human resources uses these systems for communicating within the organisation. • Intranets allow all staff to be internally connected via computers.	• Cost savings from cheap internal and external communications. • Access to a much larger potential market than could be gained through non-IT methods. • Web pages project a worldwide image of the business. • Online ordering is cheaper than paper-based systems. • B2B communications can obtain supplies at lower costs. • Internal communication is quicker than traditional methods.

Table 1.5.3 *Continued*

ACTIVITY 1.5.3

Research task: Use the internet to research one of the following and write a report explaining the potential impact on objectives and strategy of any one well-known business in your country: CAD, CAM and RFID (Radio Frequency ID tagging).

Impact on management and labour relations

Labour relations can be damaged if technological change is not explained and presented to workers in a positive way with the reasons for it fully justified. If many jobs are being lost during the process of change, then remaining workers may suffer from reduced job security, and this could damage their motivation levels. Trade unions can oppose technological change if it puts members' jobs at risk. However, if the issue is handled sensitively, including effective communication with and participation of employees, introducing new technology in the right way can improve industrial relations.

Some managers fear change as much as their workforce, especially if they are not very computer literate themselves. In addition, recognising the need for change and managing the technological change process require a great deal of management skill. However, IT can improve productivity greatly and lead to improved company efficiency – for example, the use of database programs to control stock ordering to achieve just-in-time advantages. Technology has other benefits too:

- Managers can obtain data frequently from all departments and regional divisions of the business.
- Computers can be used to analyse and process the data rapidly so that managers can interpret data and take decisions quickly on the basis of the analysis.
- It accelerates the process of communicating decisions to other managers and staff.

Information gives managers the opportunity to review and control the operations of the business. IT-based management information systems provide substantial power to centralised managers. Although this could be used for improving the performance of a business, there are potential drawbacks:

- The ease of transferring data electronically can lead to so many messages and communications that 'information overload' occurs. This is when the sheer volume of information prevents decision-makers from identifying the most important information and decisions.
- The power which information brings to central managers could be abused and could lead to a reduction in the authority and empowerment extended to work teams and middle managers. Information used for central control in an oppressive way could reduce job enrichment and hence motivation levels.

Effective managers will apply the information provided by the modern IT systems to improve and speed up decision-making. They should not allow it to change their style of leadership to a centralised or authoritarian one, using data to control all aspects of the organisation.

ACTIVITY 1.5.4

MORE CHIPS PLEASE?

The major European supermarkets have been putting IT at the front of their drive for lower costs, improved customer service and more information about their customers. Applications include barcodes, checkout scanners, automatic product reordering systems, automated stock control programs, robot-controlled transport systems in warehouses, chip and pin machines for payment, loyalty cards that record each individual shopper's purchases and internet shopping for customers.

Some of these systems have been controversial. For example, centralised ordering and delivery of products reduced the independence and control of individual store managers. The rapid growth of internet shopping left some companies with a shortage of stock and delivery vehicles, which led to poor service. Some smaller suppliers who have been unable to cope with the cost of introducing compatible IT systems to take orders from the huge retailers have been dropped.

The latest development is causing further controversy. RFID or radio frequency ID tagging involves putting a small chip and coiled antenna, at the initial point of production, into every item sold through the supermarkets. Unlike barcodes that are manually scanned, the RFID simply broadcasts its presence and data, such as sell-by date, to electronic receivers or readers. German supermarket chain Metro already uses RFID and claims that food can be easily traced back to the farm where it is produced, queues at tills no longer exist as customers' bills are calculated instantly as they pass by a receiver and all products are tracked at each stage of the supply chain – 'We know where everything is!'

Consumer groups are concerned that shoppers will be tracked and traceable too – not just the goods they have bought. Is this an invasion of privacy? Unions are opposed to it as it could lead to many redundancies due to its non-manual operation. Some supermarket managers fear yet another IT initiative that will mean even more central control. They fear breakdowns in the system and lack of training.

20 marks, 40 minutes

1. Define the term 'information technology'. [2]
2. Outline how the increased use of IT by supermarkets is likely to benefit their customers. [4]
3. Analyse the likely benefits of supermarkets using RFID to trace and collect data from every product they sell. [4]
4. Discuss the advantages and disadvantages of the wider use of IT in supermarket retailing on individual supermarket businesses. [10]

LEARNER PROFILE

Your working life is dominated by email, text, Facebook, Twitter . . . the list of areas where the modern employee has to face and master IT is endless. If you are one of those people whose first instinct when they wake up in the morning is to check for new messages on your smartphone you will know what I mean. There are over 200 million smartphones in the USA and, in 2014, 1.75 billion globally and the numbers are growing all the time. For businesses and their stakeholders this brings with it a fantastic range of opportunities and threats.

In your class discuss the impact the growth of IT has had on individuals in business organisations as inquirers and thinkers. Do you think the growth in IT is always a good thing for business?

Economic influences

Changes in the economic environment can have a very significant impact on business objectives and strategies. The global downturn of 2009–10 forced many international businesses to revise their growth and profit targets and adapt their product and marketing strategies to a world in which credit was in short supply and consumers became much less willing to spend, especially on luxury goods. The euro crisis of 2011 is having lingering effects on consumer confidence and government debt levels in many European Union economies.

fiscal policy: changes in government spending levels and tax rates

inflation: the rate of change in the average level of prices

cost-push inflation: caused by rising costs forcing businesses to increase prices

demand-pull inflation: caused by excess demand in an economy, e.g. an economic boom, allowing businesses to raise prices

Other economic factors present businesses with opportunities rather than constraints such as the opening up of China's consumer market following its membership of the World Trade Organisation in 2001.

Other changes in the economic environment result from changes in government economic policies. These policies – mainly monetary and **fiscal policies** – aim to help governments achieve four main macro-economic objectives:

- economic growth and rising living standards
- low levels of inflation
- low levels of unemployment
- balance of payments equilibrium, over time, between the value of imports and exports.

The important economic factors that businesses should monitor and respond to are explained in Table 1.5.4.

Main economic influences and government economic policies	Impact on business objectives and strategies
Economic growth and Recession	• During a period of economic growth, demand for most goods and services will increase as consumers have higher incomes – businesses may plan to expand. However, inferior goods may be rejected by consumers who now have higher incomes. • A recession will have the reverse impact – it can lead to business retrenchment, closures and redundancies. Suppliers of cheaper, inferior goods may benefit from this. • Business flexibility will be important for survival and profitability in both cases, e.g. aiming to have a product portfolio with a wide range of products to appeal to market segments with different income levels.
Interest rates – the use of monetary policy	• An increase in interest rates will reduce consumer demand for many products bought on credit, e.g. houses and cars. Businesses may offer their own credit deals to customers. • Increased loan capital costs will reduce profits for a business with high debt. Selling assets or new shares to reduce debt may be considered. • Business expansion plans may be delayed or cancelled – the expected profit may be below the interest cost on the loans required. • The country's currency is likely to appreciate as more investment finance from abroad is attracted to the country – see effects below.
Exchange rates – increases (appreciation) and decreases (depreciation) in the value of a currency value against other currencies	• A depreciation of currency (e.g. when €1: $1 changes to 1€: $0.80 there is a depreciation of the euro) will make imported goods more expensive. It also offers the opportunity for domestic firms to charge less for exports, leading to a possible increase in demand, especially if demand for them is price-elastic – i.e. responsive to price changes. • More expensive imports can raise a business's costs if it has to buy materials or components from other countries – they might try to buy more supplies from domestic suppliers. • Businesses might target foreign markets more and change their strategies towards exporting rather than selling in the domestic market. • Foreign businesses may decide to locate in the country with the depreciating currency – it will avoid the risk of its goods becoming too expensive to import into the country. • The opposite would occur in the event of an appreciation.
Tax changes through the use of **fiscal policy**	• Higher rates of income tax reduce consumers' disposable incomes – demand for luxury and income-elastic products will fall so businesses selling such products may offer lower-priced alternatives or be forced to enter other markets. • Higher rates of tax on profits (corporation tax) will reduce the profits after tax of companies. A decision to relocate to a country with lower rates of tax might be made. Poland has recently experienced an increase in foreign investment after reducing its corporation tax rate to 10%.
Unemployment	• Higher numbers of workers without employment will give businesses more choice in employee recruitment. As there are many workers applying for each vacancy, a decision may be taken to reduce wage rates, or not increase them in line with inflation, which will benefit business costs. • Average consumer incomes are likely to fall with extensive unemployment – the demand for budget ranges of cheaper goods, e.g. supermarket own brands, could increase and production of these will have to rise to meet demand.
Inflation (**cost-push** and **demand-pull**)	• Higher wage demands from workers to maintain real incomes during inflation and higher costs of materials and components will lead to cost-push inflation. If businesses cannot increase prices for fear of demand falling, profit margins will fall. Businesses might seek cheaper sources of supply or more efficient production methods to help in lowering costs per unit. • Demand-pull inflation will encourage firms to raise prices to increase profit margins. • Substantial increases in inflation will lead to action being taken by the government or country's central bank to increase interest rates – see the effects of these above.

Table 1.5.4 Economic factors and their influence on business objectives and strategies

ACTIVITY 1.5.5

CHINA TO TAKE ACTION AGAINST INFLATION

The Chinese government is becoming increasingly concerned about higher rates of inflation. Rising oil and petrol prices have increased costs to industry and firms are being forced to raise their prices to cover these higher costs. In addition, rising demand for food from a wealthier population, together with supply problems resulting in excess demand, have led to the price of pork rising by 63% and fresh vegetable prices by 46%.

The People's Bank of China increased interest rates by a further 0.27%. This was the third increase in less than a year. A spokesman from Goldman Sachs, the investment bank, reported that the increase shows that the central bank is now much more prepared to use interest rates to manage the economy and tighten **monetary policy** at the first signs of the booming economy overheating. Partly as a result of these increases in interest rates, China's GDP increased by 7.7% in 2013, and some analysts believe this should be more sustainable than the much higher rates experienced in 2007–08. However, Chinese leaders still face conflicting pressures in balancing the top priority of maintaining high-speed economic growth to create millions of new jobs each year, with managing growing environmental problems and rising cost-push pressures causing higher inflation.

monetary policy: changes in the level of interest rates which make loan capital more or less expensive

20 marks, 40 minutes

1. Define the term 'inflation'. [2]
2. Explain **two** effects rising inflation in China might have on businesses in China. [4]
3. Analyse how an increase in Chinese interest rates might have an impact on demand for a firm's products and on a firm's costs. [4]
4. Evaluate the consequences of 'high-speed' economic growth in China on businesses in China. [10]

Environmental influences

These factors include all those that influence or are determined by the surrounding physical environment. This aspect of the STEEPLE analysis is crucial for certain industries, particularly for example tourism, farming, agriculture and mineral extraction. Table 1.5.5 outlines some of the most important environmental influences.

Environmental influences	Impact on business objectives and strategies
Environmental controls on business activities such as waste disposal, use of sustainable energy, reducing packaging	Strict environmental controls could increase business costs and make a country less attractive for new investment. However, observing such controls could be used as a basis for good publicity.
Threats from natural events such as drought, earthquakes and floods	These threats could make it unwise to consider operating in the areas most likely to be affected – especially if the business activity is itself potentially dangerous as with chemicals products.
Natural resources	Abundant natural resources are likely to attract inward investment from mining and oil businesses for example. Political factors (see Table 1.5.6) might be important too if these resources are in politically unstable regions.
Infrastructure – road and air transport facilities, for example	Poor infrastructure makes business activity more difficult and often more costly. Multinational businesses often request governments to improve transport links before they will consider an investment in the country.

Table 1.5.5 Impact of environmental influences

ACTIVITY 1.5.6

AIR POLLUTION IN INDIA

In 2014 India ranked 174th out of 178 countries on air pollution in the Yale Environmental Performance Index. India's Central Pollution Control Board said that in 180 cities in 2010, particulate matter in the air was six times higher than World Health Organisation standards.

Car sales in India have boomed, and diesel is the most common fuel. Monitoring pollution in India is not well co-ordinated, and many industries continue to defy the existing environmental laws as they know that even if they are caught the prosecution process will take a very long time.

India's Environmental Pollution Control authority has reported that the level of air pollution is the cause of more than 3000 child deaths each year in Delhi alone. The report recommends a number of measures including:

- 30% tax on the sale of diesel vehicles
- higher automobile registration and parking fees
- Supreme Court should use its authority to order compliance with pollution laws
- India's national air quality standards must be made legally binding

16 marks, 32 minutes

1. Explain **two** reasons for India's growing air pollution problems. [6]
2. Discuss how the measures proposed by the Environmental Pollution Control Authority could influence the objectives and strategies of multinational businesses operating in India. [10]

THEORY OF KNOWLEDGE

Even as the USA churns out more fossil fuels, evidence abounds that alternative energy in general – and solar in particular – is staging a comeback. And the halo effect has spread to solar businesses.

Observers credit an increase in solar capacity, falling photovoltaic (PV) costs and the extension of tax credits in some countries for renewable energy for the sector's revival. Solar energy is carving a niche in creating electricity.

Solar power has the ability to create very local opportunities where you do not have to be interconnected to a whole network of infrastructure – such as the solar panels on people's houses.

According to the Energy Information Administration, renewable power for electric generation surged 23% over the last year, becoming the second biggest source for new generator capacity. At the same time, natural gas – rapidly becoming the dominant source for generating electricity – appeared to plateau.

As business becomes increasingly concerned with protecting the environment, examine the roles reason and ethics play in the market for energy.

Political influences

These factors include the nature and stability of the government, whether the country is a democracy – and if not, who controls the government and what are the ruler's main objectives – and the policies of the government towards business, trade and private ownership of assets. Table 1.5.6 outlines some important political influences and their impact on business objectives and strategies.

Political influences	Impact on business objectives and strategies
Government stability	If the government is constantly changing then this could lead to frequent changes in laws relating to business activity. The changes could make it difficult to plan future business strategies. Generally, business managers prefer stable government that has public support.
Form of political structure, e.g. democracy	Businesses might find it difficult to convince their stakeholders that it is wise to operate in or trade with an autocratic dictatorship – especially if there are concerns over human rights. The global trade embargo against South Africa helped to bring down the non-democratic pre-Mandela regime. Businesses that did trade with this government were heavily criticised.
Government's attitude to private ownership	If a government is committed to nationalisation of private businesses and high taxes on private wealth then this will discourage privately owned businesses from setting up or expanding in this country.
Trade policies and membership of free-trade areas or Customs Unions (e.g. EU)	If a government wants to restrict free trade with tariffs and quotas this will discourage business investment – apart from in industries that are protected by such measures. Global business operations tend to expand and locate in those countries which encourage free trade and are members of important free-trade groupings.

Table 1.5.6 Impact of political influences

ACTIVITY 1.5.7

POLITICAL INSTABILITY AFFECTING RUSSIA'S INVESTMENT CLIMATE

The Russian takeover of Crimea was as much a shock to Russia's business leaders as it was to the politicians in Brussels and Washington. It is forcing foreign businesses to reconsider investments in Russia.

Russia attracted $94 billion of foreign direct investment (FDI) in 2013. This is expected to fall substantially as political instability and Western government trade and finance sanctions against Russia make it a less attractive place for multinationals to invest in. Swedish car producer Volvo said it was thinking again about a proposed partnership with Russian state-owned railway equipment and tank maker Uralvagonzavod (UVZ) worth about $100 million to make modern armoured cars, thanks to the situation in Ukraine. Financial sanctions are making it more difficult for Russian companies to seek public limited company status on Western stock exchanges. The public listing plans of several large companies are now in doubt.

Source: Russia Beyond the Headlines, http://rbth.co.uk

20 marks, 40 minutes

Examine the influence political instability might have on businesses in Crimea. [20]

Legal constraints

In most countries, political and legal constraints on a business fall into the following main categories:

- employment laws
- consumer protection laws

- business competition laws
- political changes resulting from a new government, e.g. policies towards foreign direct investment by multinationals
- major policy changes, such as nationalising some UK banks after the 2008–09 crisis.

Table 1.5.7 shows the possible impact of some legal factors on business objectives and strategies.

Examples of legal factors	Impact on business objectives and strategies
Improved employee legal protection, e.g. better health and safety at work, redundancy pay, protection from discrimination, minimum pay levels, maternity pay	• Increases cost of employing staff – businesses may be reluctant to expand in this country by taking on extra staff. • Encourages businesses to increase labour productivity to pay for the cost of these legal improvements. For example, Germany has some of the most rigorous laws protecting workers' rights, yet labour productivity is one of the highest in the world. • If employers are seen to be positive about these legal changes and accept them fully, they will appear to be a caring business that will encourage well-motivated employees to work for them. Some businesses offer benefits above the legal minimum for this reason.
Consumer protection laws that constrain businesses from advertising inaccurately or inappropriately, selling faulty goods or those described incorrectly, high-pressure selling tactics, not allowing consumers to change their minds after signing credit agreements	• Sales staff will need training in the legal rights of consumers – breaking consumer laws will lead to expensive legal claims. • Design and production of new products will have to put customers' safety and product quality as priorities. • Full disclosure of any safety problems is needed to minimise risks to customers. • All of these strategies will add to costs. However, if a business is seen to put customers and customer service first, it may benefit from good publicity, word-of-mouth promotion and customer loyalty.
Competition laws can restrict unfair competition or restrictive practices by businesses, monopoly exploitation of consumers, mergers and takeovers (external growth) that could lead to a monopoly	• Collusive agreements with competitors are not permitted. • Internal growth is less likely to lead to reports and action by the competition regulators than external growth. • Expand into other countries rather than growing in existing country which can lead to monopoly market share.

Table 1.5.7 Legal factors and their impact on business objectives and strategies

ACTIVITY 1.5.8

EMPLOYMENT RIGHTS IN YOUR COUNTRY

In China, current employment rights are governed by the PRC Employment Law of 1995. There are 13 sections to this law which cover almost all aspects of employment relationships. These include working hours, holidays, health and safety, training, social welfare, disputes and discrimination on the grounds of race, sex, disability or age.

1. Why do you think the Chinese government introduced such a wide-ranging law as this, covering all aspects of employer–employee relationships?
2. Do these laws help or damage business interests? Explain your answer.
3. **Research task:** Find out about the main employment laws in your country and the main rights they offer to workers. Do you think that these laws need changing in any way? If so, how and why?

ACTIVITY 1.5.9

CONSUMER RIGHTS IN YOUR COUNTRY

In Malaysia, the 1999 Consumer Protection Act is an important law protecting the interests of consumers. It has 14 main sections which include outlawing all misleading and deceptive conduct by firms, outlawing false advertising claims, providing guarantees in respect of supply of goods and strict liability for defective and potentially dangerous products.

In India, the 1986 Consumer Protection Act provides for the regulation of all trade and competitive practices, creates national- and state-level consumer protection councils and lists unfair and uncompetitive trade practices.

1. Why do you think governments, as in Malaysia and India, pass laws to protect consumer rights?
2. Do you think that such laws help or damage business interests?
3. **Research task**: Find out the main consumer protection laws in your country. Give examples of how firms try to break these laws. Are the laws strict enough? If not, why not?

Ethical influences

These are well covered in other sections of the book – for example, in Chapters 1.3, 2.1, 2.3, 2.6, 4.1 and 4.4.

There are national differences in the values and attitudes held by the majority of the population. These differences can be seen in the contrasting ways in which countries approach issues such as:

- child labour
- corruption in business practices
- advertising and promotional material and the advertising of products directly to children.

These are just three of the ethical dilemmas that businesses must confront, especially when they operate in several countries. Failure to follow a strict and consistent ethical code in all markets being traded in could lead to major damage to the reputation of a business – bad news regarding ethical infringements can be transferred almost instantaneously by social media.

OVER TO YOU

Revision checklist

1. Why is STEEPLE important to a business planning a major change in strategy?
2. Give **one** example of how a business strategy might be affected by a consumer protection law.
3. Give **one** example of how a business strategy might be affected by an employment law.
4. Explain how an increase in interest rates might lead to a change of business strategy.
5. Explain how a depreciation of your country's currency might lead to a business in your country changing one of its strategies.
6. Do you think an economic recession in your country would lead to the soft drinks manufacturer Coca-Cola changing the strategies used to sell its products in your country?
7. Identify **two** recent social changes in your country that could have an impact on a business's objectives and strategy.

8. Give **one** example of how technology has changed production methods in an industry that you have studied.
9. Give **one** example of how technology has led to a recently introduced innovative product.
10. Explain **one** example of how environmental considerations have affected the strategy of a business.
11. Why should a business consider the political situation in a country that it plans to expand into?
12. Explain **one** problem that a business might experience if it did not account for different ethical standards in the countries it operates in.

Exam practice question

STARBUCKS BRINGS ITS CULTURE TO VIETNAM

The South-east Asian nation – known for its nerve-jangling strong coffee, often sweetened with condensed milk – has its own deep-rooted coffee culture that could prove challenging to Starbucks, the Seattle-based coffee chain. The company launched a flagship two-storey store in Ho Chi Minh City in February. So far sales at the new location are exceeding expectations, according to Starbucks' Chief Executive and Chairman Howard Schultz.

Starbucks decorated the downtown store with local art and artefacts to create a distinctly Vietnamese flavour. It also came up with a drink, the Asian Dolce Latte, to appeal to local palates. For food, it serves roast-duck wraps and French-style baguettes. But some say the chain could do more. One customer said, 'Starbucks should use drip filters perched on top of glass mugs, the way the Vietnamese do.' He added, 'If Starbucks want to succeed in Vietnam, they have to change the way they serve,' he said.

Starbucks is attracted by rapid economic growth in Vietnam and the low costs of opening and running a coffee outlet. It is a market that has huge potential sales in a country of nearly 90 million people and a desire to buy in to global brands like Starbucks. There are challenges though; the regulatory framework around business start-ups is quite bureaucratic and there is some unease amongst local politicians about the opening of a Starbucks.

20 marks, 40 minutes

1. Define the term 'economic growth'. [2]
2. Outline **two** reasons why Starbucks might be attracted to open outlets in Vietnam. [4]
3. Analyse **two** problems Starbucks might face when opening outlets in Vietnam. [4]
4. Evaluate the possible usefulness of a STEEPLE analysis to Starbucks as it tries to enter the Vietnamese market for coffee. [10]

Key concept question

20 marks, 40 minutes

With reference to one or two organisation(s) that you have studied, discuss how increased globalisation and cultural change impacts on business strategy. [20]

1.6

Growth and evolution

On completing this chapter you should be able to:

Analyse and apply:

- The main types of economies and diseconomies of scale (AO2)
- The difference between internal and external growth (AO2)

Evaluate:

- The relative merits of small versus large organisations (AO3)
- External growth methods: mergers and acquisitions and takeovers (AO3)
- The role and impact of globalisation on the growth and evolution of businesses (AO3)
- Reasons for the growth of multinational businesses (MNCs) (AO3)
- The impact of MNCs on host countries (AO3)

Setting the scene

CHINESE GIANT TAKES OVER SMITHFIELD FOODS INC.

Shuanghui Holdings Ltd, the largest meat producer in China, has taken over Smithfield Foods Inc., a US-based public limited company. 96% of Smithfield's shareholders agreed to the buyout deal, which is worth US$34 per share, a total of US$4.7 billion. Workers in Smithfield's factories are pleased with the deal; existing US managers will not be replaced and pay levels are not changing.

Smithfield is one of the largest meat-producing and -processing businesses in the USA. The takeover will give Shuanghui a huge new source of meat to supply its meat-processing plants in China. The demand for meat is increasing in the world's most populated country as incomes rise with economic growth. The importation of US-produced meat by China will increase the already close trade links between the two countries.

In the past, many Chinese companies have preferred to set up joint ventures or strategic alliances with foreign businesses but they increasingly have the spare capital that allows them to take over companies outright.

Points to consider

- Why do you think Smithfield's shareholders agreed to this takeover?
- What do you think are the benefits to Shuanghui of its takeover of Smithfield?
- Do you think Shuanghui will experience any problems as a result of this form of expansion?

Key concept link

Some businesses have grown so large that their decisions can have a major impact on some national economies. The growth in the number and size of multinational companies has been a major consequence of globalisation. Ethical issues are raised by the ability of these companies to take decisions that can act against the interest of the governments of the countries they operate in – such as paying tax on all global operations in the lowest tax country they are based in.

Introduction

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 many countries! In 2013, ExxonMobil recorded sales of over US$430 billion, yet the GDP of Thailand, for example, was US$365 billion.

scale of operation: the maximum output that can be achieved using the available inputs (resources) – this scale can only be increased in the long term by employing more of all inputs

Increasing the scale of operations

There are risks and costs involved in increasing the scale of production – purchasing land, buildings, equipment, employing more staff – and the capital used for this will always have alternative uses. Firms expand capacity by increasing the scale of production to avoid turning business away and to increase market share, but they also benefit from the advantages of large-scale production – these are called **economies of scale**.

economies of scale: reductions in a firm's unit (average) costs of production that result from an increase in the scale of operations

Economies of scale

These cost benefits can be so substantial in some industries that smaller firms will be unlikely to survive due to lack of competitiveness, such as in oil refining or soft drink production. The cost benefits arise for five main reasons.

1. Purchasing economies

These economies are often known as bulk-buying economies. Suppliers often offer substantial discounts for large orders. This is because it is cheaper for them to process and deliver one large order than several smaller ones.

2. Technical economies

There are two main sources of technical economies. Large firms are more likely to be able to justify the cost of flow production lines. If these are worked at a high capacity level, then they offer lower unit costs than other production methods. The latest and most advanced technical equipment – such as computer systems – is often expensive and can usually only be afforded by big firms. Such expense can only be justified by larger firms with high output levels – so that average fixed costs can be reduced.

Exam tip: Do not confuse 'producing more' with increasing the scale of operation. More can be produced from existing resources by increasing capacity utilisation. Changing the scale of operation means using more (or less) of all resources – for example, opening a new factory with additional machines and workers.

3. Financial economies

Large organisations have two cost advantages when it comes to raising finance. First, banks 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 are often lower than the rate charged to small, especially newly formed, businesses. Secondly, raising finance by 'going public' or by further public issues of shares for existing public limited companies is very expensive. Therefore, the average cost of raising the finance will be lower for larger firms selling many millions of dollars' worth of shares.

ACTIVITY 1.6.1

OPERATING AT FULL CAPACITY

Ben Rishi is operations manager for a factory making saucepans. The weekly maximum capacity of the factory is 3000 units. The main limit on capacity is the old-fashioned machine for stamping out the metal pans from sheet metal. Purchasing another machine would be expensive – and would require an extension to the building.

Workers are working very long shifts. Ben has also been working long days to ensure that all the factory works at full capacity. For the last three months, demand has been high and last week there were orders for 3100 pots. Ben is under pressure from his managing director to see that this number is produced. Ben is unsure whether to recommend purchasing the new machine or to buy in components from another firm in the city that has spare capacity.

12 marks, 24 minutes

1. Outline the **two** problems facing Ben because his factory is operating at full capacity. [4]
2. Explain why Ben Rishi might choose to purchase a new machine rather than buy in components from another firm. [4]
3. Analyse **two** cost advantages Ben's business might gain if it expands its scale of production. [4]

4. Marketing economies

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

5. Managerial economies

Small firms often employ general managers who have a range of management functions to perform. As a firm expands, it should be able to afford to attract specialist functional managers who should operate more efficiently than general managers, helping to reduce average costs.

Exam tip: When answering IB questions about economies of scale, make sure your answer is applied to the business in the question.

Diseconomies of scale

If there were no disadvantages to large-scale operations, nearly all industries would be dominated by huge corporations. Some are, of course, as with oil exploration, refining and retailing – the benefits of large-scale production are so substantial that smaller firms find it increasingly difficult to operate profitably. In other industries, the impact of '**diseconomies of scale**' prevents one or just a few firms from being able to completely dominate.

diseconomies of scale: factors that cause average costs of production to rise when the scale of operation is increased

Diseconomies of scale are those factors that increase unit costs as a firm's scale of operation increases beyond a certain size. These diseconomies are related to the management problems of trying to control and direct an organisation with many thousands of workers, in many separate divisions, often operating in several different countries. There are three main causes of management problems.

1. Communication problems

Large-scale operations will often lead to poor feedback to workers, excessive use of non-personal communication media, communication overload with the volume of messages being sent, and distortion of messages caused by the long chain of command. Poor feedback reduces worker incentives.

These problems may lead to poor decisions being made, due to inadequate or delayed information, and management inefficiency.

2. Alienation of the workforce

The bigger the organisation, the more difficult it is to directly involve every worker and to give them a sense of purpose and achievement. They may feel insignificant in the overall business plan and become demotivated, failing to do their best. Larger manufacturing firms are the ones most likely to adopt flow-line production and workforce alienation is a real problem due to repetitive and boring tasks.

3. Poor coordination and slow decision-making

Business expansion often leads to many departments, divisions and products. The number of countries a firm operates in often increases too. The problems for senior management are to coordinate these operations and take rapid decisions in such a complex organisation. Smaller businesses with much tighter control over operations and much quicker and more flexible decision-making may benefit from lower average production costs as a result.

Large-scale production – unit costs

The combined effect of economies of scale and diseconomies of scale on unit (average) costs of production is shown in Figure 1.6.1. There is not a particular point of operation at which economies of scale cease and diseconomies begin. The process is more difficult to measure than this, as certain economies of scale may continue to be received as scale increases, but the growing significance of diseconomies gradually begins to take over and average costs may rise. It is often impossible to state at what level of output this process occurs, which is why many managers may continue to expand their business unaware that the forces causing diseconomies are building up significantly.

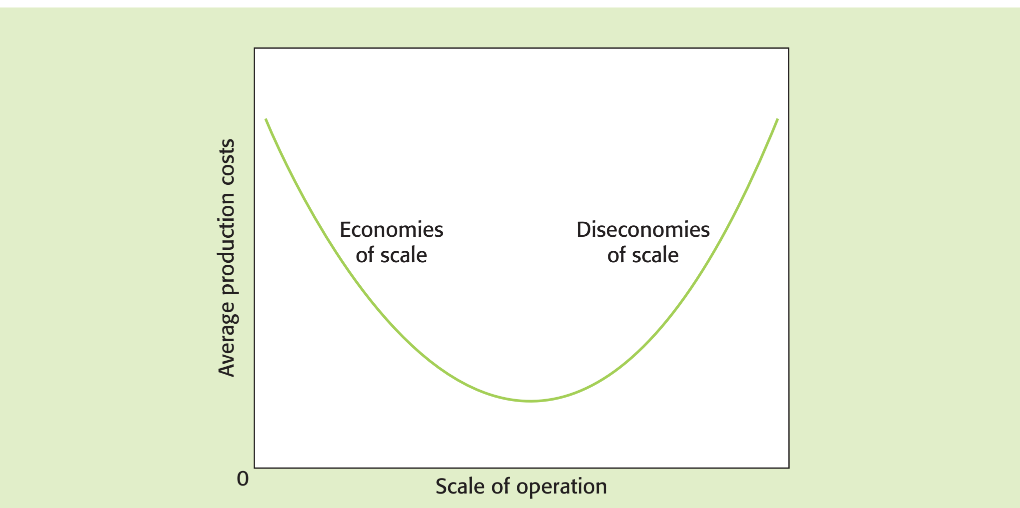


Figure 1.6.1 The impact of economies and diseconomies of scale on average costs

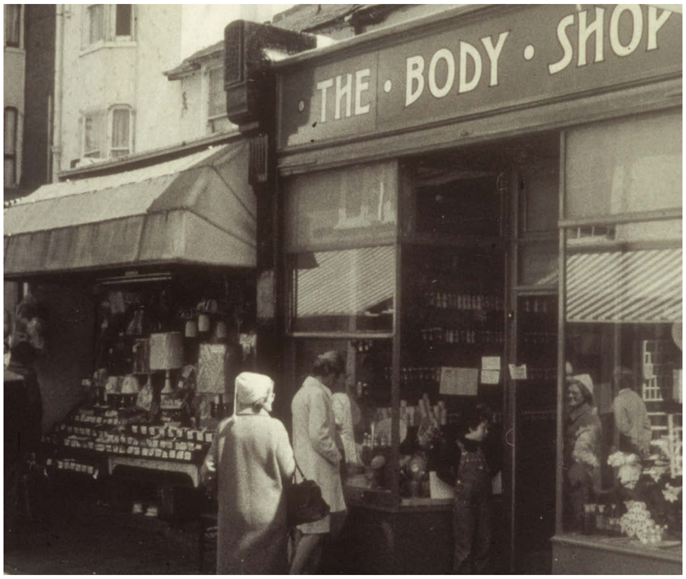
Merits of small and large organisations

Significance of small and micro-businesses

There is no universally agreed definition of small firms. However, they usually employ few people and have a low turnover compared to other firms. It is now common to make a further distinction for very small businesses known as 'micro-enterprises'. The European Union definitions are shown in Table 1.6.1.

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

Table 1.6.1 EU classifications of business size



The Body Shop opened its first shop in Brighton, England, in 1976

Small firms (including micro-enterprises) are very important to all economies:

- Many jobs are created by small firms and the small business sector employs a very significant proportion of the working population in most countries.
- Small businesses are often run by dynamic entrepreneurs, with new ideas for consumer goods and services leading to wider consumer choice.
- Small firms create competition for larger businesses. Without this competition, larger firms could exploit consumers with high prices and poor service. For example, the cost of air travel has fallen in recent years due to the establishment of small airlines competing with the large, established companies.
- Small firms often supply specialist goods and services to important industries, such as car manufacturing, allowing them to specialise in large-scale assembly.
- All great businesses were small at one time. The Body Shop, for example, began in one small rented store in 1976. The large firms of the future are the small firms today. The more small firms are encouraged to become established and expand, the greater the chances that an economy will benefit from large-scale organisations in the future.
- Small firms may have lower average costs than larger ones and this benefit could be passed on to the consumer too. Costs could be lower because of lower wage rates paid, or the cost of the administration and management of bigger enterprises may increase their average costs dramatically.

Small versus large organisations

The advantages and disadvantages of small and large business organisations are summarised in Tables 1.6.2 and 1.6.3.

Small businesses	Large businesses
• Can be managed and controlled by the owner(s) • Often able to adapt quickly to meet changing customer needs • Offer personal service to customers • Find it easier to know each worker, and many staff prefer to work for a smaller, more 'human' business • Average costs may be low due to no diseconomies of scale and low overheads • Easier communication with workers and customers	• Can afford to employ specialist professional managers • Benefit from cost reductions associated with large-scale production • May be able to set prices that other firms have to follow • Have access to several different sources of finance • May be diversified in several markets and products, so risks are spread • More likely to be able to afford research and development into new products and processes

Table 1.6.2 Potential advantages of small and large businesses

Small businesses	Large businesses
• May have limited access to sources of finance • May find the owner(s) has to carry a large burden of responsibility if unable to afford to employ specialist managers • May not be diversified, so there are greater risks of negative impact of external change • Unlikely to benefit from economies of scale	• May be difficult to manage, especially if geographically spread • May have potential cost increases associated with large-scale production • May suffer from slow decision-making and poor communication due to the structure of the large organisation • May often suffer from a divorce between ownership and control that can lead to conflicting objectives

Table 1.6.3 Potential disadvantages of small and large businesses

What is an appropriate scale of operation?

It is easy just to focus on the benefits of small businesses in certain industries – for example, in service industries such as hairdressing. However, large businesses supply most of the world's consumer goods and they do so with increasing efficiency and, in most cases, improving levels of quality. There is no rule that can be applied when deciding on the most appropriate scale of operation. Business owners must weigh up and assess:

- owners' objectives – they may wish to keep the business small and easy to manage
- capital available – if limited, growth is less likely
- size of the market the firm operates in – very small markets do not need large-scale production
- number of competitors – the market share of each firm may be small if there are many rivals
- scope for economies of scale – if these are substantial, as in water supply, each business is likely to operate on a large scale.

Exam tip: If an examination question asks you to consider the most appropriate scale of production in a given situation, you will need to assess these five factors.

THEORY OF KNOWLEDGE

Some people have the erroneous idea that a small business cannot effectively compete against larger competitors. This concept is quite far from the truth. For example, if someone were to ask you, 'What is a major source of job formations in America today?' what would you answer? If you said small business, you would be right. How about this question: 'What is the major source of newly formed individual wealth in a given country today?' Again, the small business is the answer. Why, then, is there such misinformation about the strength, versatility and wealth of small businesses? The answer is that usually large corporations get the lion's share of publicity.

Source: e-commerce times

In the light of this article, discuss the view that in the corporate world bigger is always better.

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 other business owners and directors of companies seek growth for their business? There are a number of possible reasons including:

- increased profits
- increased market share
- increased economies of scale
- increased power and status of the owners and directors
- reduced risk of being a takeover target.

Internal and external growth

Business growth can be achieved in a number of ways and these forms of growth can lead to differing effects on stakeholder groups, such as customers, workers and competitors. The different forms of growth can be grouped into **internal** and **external growth**, as shown in Figure 1.6.2.

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

external growth: business expansion achieved by means of merging with or taking over another business, from either the same or a different industry

An example of internal growth would be a retailing business opening more shops in towns and cities where it previously had none.

The different forms of external growth are shown in Figure 1.6.3.

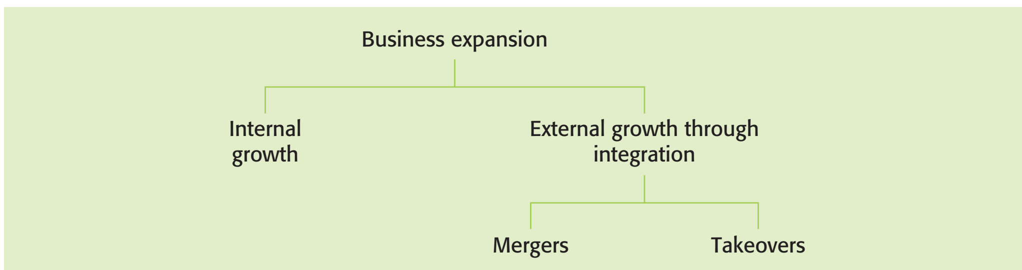


Figure 1.6.2 Different forms of growth

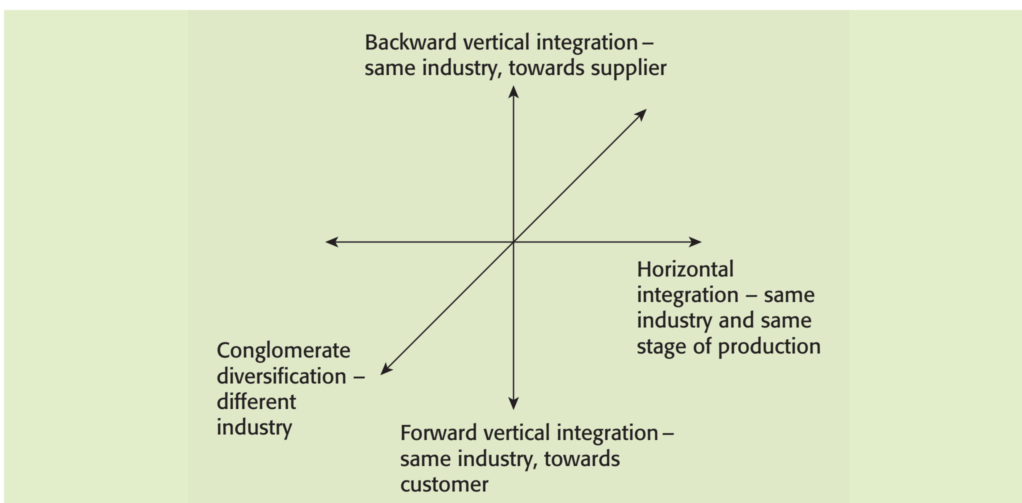


Figure 1.6.3 Forms of external growth

ACTIVITY 1.6.2

STARBUCKS CONFIRMS RAPID-GROWTH STRATEGY

Howard Schultz, the chairman of Starbucks, confirmed growth plans for the world's largest chain of coffee shops. The business will open at least 10 000 new cafés over the next four years by using internal growth. Schultz said at the company's annual meeting that he planned to double the size of the business eventually.

China will be the main focus of this growth strategy. The US giant opened its first Chinese branch in 1999 and has plans to open 1000 outlets there. 'No market potentially has the opportunities for us as China hopefully will,' said Schultz. Like many Western retailers, Starbucks sees China as its key growth area due to its fast-growing economy, lack of strong local competitors and sheer size of population.

There are plans to increase sales of non-coffee products to reduce its reliance on just hot drinks. It has expanded its sale of audio books and music, and Sir Paul McCartney, the former Beatles member, became the first artist to release an album on Starbucks' Hear Music label.

This rapid internal expansion has not been without problems. *Consumer Reports* magazine recently ranked McDonald's coffee ahead of Starbucks', saying it tastes better and costs less. The chairman has also criticised the time-saving policy of designing stores uniformly rather than with some local decoration. In 2013 Starbucks was criticised for charging high prices to consumers in China but the company responded by stating that operating costs were higher than in some other countries and high investment in China had to be paid for.

20 marks, 40 minutes

1. Define the term 'internal growth'. [2]
2. Outline **two** reasons why Starbucks has adopted a rapid expansion strategy. [4]
3. Analyse the possible advantages of Starbucks focusing growth in China. [4]
4. Evaluate the potential economies of scale that Starbucks might experience from further expansion. [10]

Exam tip: If an examination 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.

External growth is often referred to as integration as it involves bringing together two or more firms. Table 1.6.4 provides a guide to the different types of integration, their common advantages and disadvantages and the impact they often have on stakeholder groups.

THEORY OF KNOWLEDGE

Facebook buys Instagram photo-sharing network for $1 billion

Instagram – the popular photo-sharing smartphone app – is to be bought by Facebook who will pay $1bn (£629 million) in cash and stock for the takeover.

October 2010 saw the launch of Instagram as a free iPhone app that allowed users to apply various filters to their photographs before they were uploaded. A version for the Android market followed later. The free app has been a great success and Instagram state they have more than 30 million users, with 5 million pictures uploaded every day.

The chief executive of Facebook, Mark Zuckerberg, has promised that Instagram will continue to develop as a separate brand, meaning it will continue to allow users to post to rival social networking sites.

When one organisation takes over another organisation it is often said it is about the takeover organisation's desire to have control and power over a market.

Discuss in your class the human instinct to have power and control in business situations.

merger: an agreement by shareholders and managers of two businesses to bring both firms together under a common board of directors with shareholders in both businesses owning shares in the newly merged business

takeover: when a company buys over 50% of the shares of another company and becomes the controlling owner – often referred to as 'acquisition'

horizontal integration: integration with a firm in the same industry and at the same stage of production

forward vertical integration: integration with a business in the same industry but a customer of the existing business

backward vertical integration: integration with a business in the same industry but a supplier of the existing business

conglomerate integration: merger with or takeover of a business in a different industry

Type of integration	Advantages	Disadvantages	Impact on stakeholders
Horizontal integration	• Eliminates one competitor • Possible economies of scale • Scope for rationalising production, e.g. concentrating output on one site instead of two • Increased power over suppliers	• Rationalisation may bring bad publicity • May lead to monopoly investigation if the combined business exceeds certain size limits	• Consumers have less choice • Workers may lose job security as a result of rationalisation
Forward vertical integration	• Business is able to control the promotion and pricing of its own products • Secures an outlet for the firm's products – may now exclude competitors' products	• Consumers may suspect uncompetitive activity and react negatively • Lack of experience in this sector of the industry – a successful manufacturer does not necessarily make a good retailer	• Workers may have greater job security because the business has secure outlets • There may be more varied career opportunities • Consumers may resent lack of competition in the retail outlet because of the withdrawal of competitor products
Backward vertical integration	• Gives control over quality, price and delivery times of supplies • Encourages joint research and development into improved quality of supplies of components • Business may control supplies of materials to competitors	• May lack experience of managing a supplying company – a successful steel producer will not necessarily make a good manager of a coal mine • Supplying business may become complacent having a guaranteed customer	• Possibility of greater career opportunities for workers • Consumers may obtain improved quality and more innovative products • Control over supplies to competitors may limit competition and choice for consumers
Conglomerate integration	• Diversifies the business away from its original industry and markets • This should spread risk and may take the business into a faster-growing market	• Lack of management experience in the acquired business sector • There could be a lack of clear focus and direction now that the business is spread across more than one industry	• Greater career opportunities for workers • More job security because risks are spread across more than one industry

Table 1.6.4 Types of business integration

ACTIVITY 1.6.3

JET AIRWAYS, AIR SAHARA AND ETIHAD

India's largest private airline, Jet Airways, bought out its smaller rival, Air Sahara, for US$640 million in 2007. The takeover gave the airline a combined market share of about 32%. Jet Airways acquired the aircraft, equipment and landing and take-off rights at the airports Air Sahara had. Jet Airways founder and chairman, Naresh Goyal, believed that the external growth of Jet Airways would benefit shareholders. Some analysts predicted substantial synergy from this takeover. Better discounts from aircraft manufacturers were expected. Streamlining the two head offices into one unit would reduce fixed costs. The interlinking of the different air routes allowed more passengers to be offered connecting flights with the new enlarged airline.

The takeover had to be approved by the Indian Ministry of Company Affairs. There was some concern that the takeover could lead to a monopolistic position, as Jet Airways now enjoys a dominant position on many domestic air routes. In 2013 Jet Airways sold 24% of its shares to Etihad Airways, which injected US$379 million into the airline to finance new aircraft and more routes. This partial takeover was called a 'strategic alliance'.

MERCEDES SELLS CHRYSLER AFTER FAILED MERGER

After nine years of trying to make the merger of two large carmakers work successfully, Mercedes-Benz has at last admitted defeat and sold its 80% stake in the US-based operator Chrysler. The merger never increased returns to shareholders and it failed in its original aim of creating a global motor company to compete effectively with General Motors, Ford and Toyota.

Management problems in controlling the merged businesses were huge. Distance between Germany (Mercedes-Benz) and the USA (Chrysler) made communication difficult. The car ranges of the two companies had very little in common, so there were few shared components and economies of scale were less than expected. Culture clashes between the two management approaches led to top-level director disputes over the direction the merged business should take.

20 marks, 40 minutes

1. State the **two** types of integration taking place in the two case studies. [2]
2. If Jet Airways were now to merge with an aircraft manufacturer:
   a. Explain the type of integration this would involve. [4]
   b. Analyse **two** potential benefits to Jet Airways of this type of merger. [4]
3. Evaluate the likely impact of the Jet Airways takeover of Air Sahara on any **two** stakeholder groups. [10]

LEARNER PROFILE

Risk-takers

In April 2010, Hewlett-Packard purchased the company synonymous with mobile devices: Palm. Unfortunately, Palm had last been synonymous with mobile devices about a decade earlier. Palm particularly struggled against Blackberry who, in turn, suffered at the hands of the iPhone and Android. After a US$1.2 billion purchase, Palm became part of Hewlett-Packard.

The speed with which Hewlett-Packard realised its mistake was remarkable. By the summer of 2011, HP had moved well past the point of looking to find a buyer for its Palm subsidiary and instead decided to discontinue the entire thing. Even a revamped operating system, Palm's critically acclaimed WebOS, was not enough to salvage the erstwhile bright star. The mobile operating system exists today as a small open-source project.

Major business decisions often involve failure. As 'risk-takers', how can business people effectively manage the risks they take when making major decisions like takeovers?

Joint ventures, strategic alliances and franchising

Joint ventures

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

A **joint venture** is not the same as a merger, but it may lead to a merger of the businesses if their joint interests coincide and if the joint venture is successful. The reasons for joint ventures are:

- Costs and risks of a new business venture are shared – this is a major consideration when the cost of developing new products is rising rapidly.
- Different companies might have different strengths and experiences and they, therefore, fit well together.
- They might have their 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 blaming the other.
- The business failure of one of the partners would put the whole project at risk.

Strategic alliances

strategic alliances: agreements between firms in which each agrees to commit resources to achieve an agreed set of objectives

Strategic alliances can be made with a wide variety of stakeholders, for example:

- With a university – finance provided by the business to allow new specialist training courses that will increase the supply of suitable staff for the firm.
- With a supplier – to join forces in order 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, gaining competitive advantage.
- With a competitor – to reduce 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, as a result, against the laws of the country whose market is being entered.

Franchising

franchise: a business that uses the name, logo and trading systems of an existing successful business

A **franchise** contract allows the franchisee to use the name, logo and marketing methods of the franchiser. The franchisee can, separately, decide which form of legal structure to adopt. Franchises are a rapidly expanding form of business operation. They have allowed certain multinational businesses, such as McDonald's and Ben and Jerry's, to expand much more rapidly than they could otherwise have done. Why would a business entrepreneur want to use the name, style and products of another firm? Consider Activity 1.6.4, which includes all the main features of a typical franchise contract.

ACTIVITY 1.6.4

HARRY GOES IT ALONE

Harry was really bored with his job as second chef in a top-of-the-market hotel. He did not like being ordered around by the head chef. He hoped to use his talents preparing food for customers in his own restaurant. The main problem was his lack of business experience. Harry had just been to a business conference and had been interested in the franchising exhibition there. One of the businesses offering to sell franchises was Pizza Delight. This firm sold a new type of pizza recipe to franchisees and provided all the ingredients, marketing support and help with staff training. They had already opened 100 restaurants in other countries and offered to sell new franchises for a one-off payment of US$100 000. If Harry signed one of these franchising contracts, then he would have to agree to:

- buy materials only from Pizza Delight
- fit out the restaurant in exactly the way the franchiser wanted
- make an annual payment to Pizza Delight of a percentage of total turnover.

Harry would have to find and pay for suitable premises and recruit and motivate staff. Pizza Delight claimed that their brand and products were so well known that 'success was guaranteed'. As the product had been tested already, there would be none of the initial problems that small firms often experience and Pizza Delight would pay for national advertising campaigns. Harry was told that no other Pizza Delight restaurant could open within five kilometres of one already operating.

20 marks, 40 minutes

1. Define the term 'franchise'. [2]
2. Explain **two** potential benefits Harry would enjoy if he were to open a franchised Pizza Delight restaurant. [4]
3. Analyse **two** potential drawbacks to Harry if he agreed to the terms of the franchise contract. [4]
4. Using all the evidence, advise Harry on whether to take out a franchise with Pizza Delight. Justify your answer. [10]

Table 1.6.5 summarises the benefits and disadvantages of a franchised business for the franchisee.

Benefits	Possible limitations
• Less chance of new business failing as an established brand and product are being used • Advice and training offered by the franchiser • National advertising paid for by franchiser • Supplies obtained from established and quality-checked suppliers • Franchiser agrees not to open another branch in the local area	• Share of profits or sales revenue has to be paid to franchiser each year • Initial franchise licence fee can be expensive • Local promotions may still have to be paid for by franchisee • No choice of supplies or suppliers to be used • Strict rules over pricing and layout of the outlet reduce owners' control over own business

Table 1.6.5 Franchises – benefits and disadvantages to the franchisee

Globalisation

globalisation: the growing integration of countries through increased freedom of global movement of goods, capital and people

free trade: no restrictions or trade barriers exist that might prevent or limit trade between countries

protectionism: using barriers to free trade, such as tariffs and quotas, to protect a country's own domestic industries

It is often stated that **globalisation** has 'shrunk the world'. It has led to substantial improvements in global communications and substantial reductions in barriers to trade and movement of capital and goods. This 'shrinking' of the world is having a major impact on business activity, especially from multinationals. The **free-trade** movement, which campaigns against **protectionism**, and the increasing use of the internet are reducing the differences that once existed between national markets, reducing the importance of national borders and making it easier for businesses to trade with and locate in many countries. This is forcing firms, which were once protected by national governments, to become internationally competitive.

Some of the critics of globalisation have stated that the process of globalisation has exploited hundreds of thousands of people in developing countries all around the world. It has, it is claimed, caused great disruption to lives and produced very few noticeable benefits in return.

The supporters of globalisation point to the huge reductions in the numbers of people in poverty achieved by some countries which have embraced globalisation, such as the thriving economies of India, China, Vietnam and Uganda.

What are the benefits of globalisation and free trade between nations?

- Buying products from other nations (importing) means consumers are offered a much wider choice of goods and services.
- Imports of raw materials can allow a developing economy to increase its rate of industrialisation.
- Importing products creates additional competition for domestic industries and this should encourage them to keep costs and prices down and make their goods as well designed and of as high quality as possible.
- Countries can begin to specialise in those products they are best at making if they import those that they are less efficient at as compared to other countries. This is called comparative advantage.
- Specialisation can lead to economies of scale and further cost and price benefits.
- By trading in this way, the living standards of all consumers of all countries trading together should increase as they are able to buy products more cheaply than those that were produced just within their own countries.
  - Movements of international capital have increased foreign investment in both developed and developing countries.
  - Businesses can more easily recruit workers/managers from other countries, increasing the pool of skilled labour to draw from.

In recent years, there have been moves towards free trade by reducing international trade restrictions such as tariffs (taxes on imports) and quotas (quantity limits on import). These measures have been a major factor driving the 'globalisation' process.

Multinational businesses

multinational company or business: business organisation that has its headquarters in one country, but with operating branches, factories and assembly plants in other countries

Multinational companies have benefited greatly from the freedoms offered by globalisation. They are more than just importers and exporters; they actually produce goods and services in more than one country. The biggest multinationals have annual sales turnovers exceeding the size of many countries' entire economies. This sheer size – and the power and influence it can bring – can lead to many problems for nations that deal with such companies. 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 will be the ones where the head offices are based.

Why become a multinational?

There are several reasons why businesses start to operate in countries other than their main base.

Exam tip: When defining a multinational business, it is not enough to state that such businesses 'sell products in more than one country'.

1. Closer to main markets – this will have a number of advantages:
   - lower transport costs for the finished goods
   - better market information about consumer tastes as a result of operating closer to them
   - may be viewed as a local company and gain customer loyalty as a consequence.
2. Lower costs of production – apart from lower transport costs of the completed items, there are likely to be other cost savings:
   - lower labour rates e.g. much lower demand for local labour in developing countries compared to developed economies
   - cheaper rent and site costs, again resulting from lower demand for commercial property – these cost savings can make the 'local' production very efficient in terms of the market in the rest of the world and can lead to substantial exports
   - government grants and tax incentives designed to encourage the industrialisation of such countries.
3. Avoid import restrictions – by producing in the local country there will be no import duties to pay and no other import restrictions.
4. Access to local natural resources – these might not be available in the company's main operating country.

ACTIVITY 1.6.5

BORGES NOW OPERATES IN 100 COUNTRIES

Spanish food multinational Borges is aiming to develop olive plantations in India, following the setting up of its 100% subsidiary in the country. The company is also going to open a manufacturing unit in India, which will be part of the R's 65 million investment planned for the country over the next three years. The investment is being encouraged by the Indian government, which until recently protected its own manufacturers and producers.

'Plantations of olives in India will reduce the comparative cost price. It will result in a huge employment opportunity. It will contribute to the society,' said the managing director of Borges India.

For the moment, the company will concentrate on its three ranges of olive oil – extra virgin, light and pure categories – targeting the fast-growing markets in Delhi, Mumbai, Bangalore, Hyderabad, Chennai and Pune. Next year, the company will expand to 36 cities. Borges hopes that, with its newly created 100% owned subsidiary in India, it will achieve an 18% share of the olive oil market. The company's extra light olive oil was conceived primarily for the Indian consumer, since it will not interfere with the flavours and the aroma of the domestic cuisine and yet remain a healthy cooking medium.

The company's products, which include nuts, dry fruits, table olives, vinegars and salad dressings, have a presence in over 100 countries. The group was founded in 1896 and has plantations in Spain and the USA (California), besides sourcing from other countries.

10 marks, 20 minutes

1. Define the term 'subsidiary'. [2]
2. Analyse **two** possible benefits to Borges of establishing operations in India. [4]
3. Analyse **two** problems Borges might encounter establishing operations in India. [4]

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 with local workers and government officials could lead to misunderstandings. Coordination with other plants in the multinational group will need to be carefully monitored to ensure that products that might compete with each other on world markets are not produced or that conflicting policies are not adopted. Finally, it is likely that the skill levels of the local employees will be low and this could require substantial investment in training programmes.

ACTIVITY 1.6.6

SOUTH AFRICA ACCELERATES ITS CAR PRODUCTION

South Africa is now a profitable production and export base for some of the world's household names in auto manufacture, despite the country's geographical remoteness, its reputation for labour militancy and political uncertainties. South Africa has also become a key supplier of motor-industry components, providing everything from windscreens to exhaust pipes for some of the most demanding markets in the world. This did not happen by accident. It is the result of a deliberate strategy by the government to draw the world's best car manufacturers into South Africa, and make the domestic car industry more competitive.

BMW has invested Rand 1 billion upgrading its Rosslyn plant near Pretoria, which will export 75% of the 40 000 3-Series cars produced each year to Britain, Germany, Japan, America, Australia, Hong Kong, Singapore, New Zealand, Taiwan and Iran. Daily output has increased fivefold since 1989 and this has helped create 900 new jobs at the Rosslyn plant, and an estimated 18 000 jobs in the car-component industry.

The Eastern Cape remains one of the poorest regions in the country. Average black disposable income stands at a low Rand 5000 a year, compared with the white population's Rand 45 000 a year. Little wonder that when Volkswagen were looking for 1300 workers to replace those who were sacked for participating in the illegal strike, 23 000 turned up outside the factory gates in the hope of being chosen. Port Elizabeth and East London, the province's two main cities, are rapidly emerging as South Africa's new carmaking centres. The extra incomes created by the industry help to boost other local industries such as retailing and house construction. The success of multinationals 'has been a huge confidence booster for us,' says Anthony Black, an economist at Cape Town University who helped create the governments Motor Industry Development Programme. 'It has enabled us to bring about big productivity improvements, stabilise employment, reduce the real cost of new vehicles, and give consumers more choice.'

20 marks, 40 minutes

1. List **two** examples of multinational companies that have invested in South Africa. [2]
2. Explain **two** possible reasons for multinational companies setting up factories in South Africa. [4]
3. Analyse **two** possible benefits South Africa might gain from investment by multinational companies. [4]
4. Evaluate whether the South African government should continue to support investment by multinational businesses in its economy. [10]

The impact on 'host' countries of multinational operations

The potential benefits are clear:

- The investment will bring in foreign currency and, if output from the plant is exported, further foreign exchange can be earned.
- Employment opportunities will be created and training programmes will improve the quality and efficiency of the local workforce.
- Local firms are likely to benefit from supplying services and components to the new factory and this will generate additional jobs and incomes.
- Local firms will be forced to bring their quality and productivity up to international standards either to compete with the multinational or to supply to it.
- Tax revenues to the government will be boosted from any profits made by the multinational.
- Management expertise in the community will slowly improve when and if the 'foreign' supervisors and managers are replaced by local staff, once they are suitably qualified.
- The total output of the economy will be increased and this will raise gross domestic product.

It will not be all good news, however. The expansion of multinational corporations into a country could lead to the following drawbacks:

- Exploitation of the local workforce might take place. Due to the absence of strict labour and health and safety rules in some countries, multinationals can employ cheap labour for long hours with few of the benefits that the staff in their 'home' country would demand. Recent poor publicity has forced the Gap and Nike clothing companies to improve their monitoring of the employment of illegal child workers at factories that produce their clothes in Thailand. How many large businesses would not care about these practices, especially as the factories are so far removed from Western media investigation?
- Pollution from plants might be at higher levels than allowed in other countries. This could be either because of slack rules or because the 'host' government is afraid of driving the multinational away if it insists on environmentally acceptable practices. This is a sign of the great influence multinationals can have.
- Local competing firms may be squeezed out of business due to inferior equipment and much smaller resources than the large multinational.
- Some large 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.

Exam 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.

- Profits may be sent back to the country where the head office of the company is based, rather than kept for reinvestment in the host nation.
- Extensive depletion of the limited natural resources of some countries has been blamed on some large multinational corporations. The argument is that they have little incentive to conserve these resources, as they are able to relocate quickly to other countries once resources have run out.

OVER TO YOU

Revision checklist

1. List **four** benefits to the economy of your country that would result from a growth in the number of small firms.
2. A computer manufacturer is planning to expand. Explain to its management the difference between internal and external growth.
3. A producer of fruit drinks in your country has asked you to explain the difference between vertical forward and backward integration. Give examples of each that would be relevant for this business.
4. Two large banks in your country plan to merge. Examine the advantages and disadvantages to the businesses that could result from this integration.
5. In the example used in question 4 identify **two** stakeholder groups that could be affected by this planned merger.
6. In the example in question 4 explain the possible advantages and disadvantages to these two groups from the proposed merger.
7. Explain **three** reasons why the owner of a small business might decide not to expand the business.
8. Differentiate between a joint venture and a strategic alliance.
9. Explain how globalisation has encouraged the growth of multinational companies.
10. Explain **two** benefits and **two** disadvantages to your country resulting from the operations of a well-known multinational company.

Exam practice question

TALE OF TWO INDUSTRIES

The size of the average Indian steel plant compared to the size of the average Indian retail shop could not be more different. Steel plants employ thousands of workers, have millions of dollars of capital invested in advanced equipment and produce annual output valued in the millions too. Tata, one of the largest steel makers in the world, has recently grown and become a truly multinational company by taking over European steel giant Corus and UK carmakers Jaguar and Land Rover. It has been able to do this because of easier capital flows, which are a sign of increased globalisation.

Contrast this company with typical Indian retail outlets. The small shopkeepers and street hawkers that presently account for over 95% of Indian retail sales often employ just a few workers with little investment in modern technology. But all this could be about to change. There is a growing trend of mergers and takeovers in the retail sector. Large retail groups, such as Reliance and Walmart, are becoming established. It is claimed that the market share of this organised sector will be 25% by 2015. A pressure group of small retailers, the National Movement for Retail Democracy, is organising demonstrations to demand that big corporations leave the retail industry.

20 marks, 40 minutes

1. Define the term 'merger'. [2]
2. Explain why average costs of production might fall as a business increases its scale of operations. [4]
3. Analyse **one** potential benefit and **one** potential drawback to consumers of steel, such as carmakers, from a takeover of Corus by Tata. [4]
4. Evaluate whether Indian consumers would benefit from more shops owned by large retail corporations. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, examine what changes globalisation has had on the activities of multinational organisations. [20]

1.7

H

Organisational planning tools

On completing this chapter you should be able to:

Analyse and apply:

- The following planning tools in a given situation:
  - Fishbone diagram
  - Decision tree
  - Force-field analysis
  - Gantt chart (all AO3)

Evaluate:

- The value to an organisation of these planning tools (AO3)

Calculate/complete/construct:

- Examples of these planning tools (AO4)

Setting the scene

BUILDING A NEW BRIDGE

The Eastern Construction Co. has just received its first major bridge-building contract from a foreign government. Jimmy Chen has been appointed project manager for this key contract. He has seen government officials on several occasions to obtain agreement on:

- the exact size and specifications of the bridge
- the expected completion date
- the value of the contract – the price the government has agreed to pay for the completed bridge.

Jimmy has a team of managers to help him plan and calculate the exact materials and equipment needs of this building project – they will take responsibility for seeing the project through to the finish. IT specialists have been asked to draw up a Gantt chart program showing all the different tasks of the project, the estimated time for each task and the resources needed for each. This chart has shown that some tasks can be done together – such as laying the tarmac on the road and painting the steel structure, and other tasks must be completed before any other work can start – such as building an access road and laying foundations for the bridge.

After six months, building work has started and the project is on time – so far. Both Jimmy and his senior managers hope that if the project is seen as a success, other bridge contracts will be awarded to the company.

Points to consider

- Why is careful planning of this project particularly important to this company?
- Why would a chart showing the different activities and their duration be useful to Jimmy and his team?
- What problems might there be in making sure this chart was as accurate as possible?

Key concept link

To implement new strategies successfully organisations must plan necessary resources effectively. Major changes brought about by changes in 'strategic direction' require long-term planning and organising and monitoring of resources and activities.

Introduction

All organisations need to plan. **Organisational planning** includes preparing for new **projects** and managing them as effectively as possible. Projects are specific tasks which 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 – or it could be major – such as a car manufacturer developing a hybrid vehicle for the first time in response to environmental pressures.

organisational planning: process of identifying an organisation's immediate and long-term objectives, and formulating and monitoring specific strategies to achieve them; it also involves employee and resource allocation to allow for the effective completion of projects

project: a specific and temporary activity with a start and end date, clear goals, defined responsibilities and a budget

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.

Project managers must simultaneously manage the four basic elements of any project:

- **Resources** – the people, equipment and materials needed.
- **Time** – each activity will need to be timed so that an overall project duration can be worked out.
- **Money** – the project must be kept to budget and the expected profit from it should be aimed for.
- **Scope** – the overall size and scale of the project must be established and the specific objectives for it set.

To be completed successfully, a project needs to be planned and managed, costs determined and time allocated, problems dealt with and, eventually, concluded. Formal methods of **project management** offer clear guidelines and deadlines.

project management: using modern management techniques to plan, carry out and complete a project from start to finish in order to achieve preset targets of quality, time and cost

This chapter considers four tools of organisational planning.

The fishbone diagram

The **fishbone diagram** – also known as a cause-and-effect diagram or an Ishikawa diagram – may be used to analyse a problem or situation. An example is given in Figure 1.7.1, which is based on a brainstorming session where a team is attempting to establish all of the possible causes of iron contaminating a food product.

fishbone diagram: a visual identification of many potential causes of a problem

In this example, six main potential causes of the problem of iron in the product were identified. These are the most common main 'bones' that feature on the fishbone diagram. They are sometimes called the 6Ms:

- Methods – are the bottles used clean?
- Machines – are there rusty pipes in the production machines?
- Manpower – is the workforce skilled enough?
- Materials – are the raw materials to blame?
- Measurement – is the calibration incorrect?
- 'Mother nature' (the environment) – is the working environment contaminated?

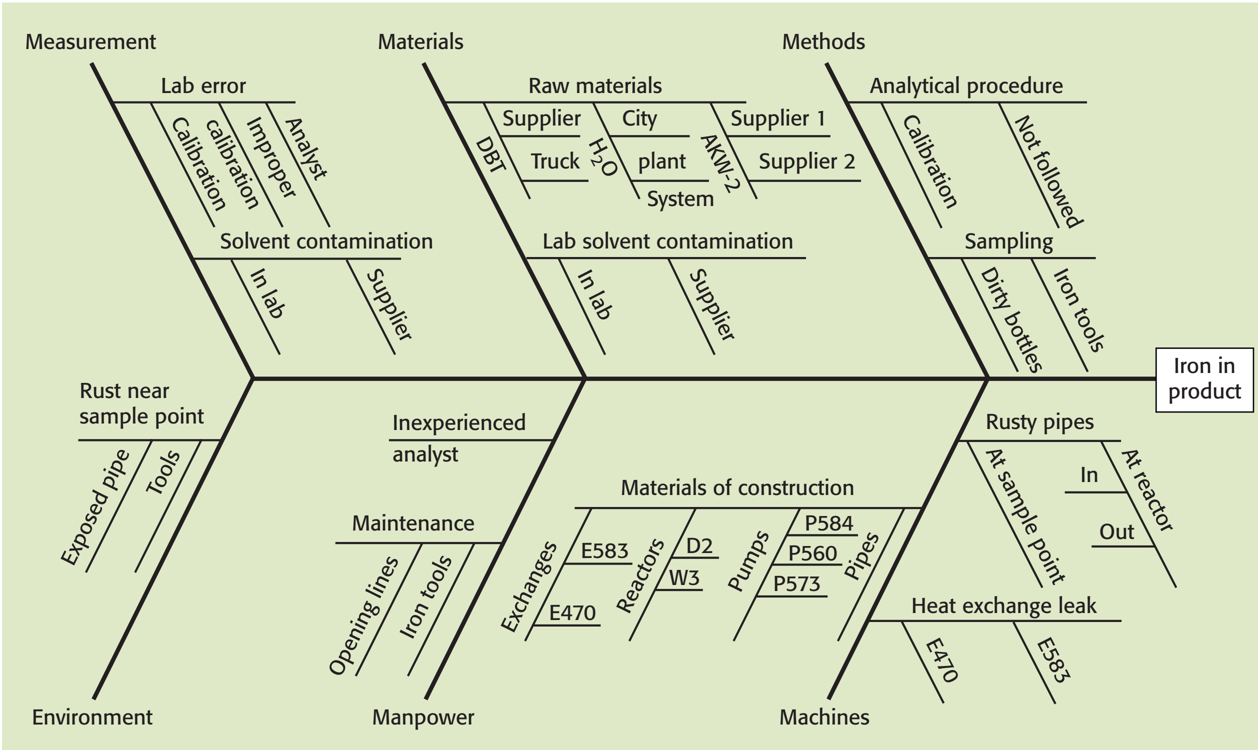


Figure 1.7.1 Example of a fishbone diagram

Source: Nancy R. Tague (2004) *The Quality Toolbox* (ASR Quality Press, 2nd edition)

More detailed discussion of each of these causes led to the factors laid out in the form of the 'smaller bones' of the fish.

Stages in the fishbone process include:

1. Agree on the problem statement and write this in the centre of the whiteboard or screen.
2. Brainstorm the main categories of the causes of the problem, or use the common generic ones (the 6Ms). These become the six main bones of the fish.
3. Brainstorm all of the detailed reasons why problems might occur under each of these headings – the small fish bones.
4. Analyse the findings of the group as shown on the diagram. Investigate the most likely causes of the problem – more research might now be necessary to arrive at a conclusion.

Once this process has been completed the business can put strategies in place to remove the most likely causes of the problem, perhaps by adopting different quality assurance systems or improving training.

Fishbone diagram – an evaluation

The fishbone diagram is a simple and easy-to-understand approach which aids the discussion and resolution of business problems. Used effectively, it can encourage employee participation. This planning tool also offers a model for building a system of performance improvements in order to resolve actual or potential problems such as training and motivation techniques.

However, it does have limitations. Its relative simplicity can be a weakness as well as a strength. The nature of the diagram may make it difficult to represent the interrelated nature of many business problems – which often may not stem from just one cause – and it cannot effectively be used to illustrate really complex problems.

ACTIVITY 1.7.1

Explain how the fishbone diagram tool could help in analysing the decline in student numbers at a high school for 16- to 19-year-old students.

Decision tree

decision tree: a diagram that sets out the options connected with a decision and the outcomes and economic returns that may result

A **decision tree** is a technique that considers the value of the options available and the chances of them occurring.

This technique is based on a diagram that is drawn to represent four main features of a business decision:

- all 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.

By comparing the likely financial results from each option, the manager can minimise the risks involved and maximise the potential returns.

Constructing decision trees

The tree is a diagram which has 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 are denoted by a square – these are decision nodes.
- A circle shows that a range of outcomes may result from a decision – a chance node.
- Probabilities are shown alongside each of these possible outcomes. These probabilities are the numerical values of an event occurring – they measure the 'chance' of an outcome occurring.
- The economic returns are the expected financial gains or losses of a particular outcome – the 'pay-offs'.

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

Working out 'expected values'

Using the formula above, the **expected value** of tossing a coin and winning \$5 if it comes down heads is $0.5 \times \$5 = \$2.50$. In effect, the average return, if you repeated this a number of times, would be to win \$2.50 – this is the expected value. The purpose of a decision tree is to show that option which gives the most beneficial expected value.

For example, the manager of an events-organising business has to decide between holding a fundraising auction indoors or outdoors. The financial success of the event depends not only on the weather, but also on the decision to hold it indoors or outdoors.

Table 1.7.1 shows the expected 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 \$2000 to arrange and the outdoor event will cost \$3000.

Weather	Indoors	Outdoors
Fine	$5 000	$10 000
Poor	$7 000	$4 000

Table 1.7.1 The possible economic returns from the alternative options

The decision tree of the event is shown in Figure 1.7.2. This diagram demonstrates the main advantages of decision trees:

- They force the decision-maker to consider all 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.

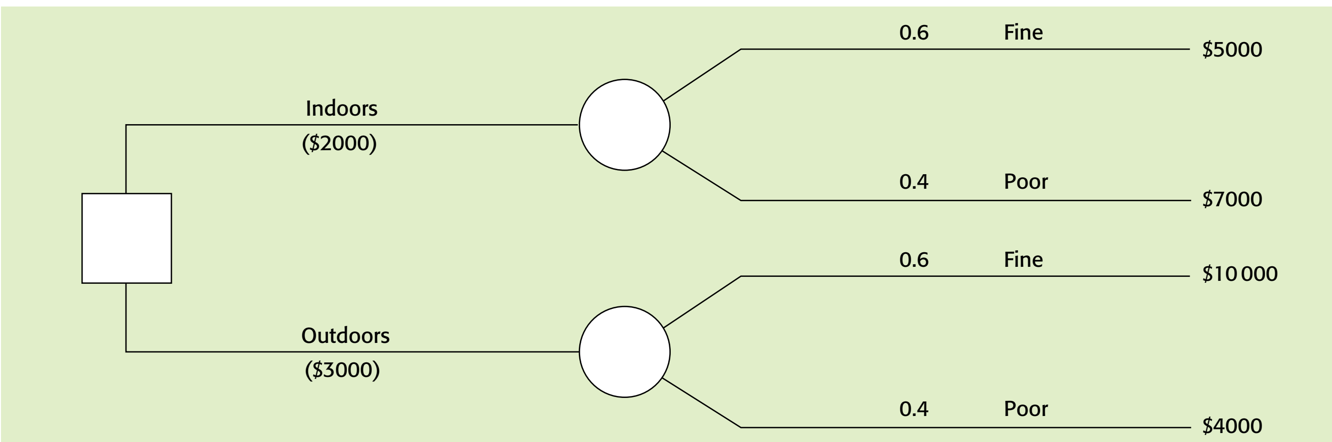


Figure 1.7.2 Decision tree for the fundraising auction

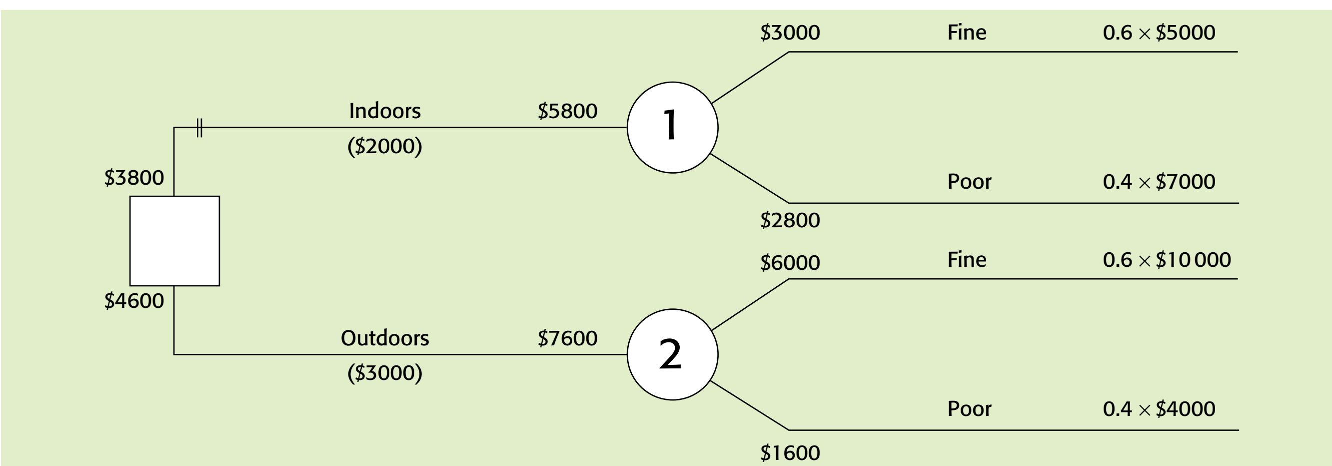


Figure 1.7.3 Calculating expected values – working from right to left

Using the tree diagram in Figure 1.7.3, which option would give the highest expected value – holding the event indoors or outdoors? The answer is gained by calculating the expected value at each of the chance nodes. This is done by multiplying the probability by the economic return of 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 1.7.3):

- The expected value at node 1 is $5800.
- The expected value at node 2 is $7600.
- Subtract the cost of holding the event either indoors or outdoors.
- Indoors = $5800 – $2000 = $3800
- Outdoors = $7600 – $3000 = $4600

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 the figure to indicate that this decision will not be taken.

THEORY OF KNOWLEDGE

Decision trees are fantastic as a mathematical model that gives the decision-maker a precise outcome on a decision at the mercy of future uncertainty. Where would you be without such mathematical models?

Consider the statement: Mathematical models enable us to make sense of future chaos.

To what extent do you think this is true?

Decision trees – an evaluation

This technique has many benefits:

- It allows the visual representation of decisions and possible outcomes from them.
- It forces managers to consider not only the possible financial outcomes from a decision but also the likely chances of success or failure.
- The calculation of expected monetary values is a good starting point for the quantitative assessment of different options.

However, when decision-making is planned there are limitations to using decision trees too:

- The primary limitation concerns the 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 'guestimates' of the most likely financial outcome. In these cases, the scope for inaccuracy of the data makes the results of decision-tree analysis a useful guide, but no more.
- The probabilities of events occurring may be based on past data, but circumstances may change. 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.

ACTIVITY 1.7.2

EXPANSION DECISION

The owner of a service station is planning to expand the business. The two options are to build a forecourt to sell petrol or to construct a showroom to sell cars. The estimated building costs are: petrol forecourt – $100 000; car showroom – $150 000. The forecast economic consequences or pay-offs during the expected lives of these investments will depend on the level of demand in the economy, as shown in the table below. The probability of demand being low during the lifespan of these investments is 0.2 and the probability of high demand is 0.8.

Demand	Petrol forecourt	Car showroom
High	$500 000	$800 000
Low	$400 000	$200 000

The economic returns from the two options

20 marks, 40 minutes

1. Construct a fully labelled decision-tree diagram to show the options facing the garage owner. Include on your diagram the pay-offs and probabilities of each option. [6]
2. Calculate the expected value of both investments and recommend which option should be taken. [4]
3. Evaluate the usefulness of decision trees to support business decision-making. [10]

The conclusion is that decision trees aid the decision-making process, but they cannot replace either the consideration of risk or the impact of qualitative factors on a decision. The latter could include the impact on the environment, the attitude of the workforce and the approach to risk taken by the managers and owners of the business. There may well be a preference for fairly certain but low returns, rather than taking risks to earn much greater rewards.

Finally, remember that 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 – they do not eliminate those risks.

ACTIVITY 1.7.3

WHICH MARKET?

Joe Keenan has an important decision to take. He operates a mobile market stall selling cooking pans and kitchen equipment. He has to decide which market to visit next Saturday. There are four options but, of course, he can only go to one town. He has estimated the revenues he could earn from each location by using past records and by consulting with other stallholders. His estimates in dollars ($), together with the chances of earning them, are given below:

Town A		Town B		Town C		Town D	
Probability	Revenue ($)	Probability	Revenue ($)	Probability	Revenue ($)	Probability	Revenue ($)
0.4	5000	0.3	3000	0.4	3000	0.3	5000
0.6	8000	0.5	4000	0.5	6000	0.3	6000
		0.2	8000	0.1	10 000	0.4	9000

20 marks, 40 minutes

1. Define the term 'expected value'. [2]
2. Using the data above, construct a decision tree of the options Joe has and add the probabilities and forecasted economic returns. [6]
3. a. Calculate the expected values of the four options that Joe could choose from. [4]
   b. On the basis of quantitative factors explain which town Joe should visit on Saturday. [4]
4. Outline **two** factors that could influence the accuracy of Joe's forecasts. [4]

LEARNER PROFILE

Reflective

In 2008 global banking virtually collapsed; it nearly took the rest of the world down with it. Rich, powerful banks employed some of the world's brightest mathematicians to develop financial models that they thought made the future certain. A certain future made 'risk-free' decision-making a reality and allowed the banks and their employees to make huge fortunes.

In 2008 the models failed and the entire system would have gone bankrupt but for government bailout money.

Wharton finance professor Franklin Allen puts it bluntly, 'It's not just that they missed it, they positively denied that it would happen,' arguing that many economists used mathematical models that failed to account for the critical roles that banks and other financial institutions play in the economy.

Reflective IB students 'give thoughtful consideration to their own learning and experience. They are able to assess and understand their strengths and limitations'.

Source: Adapted from knowledge.wharton.upenn.edu

Do you think there is a conflict between the use of mathematical models that look to reduce uncertainty and being a reflective learner?

Lewin's force-field analysis

force-field analysis: an analytical process used to map the opposing forces within an environment (such as a business) where change is taking place

Force-field analysis, first developed by Kurt Lewin, provides a framework for looking at the factors (forces) that influence change. These forces can either be 'driving forces for change' that help the organisation towards a goal or 'restraining forces against change' that might prevent an organisation reaching its goal.

Steps in force-field analysis

1. Outline the proposal for change – insert in the middle of a force-field diagram, as shown in Figure 1.7.4.
2. List forces for change in one column and forces against change in the other.
3. Assign an estimated score for each force, with 1 being weak and 5 being strong.

Figure 1.7.4 shows a proposal for installing IT-controlled manufacturing equipment in a factory.

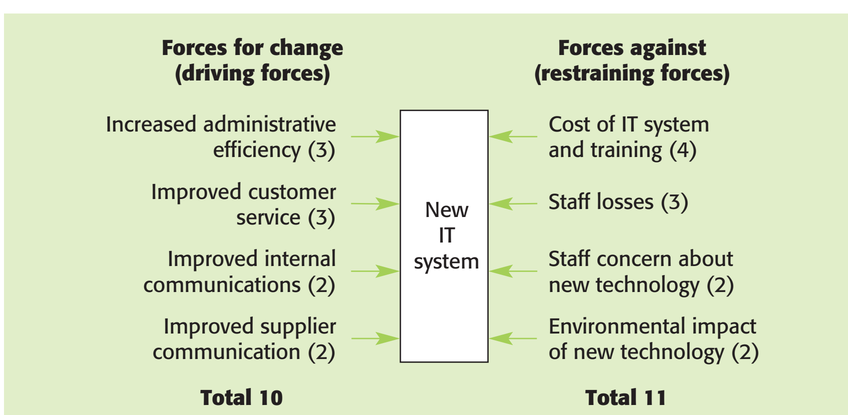


Figure 1.7.4 Force-field analysis of an IT-controlled machinery proposal

The numerical scores indicate whether the forces are weak (e.g. 1) or strong (e.g. 5).

Once the analysis has been carried out, the process can help management improve the probability of success of this major change. For example, by training staff (which might increase cost by +1) their concern about new technology could be reduced (reducing staff concern by –2).

Usefulness of Lewin's model

- The force-field diagram helps managers weigh up the importance of these two types of forces.
- It helps identify the people most likely to be affected by the change.
- It encourages an examination of how to strengthen the forces supporting the decision and reduce the forces opposed to it.
- The use of a leadership style that reduces opposition and resistance to change is highlighted as being more effective than forcing through unpopular changes in an autocratic manner.

Force-field analysis – possible limitations

Force-field analysis requires the full participation of everyone involved to provide the accurate information required for an effective analysis. This can be a disadvantage when full participation isn't possible, resulting in an analysis that doesn't provide a realistic picture of the supporting and opposing forces. Another disadvantage is the possibility that the analysis won't result in a consensus among the group. In fact, a force-field analysis may actually cause a division in the group between those who support the decision and those who oppose it.

One of the key things to keep in mind when using force-field analysis is that the analysis developed is entirely dependent upon the skill level and knowledge of the group working on the analysis. In most cases, force-field analysis is based on assumptions, not facts. Even if the assumptions are based on experience, the interpretation of the evidence should not necessarily be seen as being objective within the overall process of evaluating the driving and restraining forces.

ACTIVITY 1.7.4

Evaluate the usefulness of force-field analysis for planning and managing a major change within your school or college – for example, the introduction of IT-based lessons with students working from home on one day per week, downloading lecturers' video lessons.

Gantt charts

A **Gantt chart**, frequently used in project management, is one of the most effective ways of showing activities (tasks or events) displayed over time. On the left of the chart is a list of the activities and along the top is a time scale. Each activity is represented by a bar; the position and length of the bar shows the start date, the duration of each activity and the end date of the activity. This allows managers to see quickly:

- what the main activities are
- when each activity begins and ends
- how long each activity is scheduled to last

Gantt chart: a visual representation of a project schedule in which a series of horizontal lines shows the amount of work planned in certain periods of time

- where activities overlap with other activities – these are simultaneous activities which can be 'done together' to save the business time in completing the project
- the start and end date of the whole project. This allows the business to inform customers when the project, such as a new building, is likely to be completed.

A Gantt chart therefore shows managers what has to be done (the activities) and when (the schedule).

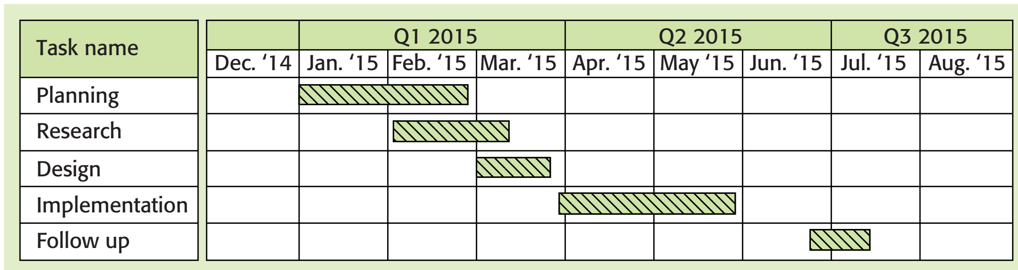


Figure 1.7.5 A simple Gantt chart

How to create a Gantt chart

Step 1: Identify the most important activities or tasks

Gantt charts only give useful information if they include all the activities needed for a project to be completed. Then, for each task, the earliest start date and its duration must be estimated. This can be done with some accuracy if similar projects have been undertaken before, but if the project is a 'one-off' then these estimates may prove to be inaccurate.

Step 2: Identify relationships between the activities/tasks

Gantt charts show the relationship between the tasks in a project. Some tasks will need to be completed before the next one can be started and others can't end until preceding ones have ended. For example, if a magazine is being prepared, the design must be completed before it can be sent to print.

These dependent activities are called 'sequential' or 'linear' tasks. Other tasks will be 'parallel' or simultaneous – i.e. they can be done at the same time as other tasks.

Management must identify which of the project's tasks are parallel, and which are sequential. Where tasks are dependent on others, the relationship between them must be noted as this will help when management starts scheduling activities on the Gantt chart.

Step 3: Input activities into software or a template

Gantt charts are now rarely drawn by hand and specialist software such as Gantto, Matchware or Microsoft Project is used. Some of these tools are cloud-based, meaning that the project team can access the document simultaneously, from any location. This helps greatly in discussing, optimising and reporting on a project.

Advantages of Gantt charts

When a Gantt chart is created, it is necessary to think through all the tasks required in the project. As part of this process managers will:

- assign responsibility for each task
- work out the duration of each task
- assess potential problems.

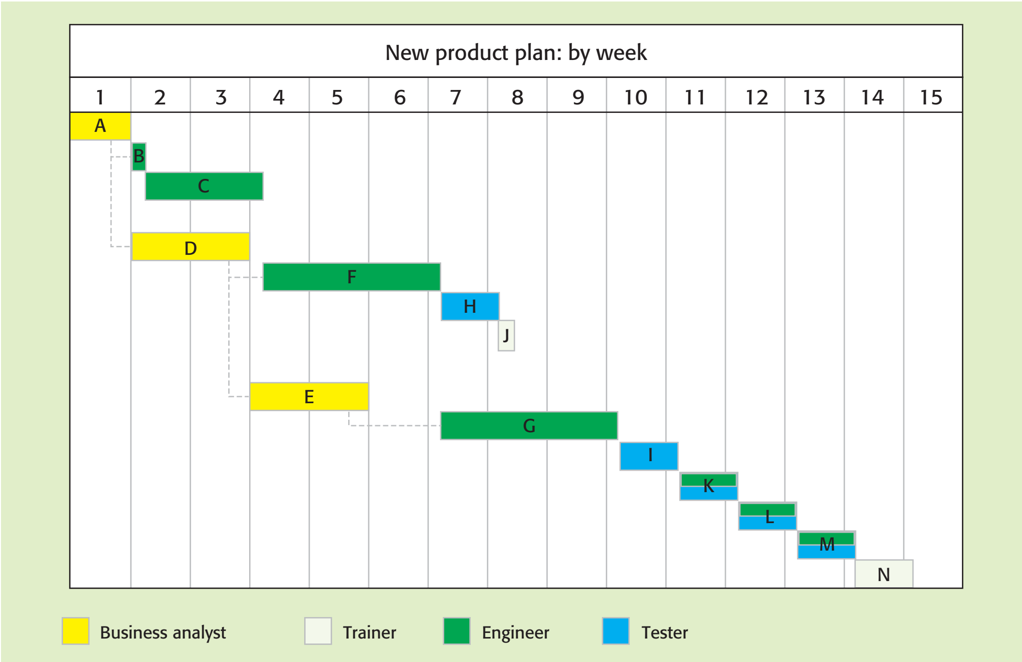


Figure 1.7.6 Gantt chart showing parallel and sequential activities

This kind of detailed planning helps ensure that the schedule is actually achievable, that the right people are given responsibility for each task, and that the impact of potential problems or delays is understood and can be planned for.

Gantt charts enable managers to schedule projects to achieve the best possible completion date. They allow managers to review all necessary tasks and the most efficient order for successful completion. Managers can also use the charts to recognise the route of the critical path. The critical path is the sequence of tasks that must be completed on time if the entire project is to be finished on schedule.

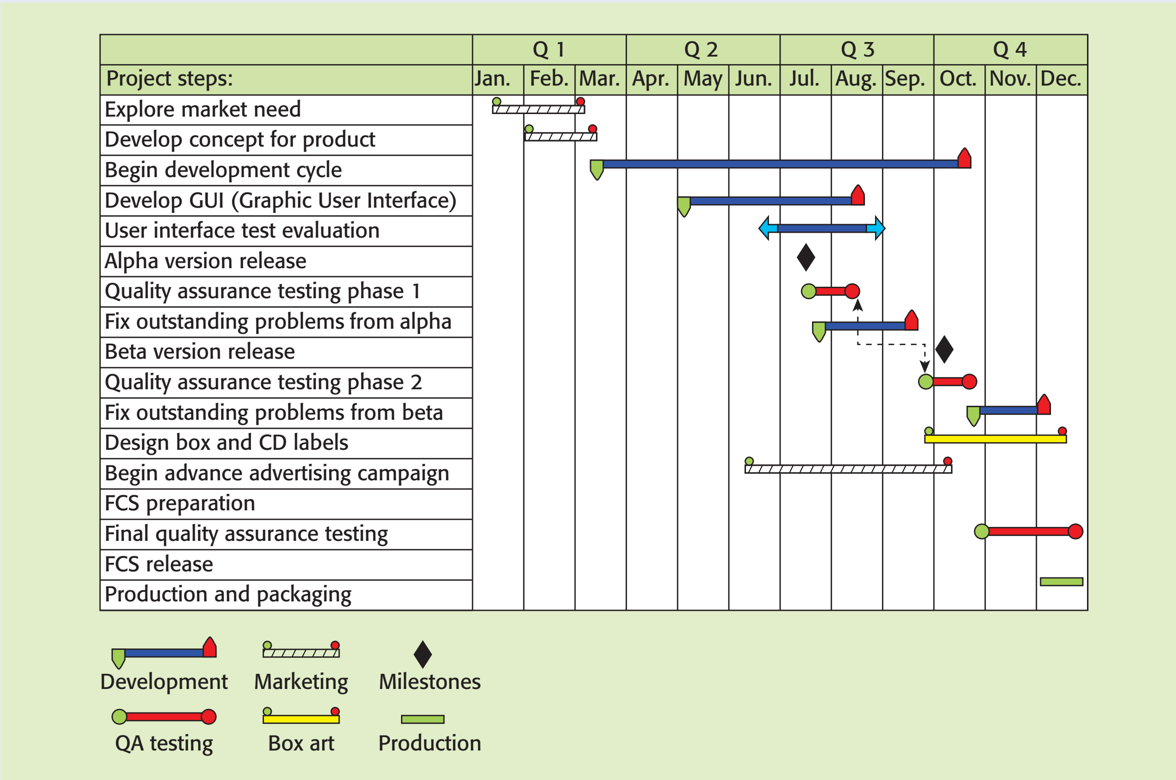
Finally, Gantt charts can be used to keep employees and customers informed of the day-to-day developments. The chart can be updated at any point to show changes in the schedule and their implications. They can also be used to communicate when key tasks have been completed.

Gantt charts – an evaluation

Although widely used as a planning tool, Gantt charts have potential limitations:

- For projects that require many tasks, the Gantt chart may become very complex and difficult to interpret.
- A Gantt chart also requires frequent updates during the project if some activities are completed later than expected.
- The 'work breakdown structure' – the list of activities and their interrelationships – has to be complete and accurate otherwise the Gantt chart will have limited value. If an activity is left out or a duration is poorly estimated then the Gantt chart will have to be redrawn.
- Finally, Gantt charts do not offer a good solution when dealing with the triple constraints of time, cost and scope. The cost of a project is not depicted on a Gantt chart, nor the full scope of a project. No matter how detailed the Gantt chart is, the full complexity is not depicted. This is because the main focus of the Gantt chart is time.

ACTIVITY 1.7.5



The Gantt chart above shows the steps to be taken in developing and launching a new product.

20 marks, 40 minutes

1. Define the term 'Gantt chart'. [2]
2. Identify **two** steps that can be undertaken simultaneously. [2]
3. Explain the benefit to the business of undertaking some steps simultaneously. [4]
4. Identify the time taken for the entire project. [2]
5. Evaluate the usefulness of Gantt charts such as this for the planning of new projects. [10]

OVER TO YOU

Revision checklist

1. Why is resource planning important for a new construction project?
2. Explain the possible usefulness of a fishbone diagram when analysing the possible causes of poor quality on a car assembly line.
3. Outline **two** possible limitations of fishbone diagrams.
4. Explain how decision-tree analysis could be useful when management of a retail business has to choose a new store location.

5. Outline **two** possible limitations of decision-tree analysis in the situation referred to in question 4.
6. Explain how force-field analysis could be useful when planning to introduce a major change in production processes in a computer factory.
7. Outline **two** possible limitations of force-field analysis in the situation referred to in question 6.
8. Explain **two** benefits of using Gantt charts when planning a new project.
9. Outline **two** possible limitations of Gantt charts.

Exam practice question

FOUR SEASONS LEISURE

After a period of consolidation in 2009–10, when the Four Seasons Leisure group saw a big contraction in demand due to the world economic slowdown, the company is looking to increase its share of the upmarket, all-inclusive holiday resort market. Thirty years of providing holidays to high-income European and North American consumers make Four Seasons Leisure one of the most prestigious brands in the Caribbean.

Despite the economic recession in 2009–10, the company performed fairly well. Profits fell by 5%, but this compared favourably with an industry average profit decline of 9%. Four Seasons has attributed the group's relative success to effective management from a team of people that have considerable knowledge and expertise in the market.

The management team is not complacent, however. The chief executive officer, Austin Walsh, thinks the company's concentration in the Caribbean is a weakness because of competition from new holiday destinations such as Dubai. Austin believes the company needs to expand into some of the new destinations that its customers are interested in visiting. The directors are considering three options for expansion:

			Projected profits based on economic conditions ($m)	
		Initial cost ($m)	Fast growth	Normal growth
Option 1	Open new resort in Dubai	120	400	200
Option 2	Open new resort in Thailand	150	500	300
Option 3	Upgrade existing resorts in Caribbean	80	150	120

The consultancy that produced the projected costs and profit data believes that there is a 20% chance of fast economic growth, 50% chance of normal economic growth and a 30% chance of a recession.

20 marks, 40 minutes

1. Construct a fully labelled decision tree showing Four Seasons' options. [6]
2. Calculate the expected values for each option and state which option Four Seasons should choose. [4]
3. Evaluate the importance of the possible non-financial factors that might affect Four Seasons' decision. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, evaluate the importance of business models in guiding business strategy. [20]

Unit

2

HUMAN RESOURCE MANAGEMENT

2.1

Functions and evolution of human resource management

On completing this chapter you should be able to:

Know and understand:

- Human resource planning (AO1)
- Common steps in the processes of dismissal and redundancy (AO1)

Analyse and apply:

- Labour turnover (AO2)
- Common steps in the process of recruitment (AO2)
- Types of training: on-the-job; off-the-job; cognitive; behavioural (AO2)
- Types of appraisal: formative; summative; 360-degree feedback; self-appraisal (AO2)
- How work patterns, practices and preferences change (AO2)

Evaluate:

- Internal and external factors that influence human resource planning (AO3)
- Outsourcing, offshoring and re-shoring as human resource strategies (AO3)
- How innovation, ethical considerations and cultural differences may influence human resource practices and strategies (AO3)

Setting the scene

HUMAN RESOURCE PLANNING IN CHINA AND AUSTRALIA

Before 1978 in China, all industry was state-owned and workers were state employees. Industries were inefficient and over-staffed – jobs were given for life. There was no human resource management (HRM) because firms had no control over staffing or recruitment. Since the growth of the private sector, the need to improve efficiency and productivity has become very great. Nearly all firms of any size now have professional human resource (HR) managers. They recruit, select and train the best workers for their firms and they can 'hire and fire' in response to changing demand for products. Many posts of responsibility are given to internal staff – it is often said that the cultural links in each firm, or *guanxi* (interpersonal relationships), are so strong that it is difficult for external recruits to break into the business structure.

Australian businesses have used 'western-style' HRM for many years. This is based on the view that good management of people has a direct impact on a firm's future profitability and success. Advertising job vacancies in papers and even on TV and social media is common. Internal promotions are often given – not for cultural reasons, but because firms do not want to lose their training investment in staff by not promoting and retaining them. Interviews are the most widely used selection procedure, but references from past employers are also important. For senior management jobs, it is common for the husband or wife to be interviewed too. Unlike China, there is a huge private recruitment industry with over 300 agencies giving workers mobility to seek jobs easily in other parts of the country; moving from one region to another in China is still unusual for most workers.

Source: http://marketing/byu/edu

2.1 Human resource management

Points to consider

- From the case study, list as many human resource management responsibilities as you can.
- Do you think recruitment, selection and training of employees are important to a firm's success? Explain your answer.
- What human resource problems might an Australian business experience if it tried to open a base in China?

Key concept link

Strategic human resource management is an approach to the management of human resources that provides a strategic framework which supports the organisation's long-term objectives. Cultural differences can lead to very different human resource management strategies.

human resource management (HRM): the strategic approach to the effective management of an organisation's workers so that they help the business achieve its objectives and gain a competitive advantage

human resource or workforce planning: analysing and forecasting the numbers of workers and the skills of those workers that will be required by the organisation to achieve its objectives

human resource or workforce plan: numbers of workers and skills of those workers required over a future time period

workforce audit: a check on the skills and qualifications of all existing employees

Introduction

Human resource management (HRM) aims to recruit capable, flexible and committed people, managing and rewarding their performance and developing their key skills to the benefit of the organisation. Effective HRM requires careful planning of the number and skills of people needed by the organisation. **Human resource planning** aims to get the right number of people with the right skills, experience and competencies in the right jobs at the right time at the right cost.

Human resource planning

HR departments need to calculate the future staffing needs of the business to try to avoid having too few or too many staff or staff with the wrong skills. HR departments must respond to the corporate plan of the business and the objectives this contains. If the overall business plan is to expand production and develop products for foreign markets, then this must be reflected in the **workforce plan**. The starting point for HR planning is always a **workforce audit**.

Human resource planning involves two main stages.

1. Forecasting the *number* of employees required

This will depend on several factors:

- Forecasting demand for the firm's product – this will be influenced by market conditions, seasonal factors, competitors' actions and trends in consumer tastes. It could be a mistake to replace a worker who decides to leave the firm if consumer demand is falling or if there is likely to be a seasonal downturn in demand. Demand forecasts may be necessary to help establish workforce planning needs.
- The productivity levels of staff – if productivity (output per worker) is forecast to increase, perhaps as a result of more efficient machinery, then fewer staff will be needed to produce the same level of output.
- The objectives of the business – these could influence future workforce numbers in two main ways. First, if the business plans to expand over the coming years, then staffing numbers will have to rise to accommodate this growth. Secondly, if the firm intends to increase customer service levels, possibly at the expense of short-term profits, then more workers might need to be recruited. A workforce plan cannot be devised without consideration of business objectives.

- Changes in the law regarding workers' rights – if the government of a country decides to pass laws which establish a shorter maximum working week or introduce a minimum wage level, then there will be a considerable impact on the workforce plan. A shorter working week might lead to a greater demand for staff to ensure that all the available work is completed on time. A minimum wage might encourage firms to employ fewer workers and to substitute them with machines.
- Labour turnover and absenteeism rate – the higher the rate at which staff leave a business, the greater will be the firm's need to recruit replacement staff. The higher the level of staff absenteeism, the greater will be the firm's need for higher staffing levels to ensure adequate numbers are available at any one time.

2. Forecasting the *skills* required

The need for better-qualified staff or for staff with different skills is a constant factor in the minds of HR managers. The importance of these issues will depend upon on the following:

- The pace of technological change in the industry, e.g. production methods and the complexity of the machinery used. The application of IT in offices has meant that traditional typists or clerks are now rarely required – skilled computer operators and web designers are in greater demand than ever.
- The need for flexible or multi-skilled staff. Workers can become over-specialised, finding it difficult to adapt when demand conditions change. Most businesses need to recruit staff or train them with more than one skill that can be applied in a variety of different ways. This gives the firm greater adaptability to changing market conditions – and makes the workers' jobs more rewarding too.

Labour turnover

If a business employed, on average, 200 employees last year and 30 left during the year, then the **labour turnover** rate would be 15%. If this result 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 is more likely in areas of low unemployment too, as there may be many better-paid and more attractive jobs available in the local area. It is also true that some industries typically have higher labour turnover rates than others. The fact that so many students, looking for part-time and temporary employment, find jobs in fast-food restaurants leads to labour turnover rates that can exceed 100% in one year. In other organisations, labour turnover rates can be very low; this is typical in law practices and in scientific research.

labour turnover: measures the rate at which employees are leaving an organisation. It is measured by:

$$\frac{\text{number of employees leaving in 1 year}}{\text{average number of people employed}} \times 100$$

Drawbacks 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 loyalty and regular, familiar contact with customers • Difficult to establish team spirit and stable work groups	• Low-skilled and less-productive staff might be leaving – they could be replaced with more carefully selected workers • New ideas and practices are brought into an organisation by new workers • A business that plans to reduce staff numbers anyway – due to rationalisation – will find that high labour turnover will do this, as leaving staff will not be replaced

Table 2.1.1 Drawbacks and potential benefits of high labour turnover

Internal and external factors that influence human resource planning: demographic change

The potential supply of labour to any organisation is affected by demographic changes. Table 2.1.2 summarises three of these changes and their potential opportunities and constraints.

Example of demographic change	Opportunities	Constraints
Natural population growth (or decline) – birth rate exceeds death rate (or vice versa)	• May be easier to recruit effective employees as the working population increases	• Increased birth rates may take years before they impact on the *working* population
Net migration (immigration compared with emigration)	• May be easier to recruit effective employees from other countries at lower rates of pay • Highly qualified employees might be recruited from other countries	• 'Brain drain' of qualified and experienced staff to other countries will reduce competitiveness • Immigrants may need more training, e.g. in language and cultural issues
Ageing population (the average age of the population increases as a result of rising life expectancy)	• It is often claimed that older employees are more loyal and reliable than younger workers • Older employees may have experience and 'people' skills that younger employees may have not yet developed	• Older employees may be less flexible and adaptable, e.g. to the introduction of new workplace technologies

Table 2.1.2 The effect of demographic change on labour supply

Changes in labour mobility

occupational mobility of labour: extent to which workers are willing and able to move to different jobs requiring different skills

High **occupational mobility of labour** helps a country achieve economic efficiency. A mobile workforce means that if jobs are lost in one industry or region, workers are willing and able to move to other jobs and/or other occupations. This helps to keep structural unemployment low.

In developed economies, labour tends to be relatively immobile because:

- high levels of home ownership mean that workers are reluctant to pay the cost in time and money of arranging a house sale and purchase in another region
- high-skill levels in one occupation may mean that workers are not equipped to deal with machines, processes and technologies in other industries and occupations.

In emerging market countries, despite strong family or ethnic ties to one area, mobility tends to be higher because:

- home ownership is low
- low skill levels mean that workers can undertake low-skilled jobs in many different industries.

geographical mobility of labour: extent to which workers are willing and able to move geographical region to take up new jobs

However, a high degree of **geographical mobility**, especially between rural and urban areas, can lead to overcrowding and very poor living conditions in towns and cities.

Many governments pursue policies to attempt to increase labour mobility. These include:

- relocation grants for key public sector workers
- job centres and other government offices to advertise job vacancies nationally
- training and retraining programmes for the unemployed.

ACTIVITY 2.1.1

GLOBAL LABOUR MOBILITY

One of the consequences of globalisation has been a shift in the global demand for labour. In recent years, many richer economies have suffered declining birth rates and shifts in types of industry creating new work opportunities. At the same time, development and increasingly open borders in emerging economies have created a labour force more eager to migrate to take advantage of these opportunities. The result has been a significant expansion of global labour mobility. Governments in both origin and destination countries have encouraged this trend. Recently introduced temporary work visas in both the USA and Germany have opened the door to increasing numbers of skilled non-permanent residents. Several origin countries in Asia, including India and the Philippines, actively seek labour markets for their workers overseas.

The benefits of these policies to businesses and to the world economy are becoming clearer. A recent World Bank report estimated that an increase of 3% in the workforce in high-income countries through migration by 2025 could increase global real income by US$356 billion.

Source: www.migrationdrc.org

20 marks, 40 minutes

1. Define the term 'labour mobility'. [2]
2. Outline **two** benefits to businesses in a developed country like Germany of migrant labour entering the German labour market. [4]
3. Explain **two** ways a developed country like Germany might attract migrant workers with appropriate skills. [4]
4. Examine the advantages and disadvantages to a country like the Philippines of migrant workers leaving the Philippines to find employment abroad. [10]

ACTIVITY 2.1.2

LOWER DEMAND FOR PEUGEOT CARS LEADS TO JOB LOSSES

Peugeot closed its Aulnay plant near Paris, which employed 3000 workers, in 2014. The company also announced 1400 job cuts at a plant in Rennes and 3600 across the rest of France.

Philippe Varin, the chairman of Peugeot said: 'The depth and persistence of the crisis impacting our business in Europe have now made this reorganisation project indispensable in order to align our production capacity with foreseeable market trends.'

Mass-market European carmakers are struggling due to the eurozone crisis and too many vehicle plants. With the existing level of over-capacity in the industry it was inevitable that the number of workers needed by some of the major manufacturers would fall. In 2014, Peugeot's sales were 23% lower compared to 2007. The company's European plants are operating at just three-quarters of capacity. Making redundancies will reduce costs and help to restore Peugeot's profitability.

10 marks, 20 minutes

1. Define the term 'redundancy'. [2]
2. Explain **two** reasons why human resource planning is important to a firm like Peugeot. [4]
3. Analyse **two** factors that might influence the number of workers employed by Peugeot. [4]

Job losses at Peugeot as a result of their factory closure

Exam tip: When discussing workforce planning in examination answers it is important to make clear that it can only be effective if it is linked closely with the firm's long-term objectives.

New communication technologies

ICT is impacting on the employee numbers and labour skill requirements in many industries. Some jobs are being lost forever whilst other opportunities are being created for flexible and ICT-trained employees. ICT has changed working life in many ways. Workers no longer need to share a location to share information and work together. ICT has simplified and streamlined work in offices and factories and this has required HR managers to adapt workforce plans to reflect changing employee needs of organisations.

ICT is changing the structure of economies, allowing firms to find new and more efficient ways of producing goods and services – often with fewer employees. Information technology combined with the internet and broadband promotes a significantly larger geographical flexibility in organising production and HR resources. Computers are used extensively to substitute for routine manual tasks, such as record-keeping, calculation, picking and sorting, and repetitive assembly work. They also provide effective support for non-routine cognitive tasks, such as engineering and architecture. The increased use of digital technology increased the demand for creative jobs and reduced demand for routine jobs for which computers served as substitutes or which were outsourced. This helps to explain the increased demand for workers with university qualifications in modern economies.

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, attracting suitable candidates for the job and selecting the best one

Recruitment

Organisations need to obtain the best workforce available if they are to meet their objectives and be competitive. Workers need to be chosen so that they meet exactly the needs of the organisation in order to reduce the risk of conflict between their personal objectives and those of the business. The **recruitment** and selection process involves the following steps:

1. Establish the exact nature of the job vacancy and draw up a job description

The **job description** provides a complete picture of the job and includes:

1. job title
2. details of the tasks to be performed
3. responsibilities involved
4. place in the hierarchical structure
5. working conditions
6. how the job will be assessed and performance 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 an idea of 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 the key tasks and responsibilities of it

2. Draw up a person specification

This analyses the qualities and skills being looked for in suitable applicants. It is clearly based on the job description because these skills can only be assessed once the nature and complexity of the job have been identified. The **person specification** is like a 'person profile' and helps in the selection process by eliminating applicants who do not match up to the necessary requirements.

person specification: a detailed list of the qualities, skills and qualifications that a successful applicant will need to have

3. Prepare a job advertisement reflecting the requirements of the job and the personal qualities looked for

The job advertisement can be displayed within the business premises – particularly if an internal appointment is looked for – on the firm's website or in government job centres, recruitment agencies and/or newspapers. Care must be taken to ensure that there is no element of discrimination implied by the advertisement as nearly all countries outlaw unfair selection on the basis of race, gender or religion. Table 2.1.3 looks at the advantages of internal and external recruitment.

Exam tip: Don't confuse the job description and the person specification.

Internal recruitment	External recruitment
• Applicants may already be well known to the selection team • Applicant will already know the organisation and its internal methods – no need for induction training • Culture of the organisation will be well understood by the applicant • Often quicker than external recruitment • Likely to be cheaper than using external advertising and recruitment agencies • Gives internal staff a career structure and a chance to progress • Staff will not have to get used to new style of management approach if vacancy is a senior post	• External applicant will bring new ideas and practices to the business – this helps to keep existing staff focused on the future rather than 'the ways things have always been done' • Should be a wide choice of potential applicants – not limited to internal staff • Avoids resentment sometimes felt by existing staff if one of their former colleagues is promoted above them • Standard of applicants could be higher than if limited to internal staff applicants

Table 2.1.3 Advantages of internal and external recruitment

4. Draw up a shortlist of applicants

A few applicants are chosen based on their application forms and personal details, often contained in a CV (curriculum vitae). References may have been obtained in order to check on the character and previous work performance of the applicants.

Exam tip: The disadvantages of each method of recruitment are the reverse 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.

5. Conduct interviews

Interviews are designed to question the applicant on their skills, experience and character to see if they are likely to perform well and fit into the organisation. Some interviewers use a seven-point plan to carry out a methodical interview. Candidates are assessed according to achievements, intelligence, skills, interests, personal manner, physical appearance and personal circumstances.

LEARNER PROFILE

At the Adidas group you will find a unique team spirit strengthened by our diversity of thought, cultures, and individuality. It's for people who believe sport can make the world a better place. More than 40 000-people strong we are united by passion. We work together to achieve the impossible, we push each other to go that bit further, and we innovate to shape the future of sport.

Our global stature has allowed us to develop a culture that crosses usual boundaries, we cherish the differences between us and we celebrate our originality. We encourage our employees to challenge themselves, to work in a different country, a different team – to go beyond what they thought they were capable of. We take pride in our successes and we learn from our mistakes, and we support the journey.

Passion, ambition, joy and pride are a large part of every day of working at the Adidas group. Every job within the Adidas group ultimately helps people to feel better, look better, and to achieve impossible things.

The emotional connection we feel towards our brands, our lifestyle, and athletes of all levels is something to value and to share. Adidas group employees shape this future together.

Source: http://careers.adidas-group.com

To what extent do the values embraced by the IB learner profile match with the values Adidas wants from its employees?

THEORY OF KNOWLEDGE

You are preparing to interview a new graduate for a management-training job with your multinational media organisation. The first candidate enters the interview room. They have a superb academic background that includes a first-class degree from a top university; they have completed plenty of relevant work experience, speak three languages fluently and have a wide range of other interests including high-level sports. On paper they are the best candidate for the job. The trouble is you do not really like them and would not want to work with them.

In your class consider the following questions:

How important are reason, emotion and intuition when evaluating someone in an interview?

Would you give the interviewee the job?

ACTIVITY 2.1.3

1. Draw up a job description for the head teacher's or principal's post at your school or college.
2. Draw up a detailed person specification for this post.
3. Produce an eye-catching and effective newspaper advertisement for this post (use IT if you can) including key features from the job description and person specification.

Training

Having recruited and selected 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 the worker.

There are four main types of training:

1. On-the-job training

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 is controlled by the business itself. **Induction training** is given to all new recruits. It has the objective of introducing them to the people they will be working with most closely, explaining the internal organisational structure, outlining the layout of the premises and making clear essential health and safety issues, such as procedures during a fire emergency.

2. Off-the-job training

Off-the-job training entails any course of instruction away from the place of work. This could be a specialist training centre belonging to the firm itself or a course organised by an outside body, such as a university or computer manufacturer, to introduce new ideas that no-one in the firm currently has knowledge of. These courses can be expensive, yet they may be indispensable if the firm lacks anyone with this degree of technical knowledge.

3. Cognitive training

Cognitive training, sometimes referred to as 'brain exercises', focuses on helping to improve the 'core' abilities and self-control necessary before an employee can function successfully. Usually cognitive training consists of a variety of exercises designed to help improve performance in areas such as sustaining attention, thinking before acting, visual and auditory processing of information, listening and reading. Cognitive training exercises 'drill for skill' directly in the areas where basic specific understanding or learning difficulties occur.

4. Behavioural skills training

Behavioural skills training aims to provide employees with the ability to communicate effectively with others and to interact with them in a constructive way. It can include:

- communication skills
- change management skills

training: work-related education to increase workforce skills and efficiency

on-the-job training: instruction at the place of work on how a job should be carried out

induction training: introductory training programme to familiarise new recruits with the systems used in the business and the layout of the business site; this form of training is usually on-the-job

off-the-job training: all training undertaken away from the business, e.g. work-related college courses

cognitive training: exercises designed to improve a person's ability to understand and learn information

behavioural skills training: is designed to improve an individual's ability to communicate and interact with others both inside and external to the organisation

- assertiveness skills
- negotiating and influencing skills
- conflict management skills
- presentation skills
- customer service skills
- networking skills
- interview skills.

Exam tip: When discussing the costs and benefits of training remember that the risk of 'poaching' is a reason often given by firms for *not* training their employees well. Perhaps they ought to do more to keep their well-trained employees instead.

Training evaluation

Training can be expensive. It can also lead to well-qualified staff leaving for a better-paid job once they have gained qualifications from a business with a good training structure. This is sometimes referred to as 'poaching' of well-trained staff and it can discourage some businesses from setting up expensive training programmes.

The costs of not training are also substantial. Untrained staff will be less productive, less able to do a variety of tasks (inflexible) and will give less satisfactory customer service. Without being pushed to achieve a higher standard or other skills, workers may become bored and demotivated. Training and a sense of achievement can lead to what were identified by both Maslow and Herzberg as important motivators. Finally, accidents are likely to result from staff untrained on safety matters.

employee appraisal: the process of assessing the effectiveness of an employee judged against preset objectives

Appraisal of employees

Employee appraisal is often undertaken annually. It is an essential component of an employee development programme. The analysis of performance against preset 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. Both appraisal and employee development are important features of Herzberg's motivators – those intrinsic factors that can provide the conditions for effective motivation at work. An appraisal form is often used which will comment on the worker's ability to meet certain criteria and may suggest areas for action and improvement or recommendations for training or promotion. Figure 2.1.1 shows some examples of questions from appraisal forms.

A1 Score your own capability or knowledge in the following areas in terms of your current role requirements (1–3 = poor, 4–6 = satisfactory, 7–9 = good, 10 = excellent). If appropriate, bring evidence with you to the appraisal to support your assessment. The second section can be used if working towards new role requirements.

1. commercial judgement
2. product/technical knowledge
3. time management
4. planning, budgeting and forecasting
5. reporting and administration
6. communication skills

Figure 2.1.1 Examples of questions from appraisal forms [*figure continues over*]

7. delegation skills
8. IT/equipment/machinery skills
9. meeting deadlines/commitments
10. creativity
11. problem-solving and decision-making
12. team-working and developing others
13. energy, determination and work rate
14. steadiness under pressure
15. leadership and integrity
16. adaptability, flexibility and mobility
17. personal appearance and image.

A2 In light of your current capabilities, your performance against past objectives, and your future personal growth and/or job aspirations, what activities and tasks would you like to focus on during the next year? Again, also think of development and experiences outside job skills – related to personal aims, fulfilment, passions.

Figure 2.1.1 *Continued*

Types of appraisal

1. Formative

Formative appraisal is based on a range of formal and informal assessment methods employed by supervisors not only to monitor an employee's progress but also to support and provide guidance for improvement. It typically involves qualitative feedback (rather than scores or grades for achievement) that focuses on the details of performance and ways of improving it. Formative appraisal – if done well – should be a supportive learning process for the employee and there should be no sense of overall failure or success.

In essence, the goal of formative assessment is to gather feedback that can be used by the instructor/supervisors and the employees to guide improvements in the ongoing work being undertaken by the workers.

2. Summative

In contrast, the goal of summative assessment is to measure the level of an employee's success or proficiency in meeting predetermined benchmarks. To be effective, these benchmarks should have been discussed and agreed with each employee before the time period over which assessment is to be made. The outcome of a summative assessment could be used to influence an employee's pay grade, annual bonus or chances of internal promotion.

3. 360-degree feedback

Performance-appraisal summative assessments are collected from 'all around' an employee. The key feature of this form of appraisal is not to use a supervisor as the sole means of providing appraisal feedback but to use many people who come into contact with the employee as sources of appraisal feedback information. These people often include:

- employee's 'line' work colleagues and peers
- subordinates
- supervisors
- internal and external customers.

The main objective of 360-degree appraisal is usually to assess training and development needs and to provide competence-related information for succession planning, not promotion or pay increases.

It is also known as multi-source assessment or multi-source feedback.

4. Self-appraisal

Employee self-appraisal, within a performance management or annual performance review system, involves asking the employee to self-evaluate his or her job performance. Typically, prior to meeting with an employee, the supervisor will ask the employee to complete an evaluation form. This will be used as a basis for discussion during the annual performance review meeting. Then at the meeting, the manager and employee discuss the self-appraisal results, and negotiate final evaluations based on both the manager's perceptions and those of the employee. Self-appraisal or self-evaluation results should be used after discussion and negotiation. Actual self-evaluation as part of performance management can take the form of evaluating progress towards predefined annual objectives and performance standards. The employee may be asked to rate him- or herself using the same rating form the manager uses, or even undertake self-ranking against a preset scale of attainment levels.

Dismissal of employees

It may be necessary for an HR manager to discipline an employee for continued failure to meet the obligations laid down by the **contract of employment**. Dismissing a worker is not to be taken lightly. Not only does it withdraw a worker's immediate means of financial support and social status, but if the conditions of the **dismissal** are not fully in accordance with company policy or with the law, then civil court action might result. This can lead to substantial damages being awarded against the firm. Dismissal could result from the employee being unable to do the job to the standard that the organisation requires. It may also be that the employee has broken one of the crucial conditions of employment. Before dismissal can happen, the HR department must be seen to have done all that it can to help the employee reach the required standard or stay within the conditions of employment. Support and training for the person should be offered. The organisation must not leave itself open to allegations of **unfair dismissal**.

contract of employment: a legal document that sets out the terms and conditions governing a worker's job

dismissal: being removed or 'sacked' from a job due to incompetence or breach of discipline

unfair dismissal: ending a worker's employment contract for a reason that the law regards as being unfair

redundancy: when a job is no longer required so the employee doing this job becomes redundant through no fault of his or her own

Redundancies

This is not the same as dismissal. **Redundancy** occurs when workers' jobs are no longer required, perhaps because of a fall in demand or a change in technology. Often, this is part of a company policy of retrenchment to save on costs to remain competitive. In 2009, General Motors in the USA made thousands of workers redundant as it tried to reduce massive losses. Directors argued that unless these jobs were cut, the company would continue to make losses which could easily result in further redundancies – or the failure of the entire business.

The way these announcements are made can have a very serious effect on the staff who remain – loss of job security – and on the wider community. If a firm is seen to be acting in an uncaring or unethical manner, then external stakeholders may react negatively to the business.

Redundancy can happen if a job that someone has been doing is no longer required and there is no possibility of that person being re-employed somewhere else in the organisation. Redundancy may also happen if, due to budget cuts, the firm needs to reduce its workforce.

Employment patterns and practices

In developed economies in recent years there has been a move away from traditional work patterns and practices.

Traditionally, these were characterised by:

- full-time employment contracts
- permanent employment contracts for most workers
- regular working hours each week
- working at the employer's place of work.

A large proportion of the working population is now faced with very different patterns of work such as:

- part-time and temporary employment contracts
- **teleworking** from home
- flexible hours contracts
- **portfolio working** – Charles Handy, the business writer, has argued that portfolio working is becoming an increasing trend and full-time working for one employer for one's working life is a thing of the past.

The main reasons for these changes are:

- focus on competitiveness, driven by competitive pressures from globalisation, by cutting overhead labour costs
- need for greater labour flexibility with the rapid pace of technological change
- greater opportunities for **outsourcing**, especially in low-wage economies
- changing social and demographic patterns, e.g. increasing number of single parents for whom full-time employment might be difficult to fit in with their lifestyles.

teleworking: staff working from home but keeping contact with the office by means of modern IT communications

portfolio working: the working pattern of following several simultaneous employments at any one time

outsourcing: using another business (a 'third party') to undertake a part of the production process rather than doing it within the business using the firm's own employees

ACTIVITY 2.1.4

INDIA WANTS MORE FLEXIBLE LABOUR CONTRACTS

The Indian government has approved a proposal that would allow employers to shut down businesses with less than 100 employees without seeking government permission. This change to the law will allow employers to end employment contracts when economic conditions are bad. The greater flexibility will allow employers to save on labour costs when the economy takes a downturn. Trade unions have criticised the decision. However, some economists say the decision will encourage employers to increase jobs when conditions are favourable.

10 marks, 20 minutes

1. Define the term 'contract of employment'. [2]
2. Outline **two** effects on employers of more flexible labour contracts. [4]
3. Explain **two** effects on employees of more flexible labour contracts. [4]

Consequences of changing work patterns and practices

Assume that, as part of its workforce plan, an insurance company has decided that ten telephone customer service advisers should be employed. Should the firm's future need for these ten additional workers be met by:

- recruiting ten full-time staff on permanent contracts?

- recruiting 20 part-time staff on 'half-time' or '**flexi-time**' permanent contracts?
- employing workers on **temporary contracts** that can be terminated at short notice?
- not adding to employed staffing levels at all, but offering outsourcing contracts to other firms or self-employed people? These will then supply a specific service or product, but will not be directly employed. This is used increasingly by businesses that want to reduce overhead employment costs.

flexi-time contract: employment contract that allows staff to be called in at times most convenient to employers and employees, e.g. at busy times of day

temporary employment contract: employment contract that lasts for a fixed time period, e.g. six months

part-time employment contract: employment contract that is for less than the normal full working week of, say, 40 hours, e.g. eight hours per week

Recent trends in labour recruitment have been towards employing more part-time staff on temporary contracts and using outsourcing and teleworking. The claimed advantages of **part-time** and flexible employment contracts are as follows.

Advantages of part-time and flexible contracts for the business

1. Employees can be required to work at particularly busy periods of the day but not during the slack times, e.g. banking staff needed at lunchtimes or theatre and cinema receptionists needed mainly in the evening. This will reduce overhead costs to a business. This flexibility offers firms real competitive advantages, as they can give good customer service without substantial cost increases.
2. More employees are available to be called upon should there be sickness or other causes of absenteeism.
3. The efficiency of employees can be measured before they are offered a full-time contract.
4. By using teleworking from home for some groups of workers, even further savings in overhead costs can be made, such as smaller office buildings.

Advantages for the workers with part-time and flexible contracts

1. This contract could be ideal for certain types of workers, e.g. students, parents with young children, or elderly people who do not wish to work a full week and those wishing to improve their work–life balance.
2. They may be able to combine two jobs with different firms, giving greater variety to their working lives.
3. Teleworking allows workers to organise their own working day at home, while meeting preset targets and deadlines and keeping in contact with head office via the internet.

There are potential drawbacks of part-time and flexible contracts too.

Drawbacks of part-time and flexible contracts for the business

1. There will be more employees to 'manage' than if they were all full time.
2. Effective communication will become much more difficult, not just because there will be more employees in total but also because it may be impossible to hold meetings with all workers at any one time. There could be greater reliance on written communication methods because of this.
3. Motivation levels may be adversely affected because part-time workers may feel less involved and committed to the business compared to full-time workers. It will be much more difficult to establish a teamwork culture if all the employees never actually meet each other because of their different working hours.
4. Some managers fear that teleworking will lead to lower productivity as workers cannot be monitored so easily as when they are present in the office.

Drawbacks for the workers with part-time and flexible contracts

1. They will be earning less than full-time workers.
2. They may be paid at a lower rate than full-time workers.
3. The security of employment and other working conditions are often inferior to those of full-time workers. This is now changing in some countries. In all European Union member states, for example, the law now gives as many employment rights to part-time as to full-time workers. This is still not the case in other regions of the world.
4. Teleworking and temporary/flexi-time contracts can lead to much less social contact with fellow workers – social interaction is an important human need.

Offering temporary employment contracts is a way firms use to reduce the overhead costs of employing staff. Lower levels of job security can mean that 'safety' needs as identified by Maslow may not be satisfied and this will have a negative effect on motivation. Temporary contracts can be either full time or part time. They are contracts for fixed periods of time as opposed to permanent contracts. Permanent contracts only end when a worker is sacked, for example for poor discipline, made redundant or leaves of their own accord. The advantages and disadvantages of temporary contracts are similar to those of part-time contracts, especially the benefit of flexibility offered to employers. Such flexibility is particularly important to seasonal business activities, such as fruit picking.

The combination of part-time and temporary contracts gives firms the chance to create a small team of full-time staff – core workers – and combine this with a number of flexible workers, who are employed only when necessary. This is further enhanced by the increasing trend towards outsourcing, that is using outside self-employed contractors to perform specific jobs within the business rather than employing staff directly. These three types of contracts are termed 'peripheral' workers as they are not part of the central core of full-time employees (see Figure 2.1.2).

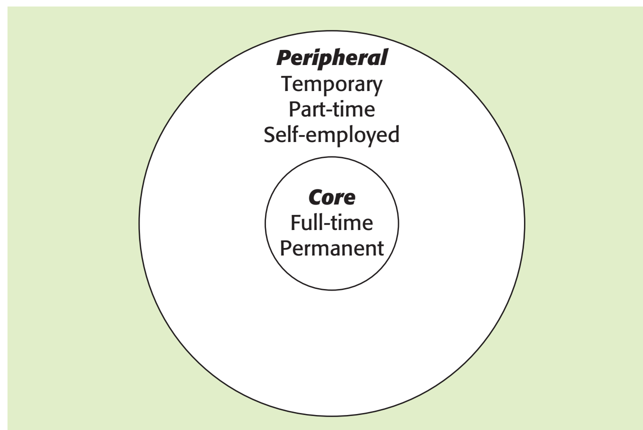


Figure 2.1.2 The differences between core and peripheral workers

ACTIVITY 2.1.5

EXXONMOBIL – EMPLOYEE TRAINING AND FLEXIBILITY

ExxonMobil's global, diverse workforce represents a source of competitive advantage for the company. ExxonMobil retains and develops its employees by fostering an environment where personal and professional growth are encouraged, and career objectives are developed and achieved. During the annual performance appraisal and development process, every employee has a structured, documented discussion with their supervisors about work accomplishments, training objectives, development opportunities and career interests.

Another aspect of ExxonMobil's retention strategy involves providing a robust corporate and technical training programme. The company's major business units spent $96 million on training employees in 2013, reaching more than 87 000 training participants. To maintain its position as a technical leader in the industry, ExxonMobil directed more than 71% of its investment toward professional on- and off-the-job technical training. Additionally, more than 3900 employees at various levels of the company participated in ExxonMobil's leadership development training programmes in 2013, of which 30% were women and 59% were employees outside the USA.

ExxonMobil's workplace flexibility programmes address individual employee needs and maximise employee productivity. ExxonMobil offers a variety of workplace flexibility programmes, which may be customised to meet individual needs. Each country's workplace flexibility programme differs based on legal requirements, infrastructure and culture. Examples of workplace flexibility programmes include adaptable workplace arrangements, modified workweeks, part-time regular employment and adjustable work hours.

Source: http://corporate.exxonmobil.com

20 marks, 40 minutes

1. Define the term 'performance appraisal'. [2]
2. Describe **two** aspects of ExxonMobil's employee training. [4]
3. Analyse **two** ways employee training can improve the profitability of ExxonMobil. [4]
4. Evaluate ExxonMobil's decision to adopt flexible work patterns amongst their workforce. [10]

Outsourcing, offshoring and re-shoring as HR strategies

These three terms are not just used in HRM – Chapter 5.4 assesses the role of these concepts in operations management.

There has been a significant trend in recent years for businesses to outsource some – and in some cases virtually all – HRM functions to other businesses. In a further effort to save on costs, much of this outsourcing has been to businesses based in low-wage economies – **offshoring**. For a number of reasons, many of the original expectations of this process have not been fulfilled so some companies are now 'bringing HR back home' by **re-shoring** all or some of the functions that were originally outsourced/offshored.

offshoring: the relocation of a business process done in one country to the same or another company in another country

re-shoring (in-shoring): reversal of offshoring; the transfer of a business process or operation back to its country of origin

When a business is considering outsourcing some HR functions there is the need to distinguish between 'core' (or 'strategic') and 'non-core' HR activities. The core activities should be left 'in-house' and the non-core activities can be considered for outsourcing.

Which HR functions are usually non-core and can be outsourced?

Virtually any HR function can be outsourced. The most commonly outsourced HR activities are:

- payroll administration
- employee recruitment (either for more junior employees or for all employees including executives)
- training and development (some or all)
- human resources information systems (e.g. employee records)

- pension administration
- exit interviews when an employee decides to leave
- childcare/eldercare assistance
- equal opportunity compliance/reporting
- legal advice
- legal compliance
- health and safety administration.

Which core activities should not be outsourced?

Strategic HR activities are those that have a direct impact on organisational performance and which can provide it with a competitive edge. They tend to be related to employee performance, organisation culture, change and innovation. While the list will vary from one organisation to the next, the following activities are the ones where an in-house HR function is most likely to be able to add value:

- change management
- strategic HR planning
- development and maintenance of HR policies
- remuneration and benefits strategy (as distinct from administration)
- termination of employment/redundancies
- cultural change programmes
- recruitment and selection for key jobs (e.g. senior management)
- succession planning
- specialised training (e.g. where the organisation has unique technology and skills requirements).

Table 2.1.4 outlines the main arguments for and against HR outsourcing and Table 2.1.5 considers some additional points regarding offshoring of these functions.

Potential benefits	Potential limitations
• Cost savings as HR salaries and administration costs can be a substantial overhead for businesses. • Access to HR specialists and experts on matters of employee law, pension regulations, data protection laws (employee records) and so on – this could be of special importance to small to medium-sized businesses that would find it difficult to justify employing these specialists directly. • Business can now focus its HR resources on strategic HR issues such as effective workforce planning – and not have to use these resources for HR administration. • HR is not generally a department that adds value – if many of the HR functions are outsourced then the business can focus on its core activities of producing products/services to meet customers' needs profitably.	• Outsourcing is not necessarily cheap – and it could be a case of 'you get what you pay for'. • Some analysts argue that although outside specialists might be very knowledgeable they may not have gained an insight into the culture and attitudes that exist within a business and, as a result, inappropriate advice or decisions might result, e.g. over the recruitment of new employees. • Although HR does not earn revenue it can 'add value' in the way in which it recruits, trains, retains and motivates employees – are these functions that should be trusted to an outside business? • Outsourcing key HR functions could mean that decisions are taken by an outside business that does not integrate its decisions or activities with other departments of the business. This lack of integration is much less likely if the HR functions are undertaken in-house.

Table 2.1.4 Benefits and limitations of HR outsourcing

Further benefits from offshoring HR functions	Further limitations from offshoring HR functions
• Even further cost savings can be made if HR functions can be undertaken by outsourced businesses that employ workers in low-wage countries – they can still perform many HR functions such as administration, employee record-keeping and employee support and advice call centres.	• Distance and different languages create potential communication problems. • Will the offshore business employ workers who are fully informed of the employee laws, practices and cultures of the country in which the business contracting out the outsourced functions is based?

Table 2.1.5 Additional benefits and limitations of HR offshoring

ACTIVITY 2.1.6

WHY ARE HR FUNCTIONS BEING OUTSOURCED?

One of the best examples of a business that has benefited from HR outsourcing is BP. It outsourced many of its HR functions to Exult in the USA and UK for HR services such as payroll, recruitment, expatriation management for employees working overseas, employee records management and relocation services for 63000 employees. The main function that remained in-house was BP's learning and development programme in the USA.

BP claimed that payroll processing became more accurate and HR processes have been standardised across the company. As a result, its core HR staff were cut by 65% – from 100 to 35 people. Such success stories have propelled companies like Sony, AT&T and American Express to outsource HR activities.

Other companies which have offshored many HR functions, however, have started to re-shore some of these. It has been claimed that the poor quality of service offered and concerns over employee data privacy when sent overseas outweigh potential cost savings.

20 marks, 40 minutes

1. Define the term 'HR outsourcing'. [2]
2. Describe how BP has outsourced its HR function. [4]
3. Explain how BP outsourcing its HR function might have reduced BP's costs. [4]
4. Discuss the advantages and disadvantages to BP of outsourcing its HR function. [10]

How innovation, ethical considerations and cultural differences influence human resource practices and strategies

Innovation

Innovation interrelates with HR strategy in two ways.

1. Innovation *in* HRM

HRM has been transformed in recent years by innovations in managing people. These include: team-working, regular appraisals, quality circles, information sharing, empowerment, performance-related pay and job enrichment.

Many of these innovations are based on the principle that employees have much more to offer than their physical qualities. By harnessing the 'complete person', the experience of many businesses is that HR managers can achieve:

- higher productivity
- higher labour retention

- attraction of high-quality employees
- greater contribution from employees to problem-solving at work and the generation of new ideas.

2. Innovation *through* HRM

Innovative products and processes create competitive advantage. What factors allow some businesses – such as Toyota and Proctor & Gamble – to be successful innovators? Many analysts now argue that HRM can influence the success of a strategy of innovation. The approaches to managing human resources that are most likely to lead to a culture of innovation within an organisation include:

- matrix organisational structure that allows for project teams to work through major developments
- delegation to junior managers to give them the authority to show initiative and take important decisions
- extensive and continuous training programmes
- regular appraisals to identify training needs and career plans
- an entrepreneurial culture that encourages risk-taking and does not penalise failure – but rewards success well.

ACTIVITY 2.1.7

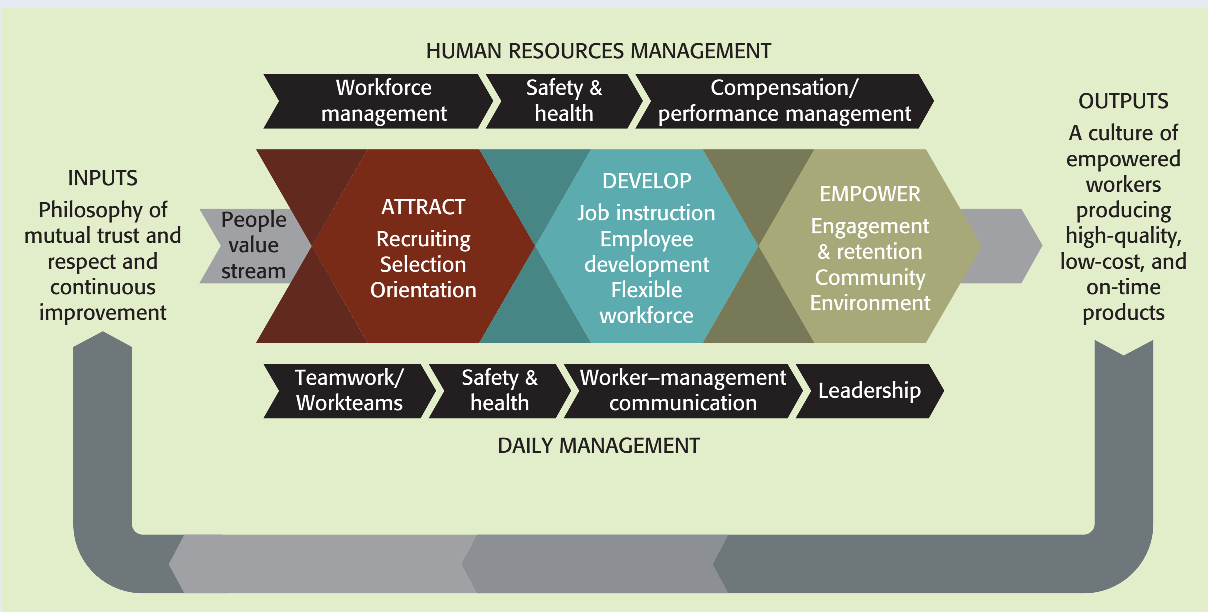


Figure 2.1.3 Toyota's human resource management strategy

Source: www.nikebiz.com

This diagram is a visual representation of Toyota's HRM strategy. The company is well known for some of the most significant innovations in car manufacturing and design – from the 'Toyota Lean Production system' to hybrid vehicles.

20 marks, 40 minutes

Evaluate how the effectiveness of Toyota's innovation can be supported by its human resource management strategy. [20]

Ethical considerations

Ethical issues for human resources managers have emerged with the globalisation of trade and the growth of increasingly large multinational companies. In particular, the blending of languages, cultures and ways of doing business create many challenges. Human resources managers must ensure the company is operating within acceptable ethical and cultural practices in each country in which it operates. The following are just some of the ethical considerations that can arise when responsible for HRM in a multinational business:

Lack of cultural awareness

HR managers must prepare employees for appropriate conduct before they are sent to their overseas destination. Training and cultural classes help to educate employees about different customs and practices in other countries. A lack of cultural awareness could be shown by a lack of respect for the conservative nature of other cultures.

Bribery

Most countries have laws that make bribes illegal in business transactions. However, these laws are weakly applied in some countries and in any case they are unlikely to cover all of the range of payments that international businesses encounter – or are asked to make. 'Facilitation payments' (some observers would refer to these as bribes) may be required to operate in a foreign country. When, on occasions, these have been discovered, the governments often rule differently on multiple situations surrounding these types of payments. This provides the company with a true ethical dilemma, particularly a human resources manager who must aid an employee facing bribery attempts overseas.

International companies can face an environment of pervasive corruption. According to a recent survey by Ernst & Young, 39% of respondents said corruption occurred frequently in their country. Some countries, such as Brazil and Indonesia, had very high rates of reported corruption – 84% and 64%, respectively. Human resources managers must prepare employees travelling to these countries on how to properly interact with clients, suppliers and authorities, as well as ensuring the employees remain safe.

Pay

Another important ethical consideration is the relative pay levels for each country. Multinationals often have offices in both developed and developing countries where the salaries are quite different. For example, a German transferred to China might make three to four times as much as their Chinese counterpart doing the same job. It may be difficult to establish effective team-working between people earning such different levels of pay for jobs requiring the exact same set of skills. In cases such as these, HRM may face the ethical issue of whether to narrow the gap in compensation by increasing pay of native workers in foreign locations.

hard HRM: an approach to managing staff that focuses on cutting costs, e.g. using temporary and part-time employment contracts, offering maximum flexibility but with minimum training costs

soft HRM: an approach to managing staff that focuses on developing staff so that they reach self-fulfilment and are motivated to work hard and stay with the business

Cultural differences

HRM strategies can be influenced in two main ways by cultural differences:

1. Culture of the organisation

A business that is focused on maximising profits or returns to shareholders may adopt a **'hard' HRM** strategy. The profit-seeking culture of the organisation is likely to be one of reducing employee costs as far as possible and to regard labour as a resource to be used and managed as any other resource. In contrast, a business such as a social enterprise may adopt a **'soft' HRM** strategy. The aim here is to develop employees as people so that they can contribute in the long term in many ways to the success of the organisation. These two extreme HRM strategies are outlined in Table 2.1.6. In practice most organisations will adopt elements of both but the culture of the firm and senior management will influence whether the HR strategy is more 'hard' than 'soft' or vice versa.

There are several important limitations to both of these extreme approaches to HR management and the limitations of one approach – hard HRM, for instance – are in effect the advantages of the other – soft HRM.

Limitations of soft HRM	Limitations of hard HRM
• Increased global competition makes low-cost operations one of the main ways to stay competitive – and labour costs can be cut by employing labour on flexible contracts. • Flexibility of labour means that fixed costs of employing workers are now replaced with variable costs – which are easier to control. • If workers compete for jobs and do not have permanent job security then this could encourage them to work harder and be more productive. • Workers who are trained and developed fully by an organisation can more easily gain employment – perhaps at higher pay levels – in other businesses.	• 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 and unwilling to participate in business developments – this could reduce company efficiency and profitability. • Bad publicity regarding the treatment of workers – especially the 'them and us' division between core and peripheral staff – might lead to negative consumer and pressure group actions against the company. • It is not suitable for professional, qualified employees, e.g. accountants or research scientists, as these workers must be retained and developed to allow them to contribute fully to the organisation.

Table 2.1.6 Limitations of soft and hard HRM

2. National cultures

HR management practices may need to be adapted to suit national conditions and culture. Different national cultures approach HR management in very different ways. There is certainly no one way of managing human resources and as globalisation integrates the world's economies, developing sensitivity to how other cultures operate in business is becoming essential, especially for multinational businesses.

ACTIVITY 2.1.8

CULTURAL DIFFERENCES AND HRM

Japanese culture places a high value on fixed gender roles, an importance on structure and a focus on long-term goals. Individualism is not encouraged as equality is seen as a way of maximising cohesion and in turn, productivity. Japanese firms invest an enormous amount in their employees' training and development. New employees train for six to twelve months in each of the firm's major offices or divisions so that within a few years they know every facet of the company operations. In Japanese organisations, supervisors and employees have a largely equal relationship where consensus on both parts is required for making decisions.

In North America a person can change from career to career, from being a chartered accountant to a band roadie, but in Japan, similar to other Asian cultures, employees are expected to stay with one company for their entire working careers.

Chinese society preserves tradition, places high value on education and training, and is inclined to overcome obstacles with time. In terms of individualism, the Chinese rank lower than any other Asian country. Chinese management style is authoritative and directive, and managers are expected to make decisions on behalf of the group. Unlike Japanese organisations, instructions are always delegated from the top down.

The decision-making process within Chinese firms is based on respect, evasiveness, hierarchy and discipline. Open conflict is avoided at all costs, even if upper management is clearly making a wrong decision.

When it comes to signing contracts, the Chinese see this agreement as a start of a relationship rather than an official business accord. One reason for this is the pictorial nature of the Chinese language. It can be difficult to write very precise and accurate meanings to contracts, so the real business gets sorted out after the contract is signed. Also, gift-giving, dinners and doing favours are common ways of doing business in the People's Republic.

Unlike Asian countries, individualism is significantly higher in Germany. Some analysts claim that German management often puts a high valuation on people's time and freedom. Germans as a people value competitiveness, assertiveness, ambition and the accumulation of wealth and material possessions. German companies concentrate intensely on product quality and product service. German managers describe this as *Leistungswettbewerb*, i.e. competition on the basis of excellence in their products and services. German managers and employees are often close, because they believe that they are working together to create a good product.

Source: www.hrmtoday.com

20 marks, 40 minutes

1. State **two** differences between Japanese and Chinese approaches to human resource management. [2]
2. Explain **two** effects an 'equal relationship between supervisors and employees' in Japanese firms might have on the efficiency of Japanese workers. [4]
3. Analyse **two** effects 'individualism' in German organisations might have on the motivation of workers in German organisations. [4]
4. Discuss the problems that a German business like Volkswagen might experience if it started operations in Japan and China. [10]

OVER TO YOU

Revision checklist

1. Outline **two** factors that will influence a car manufacturer's workforce needs for the next year.
2. Why is it difficult for an HR department to predict workforce needs for the future?
3. State **three** reasons why the skills requirements of the workforce of a manufacturing firm are likely to change over time.
4. Explain why the recruitment of appropriate employees is important to a business providing customer services.
5. Explain why relatively high labour turnover might not be a problem for a business.
6. Explain the difference between cognitive and behavioural training.
7. Distinguish between a job description and a person specification.
8. Explain why a person specification is important to the selection process.
9. A business has a vacancy for a senior executive. Outline **two** reasons for appointing an internal candidate.
10. Why should the costs of training be weighed against the costs of not training staff?
11. Explain the importance of employee appraisal programmes for worker motivation.

12. Explain why it can be important to both the firm and the employee to have flexible working opportunities.
13. Explain the difference between dismissal and redundancy.
14. Explain **three** reasons why there are changes in work patterns and practices.

Exam practice question

GOOGLE IS THE NUMBER ONE BUSINESS TO WORK FOR IN 2013

The media company is the number one employer once again and the US-based giant seems to be a great place to work. It is famed for its innovative approach to human resource management. The business employs 42 162 people and is creating over 4000 new jobs a year so it is a fast-changing, dynamic place to work.

HOW DO THEY DO IT?

There is the catered kitchen with free food, the games room with foosball and pinball, the orange tube slide for employees who don't want to take the stairs – even a firefighter's pole to slide down to a lower floor. And dress code? Techies are legendary for their disdain of formality and the directors at a Google office often arrive for work in blue jeans and a T-shirt. There's also the cachet of working for a global company, founded in 1998, whose search engine rules the vast cyberworld and whose annual revenues have risen to an astounding $37 billion. One employee said, 'I find it such an exciting place to work, to know that people all over the world are working for Google and developing such new and exciting ideas.'

But make no mistake. Toiling at Google is no day at the skateboard park or sleeping in 'til noon after a night playing video games. It means sitting down every Friday with thousands of other employees for a giant 'town hall' meeting by video with chief executive officer Larry Page, in California, to go over what happened during the week.

Getting a job at Google has been described like getting a job as an astronaut because the recruitment process is so rigorous.

Each Google office is expected to come up with new ideas, deliver when called upon and compete with other sites in the company and against the sharpest minds at Apple, Research In Motion, Microsoft and other competing firms.

Source: Adapted from http://fortune.com

20 marks, 40 minutes

1. Define the term 'human resource management'. [2]
2. Describe what might be the different stages of Google's recruitment process. [4]
3. Analyse **two** benefits to Google of recruiting 4000 new employees a year. [4]
4. Examine the advantages and disadvantages of Google's approach to the working environment as part of its human resource management. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, examine what changes globalisation brings about in the management of human resources. [20]

2.2

Organisational structure

On completing this chapter you should be able to:

Know and understand:

- Important terminology to facilitate understanding of different types of organisational structures (AO1)

Analyse and apply:

- Different types of organisational charts (AO2)
- Changes in organisational structures (AO2)

Evaluate:

- How cultural differences and innovation in communication technologies may impact on communication in an organisation (AO3)

Draw and prepare:

- Different types of organisational charts (AO4)

Setting the scene

WHAT IS HAPPENING TO ORGANISATIONAL STRUCTURES?

Traditionally, head offices housed all key personnel taking all important decisions. Now, more and more firms, such as Microsoft, are using 'flatter' and more decentralised structures where decisions are taken anywhere else but head office! Instead of all power being focused at the top of an organisation there is now much more involvement and collaboration in decision-making. Why are these changes happening?

- Employees are becoming better qualified and more knowledgeable.
- Centrally made decisions means local factors are not taken into account.
- Communication technologies are becoming quicker and more mobile.
- Today's world needs organisations that encourage and promote leaders who can push, convince and lead people to work in collaborative teams.

Source: www.timesonline.co.uk

Points to consider

- Has your school or college got an organisational structure? Describe its main features.
- Why would taking all decisions at head office be a 'safe' but inflexible organisation structure?
- Do you think that businesses might need to change the structure of their organisation due to business growth and the need to cut costs and be more flexible? Explain your answer.

Key concept link

The culture of an organisation is usually reflected in its internal structure. Different cultures – business and national cultures – often require management to adapt the internal hierarchies and chains of command of the organisation to respond to and reflect these differences.

Fewer decisions are taken at head office when an organisation is decentralised.

Introduction

A sole trader with no employees needs no **organisational structure**. Even if this sole owner were to take on just one worker or one partner, a sense of formal structure would become necessary. Who is to do what job? Who is responsible to whom and for which decisions? If the business expanded further, with more workers, 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. So what is meant by organisational structure? What would happen if it was confused or misunderstood? How does the structure impact on workers and managers? What are the key principles of designing and analysing an organisation's structure? These are the issues that we will look at in this chapter.

organisational structure: the internal, formal framework of a business that shows the way in which management is organised and linked together and how authority is passed through the organisation

The traditional hierarchical structure

This structure has different layers of the organisation with fewer and fewer people on each higher level – Figure 2.2.1 demonstrates this. This example is organised by function or department.

In general terms, it is often presented as a pyramid, as shown in Figure 2.2.2.

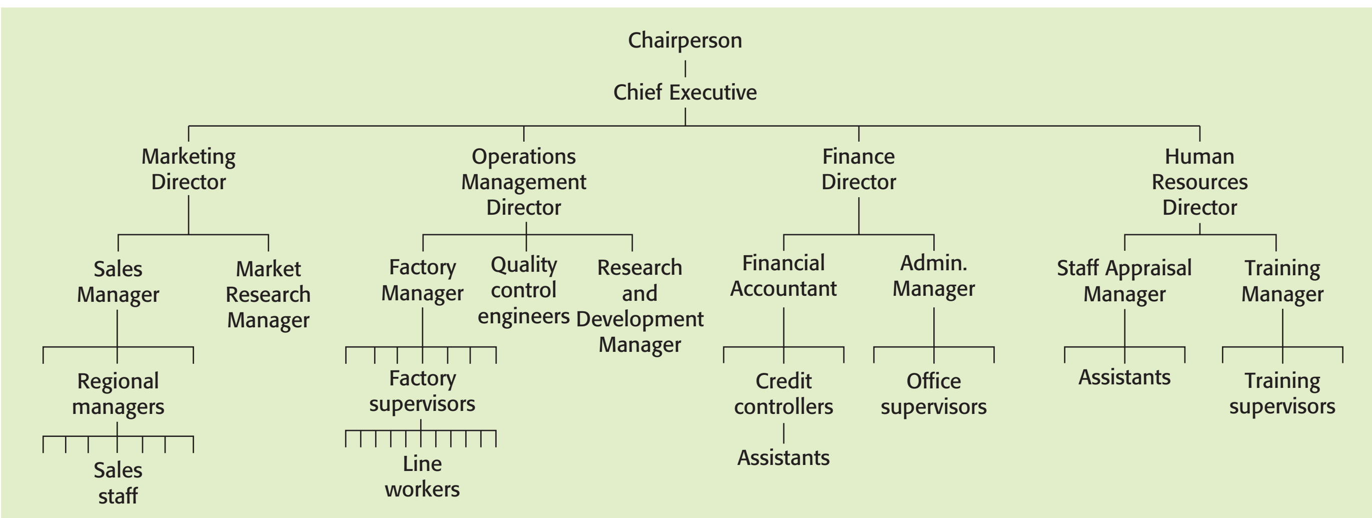


Figure 2.2.1 An example of an organisational structure organised by function

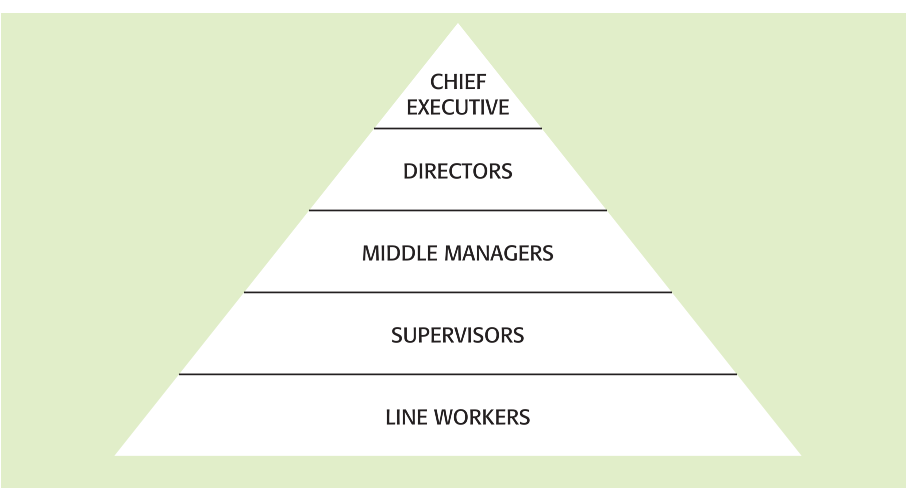


Figure 2.2.2 A typical hierarchical pyramid

The organisational structure chart displays a number of important points about the formal organisation of any business. It indicates:

- who has overall responsibility for decision-making
- the formal relationships between people and departments – workers can identify their position in the business and who is their immediate 'line' manager
- how accountability and authority are passed down the organisation – the chain of command
- the number of subordinates reporting to each more senior manager – the span of control
- formal channels of communication both vertical and horizontal
- the identity of the supervisor or manager to whom each worker is answerable and should report.

Key principles of organisational structure

Levels of hierarchy

level of hierarchy: a stage of the organisational structure at which the personnel on it have equal status and authority

tall (vertical) structure: one with many levels of hierarchy and, usually, narrow spans of control

flat (horizontal) structure: one with few levels of hierarchy and wide spans of control

Each **level** in the hierarchy represents a grade or rank of staff. Lower ranks are subordinate to superiors of a higher rank. The more levels, the greater is the number of different grades or ranks in the organisation. A **tall organisational structure** has a large number of levels of hierarchy and this creates three main problems:

- Communication through the organisation can become slow with messages becoming distorted or 'filtered' in some way.
- Spans of control are likely to be narrow – see Fig 2.2.4 below.
- There is likely to be a greater sense of remoteness, among those on lower levels, 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. This will encourage managers/supervisors to delegate more extensively as they cannot effectively control the work of a large number of employees. It will also have a short chain of command and, potentially, better communication between the top of the hierarchy and the lower levels.

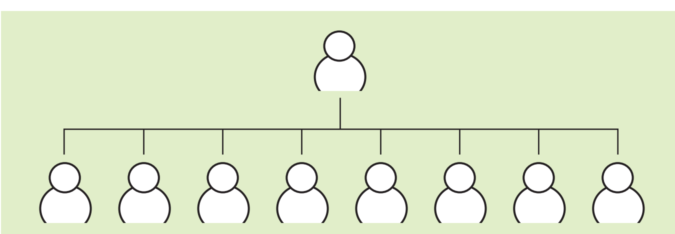


Figure 2.2.3 Flat structure with a wide span of control of eight

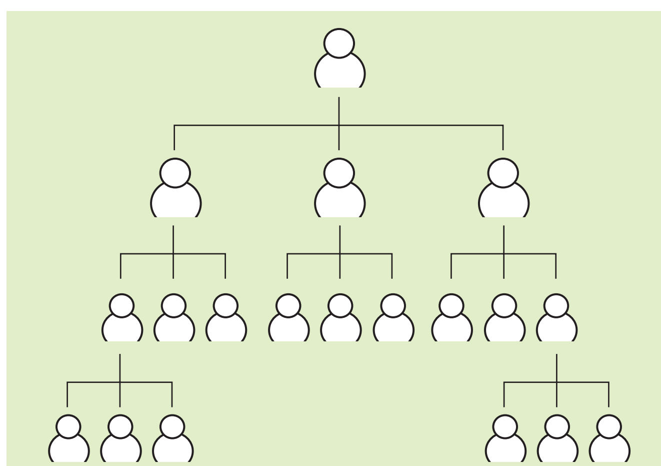


Figure 2.2.4 Tall structure with a narrow span of control of three

Span of control

Spans of control can be wide – with a manager directly responsible for many subordinates – or narrow – a manager has direct responsibility for a few subordinates. The wider the average span of control, the fewer the levels of hierarchy, other things being equal.

span of control: the number of subordinates reporting directly to a manager

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** – potentially slowing down communications.

chain of command: this is the route through which authority is passed down an organisation – from the chief executive and the board of directors

Delegation and accountability

These are very important principles which can have far-reaching effects on both the organisational structure and the motivation levels of subordinate employees. As Herzberg and other researchers have pointed out, the process of **delegation**, requiring workers to be accountable for their work, can be very beneficial to motivation. Generally, the wider the span of control, the greater is the degree of delegation. Figure 2.2.3, which shows a wide span of control of eight, is likely to encourage delegation, whereas Figure 2.2.4, which shows a narrow span of control of three, is likely to lead to close control of subordinates.

delegation: passing authority down the organisational hierarchy

Imagine a manager with a span of control of 15 subordinates. It might be impossible to closely supervise the work of each of these every day – the manager would have no time for more important 'strategic' matters. Thus, the manager will delegate authority to his or her staff, and will trust them to perform well. Clearly, the staff are **accountable** to the manager for good performance; but he or she retains ultimate responsibility for the work done in the department whether it was delegated to others or not. Table 2.2.1 summarises the advantages and limitations of delegation.

accountability: the obligation of an individual to account for his or her activities and to disclose results in a transparent way

Advantages of delegation	Limitations of delegation
• Gives senior managers more time to focus on important, strategic roles • Shows trust in subordinates and this can motivate and challenge them • Develops and trains staff for more senior positions • Helps staff to achieve fulfilment through their work (self-actualisation) • Encourages staff to be accountable for their work-based activities	• If the task is not well defined or if inadequate training is given, then delegation will be 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 – this will not be motivating

Table 2.2.1 The advantages and limitations of delegation

Delayering

Many businesses aim for a flatter organisational structure to reduce the costs of management salaries. This process is known as **delayering** (see Table 2.2.2). It leads to wider spans of control and increased delegation to subordinates. This development in organisational structures has been assisted by improvements in IT and communication technology, which better enable senior managers to communicate with and monitor the

delayering: removal of one or more of the levels of hierarchy from an organisational structure performance of junior staff and widely dispersed departments. This has had the effect of diminishing the importance of the role of middle managers.

Advantages of delayering	Disadvantages of delayering
• Reduces business costs • Shortens the chain of command and should improve communication through the organisation • Increases spans of control and opportunities for delegation • May increase workforce motivation due to less remoteness from top management and greater chance of having more responsible work to perform	• Could be one-off costs of making managers redundant, e.g. redundancy payments • Increased workloads for managers who remain – this 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 (see Chapter 2.4)

Table 2.2.2 The advantages and disadvantages of delayering

Bureaucracy

bureaucracy: an organisational system with standardised procedures and rules

Bureaucracy is a system that is most commonly found in government organisations. It discourages initiative and enterprise as decisions are taken centrally and then put into effect by staff following set procedures and protocols. Max Weber, the sociologist, identified the main attributes of bureaucracy as rationality and efficiency. However, he also recognised its impersonality and ineffectiveness when a decision needed to be adapted to suit an individual case.

Centralisation and decentralisation

centralisation: keeping all of the important decision-making powers within head office or the centre of the organisation

decentralisation: decision-making powers are passed down the organisation to empower subordinates and regional/product managers

Centralised businesses want to maintain exactly the same image and product range in all areas – perhaps because of cost savings or to retain a carefully created business identity in all markets. Examples of **decentralised** businesses are those multinationals that allow regional and cultural differences to be reflected in the products and services they provide. 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 sell European winter clothes in Singapore, for example. See Table 2.2.3 for the advantages of centralisation and decentralisation.

Advantages of centralisation	Advantages of decentralisation
• A fixed set of rules and procedures in all areas of the firm should lead to rapid decision-making – there is little scope 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. • Central buying should allow for greater economies of scale. • Senior managers at head office will be experienced decision-makers.	• More local decisions can be made which 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 skills and this prepares them for more challenging roles. • Delegation and empowerment are made easier 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 every time.

Table 2.2.3 The advantages of centralisation and decentralisation

ACTIVITY 2.2.1

TATA STEEL REORGANISES STRUCTURE

India's Tata Steel has reorganised its management structure to realise its corporate goal of becoming a leading player in the global steel industry. The company has formed a centralised body to create common strategies across the whole group, which has steelworks in the UK, Thailand and the Netherlands as well as India. The functions that will be centralised will be technology, finance, corporate strategy and corporate communications.

Source: http://uk.biz/yahoo.com

10 marks, 20 minutes

1. Define the term 'centralised decision-making structure'. [2]
2. Outline the difference between centralised and decentralised decision-making structures in an organisation like Tata. [4]
3. Explain **two** reasons why Tata has maintained centralised control over finance and corporate strategy. [4]

Different types of organisational structures

The 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 an ambitious employee are illustrated by the different levels of hierarchy. The role of each individual will be clear and well defined, and 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.

hierarchical structure: a structure in which power and responsibility are clearly specified and allocated to individuals according to their standing or position in the hierarchy

This hierarchical type of structure can be organised by product, function or region.

By product

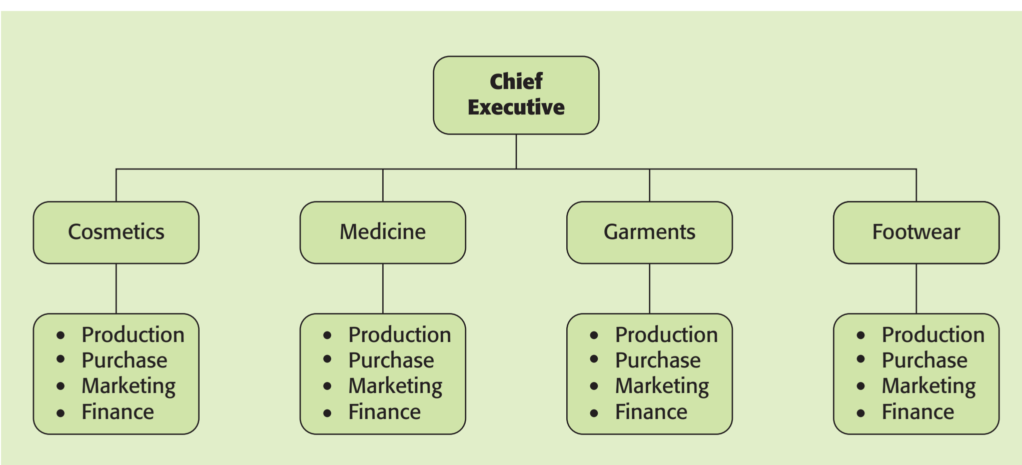


Figure 2.2.5 Organisational structure by product division

An organisational structure based on products usually consists of several parallel teams focusing on a single product or service line. Examples of a product line are the different car brands under General Motors or Microsoft's software platforms. One example of a service line is Bank of America's retail, commercial, investing and asset management arms.

An organisational structure based on product divisions gives a larger business the ability to segregate large sections of the company into semi-autonomous groups. These groups are often mostly self-managed and focus on a narrow aspect of the company's products or services. As with any organisational structure, divisions have both strengths and weaknesses.

Unlike functional departments, product divisions tend to be more autonomous, each with its own top executive. They typically manage their own recruitment, budgeting and advertising. Though small businesses rarely use a product divisional structure, it can work for such firms as advertising agencies which have dedicated staff and budgets that focus on major clients or industries.

Advantages

- Product divisions can work well because they allow a team to focus on a single product or service, with an appropriate leadership structure.
- Having a senior executive – often a member of the Board of Directors – makes it more likely the division will receive the resources it needs from the company.
- A product division's focus allows it to build a common culture and *esprit de corps* that contributes both to higher morale and a better knowledge of the division's range of products. This is preferable to having its product or service managed by multiple departments through the organisation.

Disadvantages

- Product divisions may compete with each other for available financial resources and this might reduce cooperation between them.
- Divisions can result in compartmentalisation that results in lack of coordination or even duplication of developments. For example, Microsoft's business-software division developed the Social Connector in Microsoft Office Outlook 2010. They were unable to integrate Microsoft SharePoint and Windows Live until months after Social Connector could interface with MySpace and LinkedIn. Some experts suggested that Microsoft's divisional structure contributed to a situation where its own products were incompatible across internal business units.

By function

This traditional form of organisational structure is illustrated in Figure 2.2.1.

Advantages

- Grouping employees by functional skills, e.g. marketing, can improve efficiency. Specialists are clustered together, which promotes collaboration and the opportunity for the further development of professional expertise.
- Employees can capitalise on their specialised skills as a means to move up the ladder in a given department.
- As each department specialises in a specific function, managers train and develop employees within their unit to be proficient in their given role.

Disadvantages

- Such a structure tends to suggest that one-way (top downwards) communication is the norm – this is rarely the most efficient form.

- There are few horizontal links between the departments, and this can lead to lack of coordination between them.
- Managers are often accused of tunnel vision because they are not encouraged to look at problems in any way other than through the eyes of their own department. They can become too focused on departmental objectives and not overall corporate aims.
- This type of structure is very inflexible and often leads to change resistance. This is because all managers tend to be defending both their own position in the hierarchy and the importance of their own department.

By region

Multinational businesses are often structured using regional divisions. Large businesses that only operate in one country might also divide the structure into different regions of a single country.

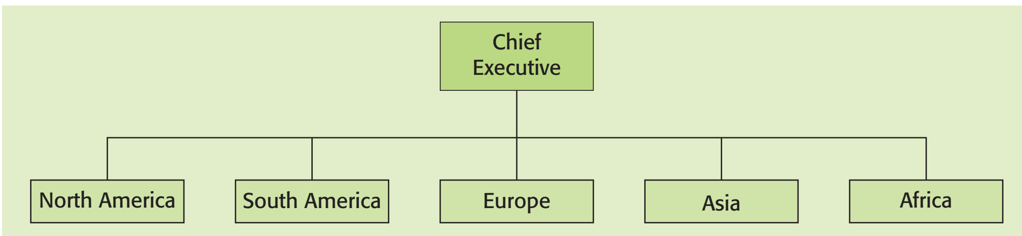


Figure 2.2.6 Organisational structure by region

Advantages

- Communication between representatives can be very direct and personal in a geographical organisational structure – rather than having to establish working relationships with people on the other side of the world through email and telephone.
- Grouping employees into regional sections can encourage the formation of strong, collaborative teams that work effectively together and engage in planning and decision-making together.
- The ability to recruit local management offers companies the advantage of having leaders who are completely familiar with the local business environment, culture and legal climate.
- Better decisions can result from relying on the knowledge and experience of regional managers who are aware of specific cultural factors. Recruiting a mix of local and head-office managers to lead a geographical unit has the advantage of linking local culture with company culture. Customers can feel more at ease when speaking with local representatives who fully understand their language and idiomatic expressions.
- Tracking the performance of individual regional markets is simplified under this structure, as measures such as revenues, profit margins, costs and performance improvements can be tracked to specific regions.

Disadvantages

- Some disadvantages of the geographical structure may include the duplication of personnel between head office and regional offices.
- There may be conflict and unhealthy competition between different areas.
- It could make it more difficult to be consistent in core company beliefs – e.g. ethical code of practice – from one area to the next.
- Inconsistent company strategies might be adopted in different regions as a result of poor coordination between regional offices.

Factors influencing organisational structure

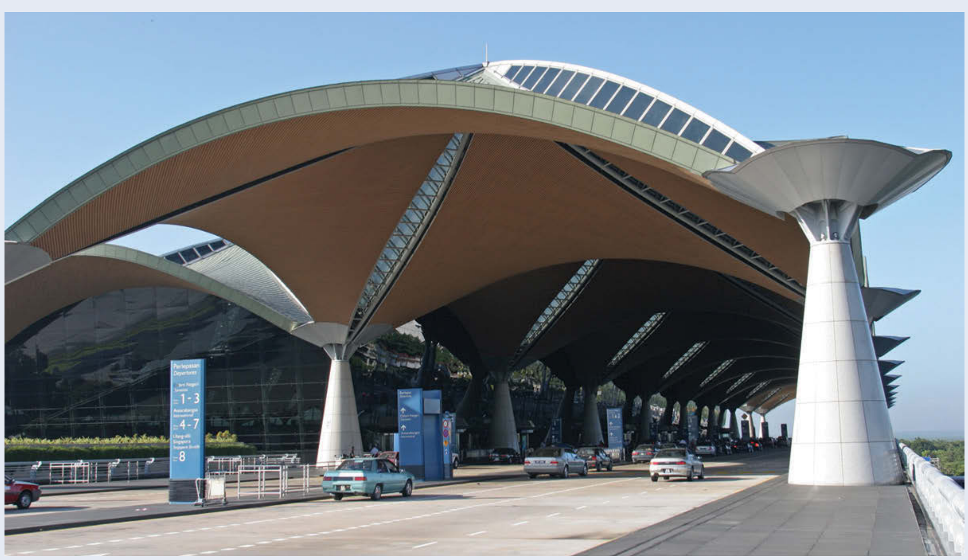
A range of factors determine the internal structure of the organisation:

1. The size of the business and the number of employees.
2. The style of leadership and culture of management. If senior managers adopted an autocratic style taking all key decisions themselves, then narrow spans of control would be adopted in a hierarchical structure. A democratic leader would tend to adopt very few levels of hierarchy and delegate extensively. (See Chapter 2.3 on leadership styles.)
3. Retrenchment caused by economic recession or increased competition might lead to delayering to reduce overhead costs – this would reduce levels of hierarchy and shorten the chain of command.
4. Corporate objectives – for example, if one of the long-term objectives of the business is to expand in other countries, then the organisational structure must be adapted to allow for some decentralisation.
5. New technologies – especially IT – can lead to a reduced need for certain employee types, e.g. managers sending messages by email rather than by letters typed by secretaries. In addition, central control might be made easier by the flow of information through IT and this could make middle management layers less important.

ACTIVITY 2.2.2

MAS MUST CHANGE STRATEGY, SAYS NEW BOSS

'Loss-making Malaysia Airline System (MAS) must raise labour productivity and double services in the region to become profitable,' its new boss said in recent remarks. The national carrier's present hierarchical structure was unsuitable as operational costs were far too high, the Managing Director said in an interview with the *Sun* newspaper. Productivity and customer service were also 'disappointing' and had contributed to a decline in overall performance, he said.



Kuala Lumpur International Airport, Malaysia

'I liken MAS to a house that is supposed to be double-storeyed but instead has five storeys. In such a situation, the position is untenable,' he said. 'We need to reduce the number of storeys or levels in the organisation. MAS's operational costs are higher than that of the industry and its competitors. Each department does not operate according to expectations.' He said MAS aircraft were stationary too long and were underutilised. He also voiced concern over poor productivity in the catering division. The airline has now reported losses for four straight years and has borrowings totalling 10.34 billion ringgit. On a suggestion that the airline should decentralise and separate its international and domestic operations, the Managing Director said this was being studied, but the management found that 'separation is not the best choice'.

20 marks, 40 minutes

1. Define the term 'hierarchical structure'. [2]
2. Explain **two** possible reasons why labour productivity is lower in MAS than in other airlines. [4]
3. Analyse **two** possible effects on the performance of MAS of a decision to separate its domestic and international operations. [4]
4. Evaluate the impact on three different stakeholders in MAS of its decision to delayer its organisational structure. [10]

Changes in organisational structures

There are alternative organisational structures, other than the hierarchical type.

The matrix structure

matrix structure: an organisational structure that creates project teams that cut across traditional functional departments

The **matrix structure** approach to organising businesses aims to eliminate many of the problems associated with the hierarchical structure. This type of 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 2.2.7.

This method of organising a business is task- or project-focused. Instead of highlighting the role or status of individuals it gathers together a team of specialists with the objective of completing a task or a project successfully. Emphasis is placed on an individual's ability to contribute to the team rather than their position in the hierarchy. The use of matrix

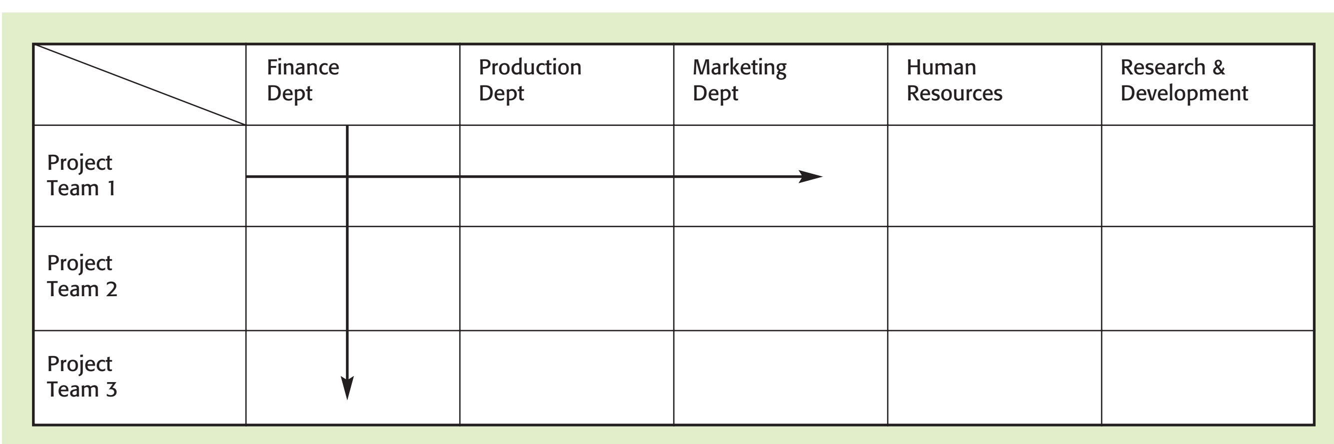


Figure 2.2.7 A matrix organisational structure

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 staff will be more motivated to contribute.

Advantages

- It allows total communication between all members of the team, cutting across traditional boundaries between departments in a hierarchy where only senior managers are designed to link with and talk to each other.
- There is less chance of people focusing on just what is good for their department. This is replaced with a feeling of what is good for the project and the business as a whole.
- The crossover of ideas between people with specialist knowledge in different areas tends to create more successful solutions.
- As new project teams can be created quickly, this system is well designed to respond to changing markets or technological conditions.

Disadvantages

- There is less direct control from the 'top' as the teams may be empowered to undertake and complete a project. This passing down of authority to more junior staff could be difficult for some managers to come to terms with.
- The benefit of faster reaction to new situations is, therefore, at the expense of reduced bureaucratic control, and this trend may be resisted by some senior managers.
- Team members may have, in effect, two leaders if the business retains levels of hierarchy for departments but allows cross-departmental teams to be created. This could cause a conflict of interests.

Horizontally linked structure

This structure is primarily found in the IT and high-tech sectors. In a horizontal structure, employees are grouped by function into three areas – planning, building and running. For example, the planning department is responsible for developing new projects and may include employees from research, development and finance. The building department would then construct or assemble the projects; and the running department would include sales, marketing and maintenance. This structure allows the company to respond quickly to changing market conditions and technological advances but may not work as well for companies that produce products with a longer lifespan, or for service industries.

LEARNER PROFILE

Being an effective communicator is seen as one of the key characteristics of a good manager. Being able to lead, direct and motivate your team comes so much more easily when you are a great communicator. So what makes a great communicator?

Here are seven characteristics of great communicators:

- they connect – 'Amazing communicators know that people won't start listening unless they connect intellectually and emotionally'.
- they engage – 'are well informed and yet ready to learn, listen and participate'.

- they disarm – 'are humble and authentic and show genuine interest in others'.
- they focus – 'carefully structure the ideas and stories to hold audience interest'.
- they clarify – 'find ways to simplify complex concepts'.
- they reinforce – 'artfully reinforcing key points through storytelling and context'.
- they learn – 'from experts and study technique'.

Source: Adapted from www.inc.com

In small groups prepare a presentation for your class on any business topic that incorporates the 'Seven characteristics of great communicators'.

Changes in organisational structure

Handy's Shamrock organisation

Charles Handy is a well-known writer on organisational structure who has focused on the changes being introduced into many business organisations as a result of greater cost pressures and the need for greater flexibility.

He first used the term the 'Shamrock organisation' (see Figure 2.2.8) with the three leaves made up of the following:

- Core managerial and technical staff, who must be offered full-time, permanent contracts with competitive salaries and benefits. These workers are central to the survival and growth of the organisation. In return for high rewards they are expected to be loyal and work long hours when needed. As core workers are expensive, their numbers are being reduced in most organisations.
- Outsourced functions by independent providers, who may once have been employed by the company. Also known as the 'contractual fringe', these workers provide specific services that do not have to be kept within the core. These may include payroll services, transport, catering and IT.
- Flexible workers on temporary and part-time contracts, who are called on when the situation demands their labour. As the organisation demonstrates little concern or loyalty towards these workers, they often respond in kind. These workers are most likely to lose their jobs in an economic downturn.

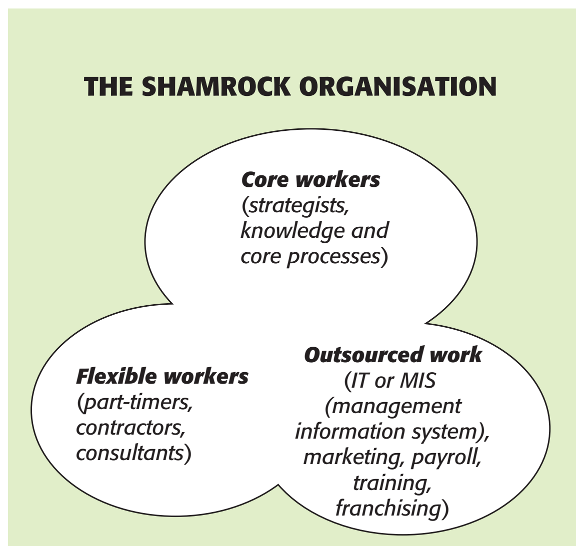


Figure 2.2.8 Charles Handy's Shamrock organisation

The flexible future

Over the last 20 years, many large businesses, including most multinationals, have been forced to retrench, rationalise and downsize their organisations. At the same time, the increasing pace of globalisation and technological change means that huge organisational structures with many levels of hierarchy and slow bureaucratic systems have had to change. For example, if communication takes a long time to go up and down the hierarchy, then business is lost and the organisation gets a bad reputation for being unresponsive to customer needs.

So, in the current environment, businesses need a flexible and fluid organisational structure. More businesses are moving away from a traditional 'command' structure to one centred on team-based problem-solving. This involves removing horizontal boundaries between departments altogether and reducing middle management layers to the absolute minimum. Future success will depend greatly on being able to respond rapidly to the changing business environment and this almost certainly means that the days of the traditional pyramid hierarchy are numbered.

Communication in an organisation

Business communication

effective communication: the exchange of information between people or groups, with feedback

feedback: the response to a message by the receiver

Communication is only **effective** if the message has been received and understood by the receiver and the sender knows that it has been understood. Figure 2.2.9 shows the key features of effective communication:

- sender (or transmitter) of the message
- clear message
- appropriate medium (way in which the message is sent)
- receiver
- **feedback** to confirm receipt and understanding.

If the message has been sent, but there has been no feedback, then the effectiveness of the communication cannot be judged. Businesses communicate externally – with suppliers, customers, shareholders and the government, for example. Internal communication is between different people or groups within the organisation.

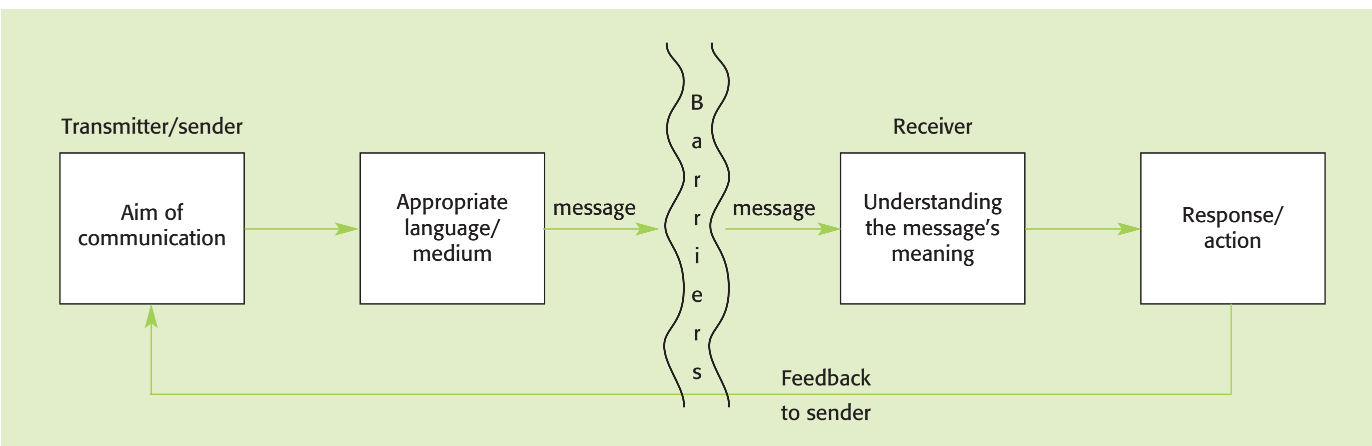


Figure 2.2.9 Effective communication – barriers must be reduced or eliminated

Importance of effective communication

The effectiveness of internal communication can have an impact on many areas of business:

- Employee motivation and labour productivity – if employees are encouraged to participate through group discussion, for example, then effective communication will aid motivation.
- The number and quality of ideas generated by the workforce – if employees are asked for their ideas, then this can assist with problem-solving.

- Speed of decision-making – the more people who have to be communicated with, the slower the decision-making system.
- Speed of response to market changes – if changes in consumer tastes take a long time to be communicated to the main decision-makers, then the business will be slow to respond with appropriate products.
- 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.
- Effective coordination between departments – this will be helped by good communication links between them.

Poor communication will lead to demotivated workers, uncoordinated departments, poor customer service and a lack of overall direction for the organisation. Two of the main communication issues that most businesses must focus on are:

- What impact should different cultures have on communication?
- How can innovations in technology improve business communication?

Cultural differences

Communicating across different cultures is challenging. Each national or ethnic culture has set beliefs and practices that its members take for granted. Few people are aware of their own cultural biases as 'cultural imprinting' starts at a very early age. While some of a culture's knowledge, rules, beliefs and values are taught explicitly, most of the information is absorbed subconsciously.

The challenge for multinational communication

The impact of cultural differences on communication methods is very great. Business organisations worldwide are discovering that intercultural communication is of increasing importance – not just because of increased globalisation, but also because domestic workforces are growing more and more diverse, ethnically and culturally.

All international communication is influenced by cultural differences. Examples of different cultural approaches in business might include the speed of contract negotiations, level of formality between business partners, and subtle versus direct conversation about money. Even the choice of communication medium can have cultural overtones. The determining factor may not be the degree of industrialisation, but rather whether the country falls into a 'high-context' or 'low-context culture'.

High-context cultures (Mediterranean, Slav, Central European, Latin American, African, Arab, Asian, American-Indian) leave much of the message unspecified, to be understood through context, non-verbal cues, and between-the-lines interpretation of what is actually said. By contrast, low-context cultures (most Germanic and English-speaking countries) expect messages to be explicit and specific. Therefore, culture directly affects verbal and non-verbal business communication. Some cultures, including Australia, the

UK and Germany, place high significance on the words actually spoken. Other cultures, including Japanese and Arab cultures, still place significance on the spoken word, but also place great significance on the context of the conversation. Silence carries significance in all cultures, and this might be interpreted in different ways during cross-cultural business meetings.

In ***sequential cultures*** (like North America, the UK, Germany, Sweden and the Netherlands), business people give full attention to one agenda item after another.

In ***synchronic cultures*** (including South America, southern Europe and Asia) the flow of time is viewed as a sort of circle, with the past, present and future all interrelated. This viewpoint influences how organisations in those cultures approach deadlines, strategic thinking, investments and the concept of 'long-term' planning.

Communication – reason and emotion

In international business practices, reason and emotion both play a role. Which of these dominates depends upon whether people readily show emotions (affective), e.g. in business meetings, or are emotionally 'neutral'. Members of neutral cultures do not express their feelings, but keep them carefully controlled and subdued. In cultures with high emotions, people show their feelings plainly by laughing, smiling, grimacing, scowling, and sometimes crying, shouting or walking out of the room!

In the course of normal business activities, people from neutral cultures are more careful to control the amount of emotion they display. Studies have shown that emotional reactions are found to be least acceptable in Japan, Indonesia, the UK, Norway and the Netherlands and most accepted in Italy, France, the USA and Singapore.

People from neutral cultures may sympathise with the Dutch manager and his frustration over trying to reason with 'that excitable Italian'. After all, a business idea either works or it does not work. The way to test the validity of an idea is through trial and observation – surely that makes sense, doesn't it? Well, not necessarily to the Italian manager who felt the issue was deeply personal and who viewed any 'rational argument' as totally irrelevant!

When it comes to communication, what is appropriate and correct in one culture may be ineffective or even offensive in another. In reality, no culture is right or wrong, better or worse – just different. Businesses that operate globally should accept that there is no single best approach to communicating. The key to cross-cultural success is to develop an understanding of, and a respect for, the differences.

THEORY OF KNOWLEDGE

Modern offices are becoming increasingly multicultural in a globalised world. In big financial centres like New York, London, Hong Kong and Singapore the offices of banks, insurance companies and media outlets are made up of highly skilled and educated staff from all over the world. You can be sitting at a desk where the man sitting next to you is from Rio, where the woman across the room who has shouted out the latest share price is Australian and the Ghanaian team leader has just put a fresh cup of coffee in front of you. One common theme is that you all speak to each other in English.

Discuss in your class the opportunities and threats associated with globalised workplaces where the language of communication is increasingly English.

Link to technological innovation

Modern technology, including the internet, tablets, social media and mobile (cell) phones, has facilitated more rapid communication between businesses around the world. While this greatly expands a business's opportunity for growth and profitability, it does increase the chance that a lack of cultural sensitivity during communication can result in an offended client or business partner. Such examples of cultural insensitivity can lead to the loss of partnerships and contracts worth billions of dollars.

Communication breakdown

Ignoring culture in business communication can lead to problems and communication disruptions. Internal business communication can be disrupted or misinterpreted if workers don't share the same understanding of goals, expectations and processes as managers. Understanding a culture can help businesses anticipate potential challenges or barriers in the adoption of new policies or processes before efforts break down. For example, some business cultures such as in Western Europe may thrive in an exchange- and dialogue-based communication system while other cultures (for example, Japanese and Arab cultures) rely more heavily on subtext. If new information or ideas are suddenly imposed on employees accustomed to a participative business culture, there may be a deep-seated resistance and the project will fail.

ACTIVITY 2.2.3

CULTURAL DIFFERENCES AND EFFECTIVE COMMUNICATIONS

Coca-Cola operates in nearly every country in the world. It has to negotiate contracts with governments, suppliers, canning businesses and customers (e.g. supermarket buyers) in many different countries using many different languages. Senior executives understand the importance of cultural differences and take steps to avoid offending cultural sensitivities when communicating with its stakeholdvers outside the USA.

20 marks, 40 minutes

Discuss the significance for a company such as Coca-Cola of understanding cultural differences when communicating effectively with three different stakeholder groups. [20]

Innovations in communication technology

The impact of new technology on how a business communicates internally – between managers and employees – has been changed forever by the latest technological devices. Mobile (cell) smartphones, iPads and other tablets, networks, intranets and cloud computing – these are just some of the recent developments that allow people within a business to keep in touch in ways that, even 20 years ago, would have been unimaginable.

Networking allows collaboration between workers on reports, programming and other document production. It forms the core of how most business communication is performed today. Cloud computing allows businesses, such as large multinationals, to operate globally without sacrificing security or limiting user access. Some businesses – such as LinkedIn and Kaplan – give all employees an iPad to allow easier internal communication and easy access to the **intranet**/internet. External communication with customers is now often focused on social media such as Facebook and Twitter.

intranet: internal computer networks built on internet technologies

Innovations in communication technology – potential limitations

Are there any drawbacks to IT use in business communication? Initial cost can be significant, some security issues remain and employees may need training. But above all, the tendency to reduce interpersonal contact is not necessarily desirable – either for good communication with employees, customers or suppliers or for satisfying social needs.

Electronic media

These have the benefit of speed and are often combined with a written record. Internet and email use, intranets, fax messages, video conferencing and internet-linked mobile phones (which also allow for oral communication) have all revolutionised business communications in recent years. However, these applications of electronic media also have their drawbacks:

- They may require staff to be trained, and the young are usually much more proficient in their use than older employees.
- They reduce social contact and can create a sense of isolation so an important social need may go unsatisfied. Staff may use company time to send personal messages.
- There are security issues with computer technology and hard copies of important messages are often kept in case of a virus.
- Finally, there is increasing evidence that IT can lead to **information overload** as a result of the speed and low usage cost of these methods. Too many messages – for example, the sheer volume of email messages can take some workers several hours to reply to each day – can prevent the really important communication from being noticed and acted upon. Too much information can also cause stress and a feeling of overwork. The benefits offered by IT and other electronic methods have to be weighed against their actual cost – in terms of equipment and training – and their other potential drawbacks.

information overload: so much information and so many messages are received that the most important ones cannot be easily identified and quickly acted on – most likely to occur with electronic media

ACTIVITY 2.2.4

EMAILS ARE RUINING MY DAY!

Two million emails are sent every minute in the UK alone. Office staff can spend up to half of each working day going through their inbox. This makes workers tired, frustrated and unproductive. A recent study found that one-third of office workers suffer from email stress caused by both the number they receive, the unnecessary length of some of them and the poor clarity of the language often used.

Now firms are being forced to help staff deal with their avalanche of emails. Some hire email consultants to advise on best email practice, while other firms now insist on an email-free day each week.

Undertake research within your school or college to discover the average amount of time staff and students spend each day on reading and sending emails. Present your findings in a report. Recommend how the use of IT to send messages at your school/college could be made more effective in order to save time but maintain effective communication.

ACTIVITY 2.2.5

TECHNOLOGY IN BUSINESS COMMUNICATIONS

Technology has changed business in many ways, but its effect on communication is arguably one of the most significant. According to Walden University College of Management and Technology, communications through email, text messaging, instant messaging and social networking have been among the most profound effects of technology on every area of business. The benefits include:

Speed – Whether you need to speak with an employee who is travelling in another state or country or you need to communicate with your supplier half way around the world, technology allows you to do so instantaneously.

New opportunities – Technology allows individuals to communicate and carry on a business relationship without ever meeting face to face, so, for example, people in all parts of the world now have the chance to interact with a company in a rural part of the United States.

However, many business analysts understand the potential problems of mainly communicating using new technology:

Impersonal perception – A significant disadvantage of business communication technology is the perception that a business is impersonal. Consumers who are consistently sent electronic communication from business organisations are more likely to have this perception. Employees may also see electronic communication as impersonal if they only receive messages from managers or other employees through email. Email can also create confusion requiring employees to seek more feedback than normal compared to more personal communication methods.

Security issues – Using business technology in communication can create various security issues. Emails, text messages and other website communication are often vulnerable to hackers or other individuals who should not have access to certain information.

Equipment and training expenses – Companies typically have to purchase additional equipment to implement business communication technology into their operations and train employees to use the equipment effectively and securely.

20 marks, 40 minutes

1. Define the term ‘effective communication’. [2]
2. Describe **two** ways multinational organisations can use communications technology to communicate with their customers. [4]
3. Analyse **two** benefits to a multinational business of using the latest communications technology when communicating with customers. [4]
4. Evaluate the potential consequences that could result from a business focusing almost entirely on new technology for its internal communications. [10]

OVER TO YOU

Revision checklist

1. Why do organisations need a formal structure?
2. Identify **three** benefits of a typical hierarchical structure.
3. Explain **two** drawbacks of a typical hierarchical structure.
4. What is meant by a 'long chain of command'?
5. What is meant by a 'wide span of control'?
6. Outline **two** problems associated with a 'long chain of command' and a tall structure.
7. Explain how the organisational structure of a business might change as it expands.
8. Explain the difference between a structure based on product and a structure based on region.
9. Explain the benefits of a matrix structure.
10. Explain why some businesses have a centralised structure.
11. Outline the importance of delegation to a business.
12. Would you advise a multinational furniture retailer to adopt a centralised management structure? Explain your answer.
13. Explain Handy's Shamrock organisation.
14. Explain **two** differences between different cultures that could make communication difficult for a multinational business.
15. Explain **two** potential benefits and **two** potential limitations of using new technology for business communications.

Exam practice question

MITSUBISHI MOTORS REJIGS STRUCTURE

Mitsubishi Motors (MMC), the Japanese carmaker that is 37% owned by DaimlerChrysler, revealed significant changes to its senior and middle management structure at a shareholders' meeting. The changes reflected underlying tensions between the company's incoming German managers and established Japanese executives who found it difficult adjusting to the new culture. The restructuring aimed to weed out managers whose more traditional mentality could delay the sweeping reforms underway under the new management. Other managers were to be offered early retirement. MMC's chief operating officer and president wanted to dispense with managers at any level who remain locked into the 'length of service' mentality and acted ahead of the shareholders' meeting to weed them out.

The president of Mitsubishi demonstrated his commitment to reform when he announced that 60 senior staff advisers – who were of an advanced age and made a marginal contribution to the company despite generous remuneration – would be removed.

Soon after, the new chief operating officer appointed a 'COO Team' comprising about 25 mainly non-Japanese executives from DaimlerChrysler. This team, drawn from different departments, was responsible for overseeing the implementation of the company's restructuring plan. Some long-standing members of MMC's middle and upper management resented the presence and power of the COO Team, all of whom were under 40 years old and who were controlling the strategic direction of the company. The tension between the COO Team and some of MMC's managers was described as stemming from Japanese managers with a 'job for life' attitude. This is not part of German management culture.

20 marks, 40 minutes

1. Explain what is meant by 'delayering'. [2]
2. Explain why 'culture conflict' seems to exist in Mitsubishi Motors. [4]
3. Analyse **two** possible benefits to Mitsubishi Motors of reducing the chain of command through delayering. [4]
4. Evaluate the possible consequences for the efficiency of Mitsubishi Motors of the new management structure described in the case study. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, discuss the importance of innovation and culture in a business's organisational structure. [20]

2.3

Leadership and management

On completing this chapter you should be able to:

Analyse and apply:

- The key functions of management (AO2)
- Differentiate between management and leadership (AO2)

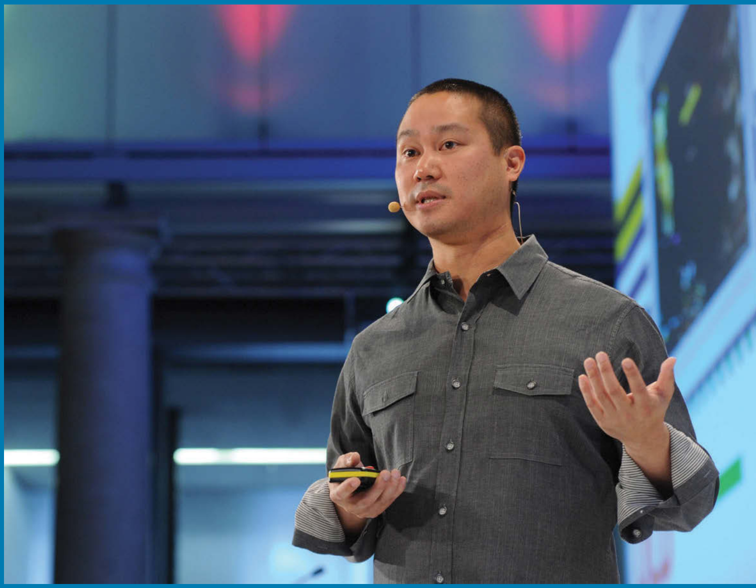
Evaluate:

- Different leadership styles (AO3)
- How ethical considerations and cultural differences may influence leadership styles (AO3)

Setting the scene

WHAT MAKES A GOOD LEADER?

A frequently asked question is: What makes a good leader? There are many factors involved in successful leadership but one thing is clear: as technological change accelerates and old industries fade but new ones develop, the best leaders are those who have the foresight and flexibility to be able to adapt their work-place methods to match each company, its vision and the demographics of its workforce. Here are some famous quotes from, or about, leaders around the world:



Tony Hsieh

Ted Devine, Insureon: 'Having a completely open plan office says this about leadership: No walls, no barriers, no hierarchy. Everybody can talk to everybody. Everybody can participate in a decision. We work together, and that's very important in leadership.'

Sheila Johnson, BET cable network: 'I want every one of my employees to look at me with dignity and respect. I want to be someone they are proud to work for.'

Jeff Weiner, LinkedIn: As a manager, Weiner takes time to acknowledge relatively small accomplishments by his employees. He often ends a meeting or speech by asking what he could have done better. His workdays are as long as – or longer than – those of his employees. 'That allows him to be extremely credible as a leader,' says David Hahn, LinkedIn's vice president.

Tony Hsieh, Zappos: 'Tony's imprint is all over the company,' says Jamie Naughton, a Zappos' senior manager. 'Our culture was inspired by how he does business and the people he hires and how we all are as a group. He takes a hands-off approach to leadership that requires effective delegation. He is more of an architect; he designs the big vision and then gets out of the way so that everyone can make the things happen.'

2.3 Human resource management

Points to consider

- What do you think 'leadership' means?
- Do you think that all of the quotes above suggest 'good leadership'? Why?
- Do you think there is a difference between 'leading' people and 'managing' them? Explain your answer.

Key concept link

Business leaders and senior managers have great influence on the success of the organisation. They determine strategy, establish the culture of the business and outline the ethical standards to be followed.

Introduction

Leadership is a key part of being a successful manager. It involves setting a clear direction and vision for an organisation that others will be prepared to follow. Employees will want to follow a good leader and will respond positively to them. A poor leader will fail to win over staff and will have problems communicating with and organising workers effectively. Most good managers are also good leaders – but some managers are not. Managers who focus on control of people and allocation of resources can fail to provide a sense of purpose or focus that others will understand and be prepared to follow. Without clear and charismatic leadership workers may be very well 'managed', but will they be inspired to help the leader and the business take a fresh direction and achieve new goals?

The functions of management

manager: responsible for setting objectives, organising resources and motivating staff so that the organisation's aims are met

Managers 'get things done' – not by doing all jobs themselves but by working with and delegating to other people. The key functions of management are common to all managers in any size of organisation. These are best explained by reference to some of the best-known management writers such as Handy, Fayol and Drucker. For example, Henri Fayol suggested the following:

1. **Setting objectives and planning** – all good managers think ahead. Senior management will establish overall strategic objectives and these will be translated into tactical objectives for the less senior managerial staff. The planning needed to put these objectives into effect is also important. A new production or marketing objective will require the planning and preparation of sufficient resources.
2. **Organising resources to meet the objectives** – this is not just about giving instructions. People throughout the business need to be carefully recruited and encouraged to take some authority and to accept some accountability via delegation. Senior managers will ensure that the structure of the business allows for a clear division of tasks and that each section or department is organised to allow them to work towards the common objectives.
3. **Directing and motivating staff** – this involves guiding, leading and overseeing employees to ensure that organisational goals are met. The significance of developing staff so that they are motivated to employ all of their abilities at work is now widely recognised. This will make it more likely that organisational aims are achieved.

4. **Coordinating activities** – as the average size of business units increases, which is especially true for multinationals, so the need to ensure consistency and coordination between different parts of the organisation increases. The goals of each branch, division, region and even all staff must be welded together to achieve a common sense of purpose. At a practical level, this may mean avoiding the situation where two divisions of the same company spend money on research into the same new product, resulting in wasteful duplication of effort.
5. **Controlling and measuring performance against targets** – management by objectives 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. As Herzberg points out, it is just as important to provide positive feedback when things are going right.

Mintzberg's management roles

To carry out these functions managers have to undertake many different roles. In *The Nature of Managerial Work* (1973), Henry Mintzberg identified ten roles common to the work of all managers. These are divided into three groups:

1. Interpersonal roles – dealing with and motivating staff at all levels of the organisation
2. Informational roles – acting as a source, receiver and transmitter of information
3. Decisional roles – taking decisions and allocating resources to meet the organisation's objectives.

Mintzberg's managerial roles are set out in Table 2.3.1.

Role	Description of role activities	Examples of management action to perform the role
Interpersonal		
Figurehead	Symbolic leader of the organisation	Opening new factories/offices Hosting receptions Giving important presentations
Leader	Motivating subordinates Selecting and training other managers/staff	Any management tasks involving subordinate staff
Liaison	Linking with managers and leaders of other divisions and other organisations	Leading and participating in meetings Correspondence with other organisations
Informational		
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	Presenting reports to groups of stakeholders (e.g. annual general meeting) and communicating with the media
Decisional		
Entrepreneur	Looking for new opportunities to develop the business	Encouraging new ideas from within the business and holding meetings to put new ideas into effect

Table 2.3.1 Managerial roles according to Mintzberg [*table continues over*]

Role	Description of role activities	Examples of management action to perform the role
Disturbance handler	Responding to changing situations that may put the business at risk Taking 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 allocation of the organisation's financial, human and other resources	Drawing up and approving estimates and budgets Deciding on staffing levels for 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 2.3.1 *Continued*

ACTIVITY 2.3.1

ALLSTYLES DEPARTMENT STORE

Rebecca Allahiq's working day was busy and varied. She had recently been appointed general manager of the Allstyles department store. It had ten departments selling a wide range of products from men's and ladies' clothing to carpets, furniture and electrical goods. A local TV company had asked if they could film a typical working day for a programme they were making about different people's working lives. Rebecca agreed and the ten-minute programme used six different clips of film with Rebecca involved in the following activities:

1. Meeting with all departmental managers to explain the store's pricing and promotional strategy for the next 'End of season sale'. She told all managers to inform employees of the agreed price reductions and the way in which goods should be presented.
2. Attending a planning meeting with executives from head office to agree the 12-monthly sales targets for the store. Rebecca explained that the opening of a competitor's store nearby was a factor that should be taken into account.
3. Presenting three shop workers with 'Reach for the stars' badges for outstanding sales records over the last month. She had her picture taken with them for publication in the store's internal newspaper.
4. Reviewing the poor performance of the electrical products division with the manager. Poor absenteeism figures had contributed to this problem. Rebecca suggested that the manager should attend additional training sessions on staff motivation and monitoring of staff performance.
5. Meeting with builders, architects and planners to discuss progress on the new store extension. Rebecca was concerned that they were not working together closely enough and the project could fall behind schedule.
6. Settling a dispute between two departmental managers over which department should be able to stock a new electronic exercise bicycle – sports or electrical goods? It was agreed that it could not be displayed in both because of lack of space, so sports would stock it for six months next to gym equipment. Sales would be monitored closely and if it did not do well, then relocation might be possible.

20 marks, 40 minutes

1. Identify all of the different management functions that Rebecca fulfilled during this busy day. [6]
2. Outline the personal characteristics that you think Rebecca needed to carry out all of these roles successfully. [6]
3. Examine the problems that this store might encounter if Rebecca was not an effective manager. [8]

LEARNER PROFILE

Caring

'No act of kindness is too small. The gift of kindness may start as a small ripple that over time can turn into a tidal wave affecting the lives of many.' Kevin Heath, CEO, More4kids

More4kids.info is an online encyclopedia of parenting-related topics. Central themes of More4kids topics of interest for parents and caregivers include: parenting, pregnancy, homeschooling, children's health, baby development, baby names and women's health issues.

To what extent can the caring attitude of the CEO of an organisation make that organisation one that cares?

The differences between management and leadership

A good manager does not always make an effective leader. There is often a problem in understanding the difference between management and **leadership**, says John Kotter, Konosuke Matsushita professor of leadership at Harvard University. He fears that too often the terms are used synonymously.

leadership: the art of motivating a group of people towards achieving a common objective

'Management is a set of processes that keep an organisation functioning. They make it work today – they make it hit this quarter's numbers. The processes are about planning, budgeting, staffing, clarifying jobs, measuring performance and problem-solving when results did not go to plan.' (**Source:** careers.theguardian.com)

Leadership is very different, Kotter believes. He considers it to be about aligning people to the vision of the business which means communication, motivation and inspiration.

Table 2.3.2 summarises some of the key differences between leaders and managers.

Leadership	Management
Motivating and inspiring others	Directing and monitoring others
Innovators who encourage others to accept change	Problem-solvers
Stems from personal qualities or traits	Official position of responsibility in the organisation
Natural abilities and instincts	Skilled and qualified to perform role
Believes in doing the right thing	Believes in doing things right
Respected and trusted by followers – they want to follow because of leader's personality	Listened to by others because of status – not necessarily because of personality
Creates and develops a culture of change	Accepts and conforms to the 'norms' of the organisation

Table 2.3.2 Differences between leaders and managers

What makes a good leader?

Many studies have been conducted on this point – some argue that leaders are 'born' with natural assets that create an aura or charisma that others will find appealing. This is the essential idea behind trait theory, which suggests that effective leaders are in some ways naturally different from other people. A number of personal characteristics have been identified as being common among effective leaders, including:

- a desire to succeed and natural self-confidence that they will succeed
- ability to think beyond the obvious – to be creative – and to encourage others to do the same
- multitalented enabling them to understand discussions about a wide range of issues affecting their business
- incisive mind that enables the heart of an issue to be identified rather than unnecessary details.

Not all leaders or managers will have all of these important characteristics. Other research is more inclined to support the view that leaders can be trained to adopt the key attributes of good leadership. Indeed, critics of trait theory argue that it ignores the impact of life's experiences on the quality of leadership.

Leadership styles

There are five distinct leadership (or management) styles (see Table 2.3.3):

Autocratic leaders

autocratic leadership: a style of leadership that keeps all decision-making at the centre of the organisation

Autocratic leaders will take decisions on their own with no discussion. They set business objectives themselves, issue instructions to workers and check to ensure that they are carried out. Workers can become so accustomed to this style that they are dependent on their leaders for all guidance and will not show any initiative. Motivation levels are likely to be low, so supervision of staff will be essential. Managers using this style are likely only to use one-way communication – that is, they will issue instructions but will not encourage any feedback from the workforce.

This style of management does have some applications. Armed forces and the police are likely to adopt this approach, as orders may need to be issued quickly with immediate response. Also, in crises, such as an oil tanker disaster or a railway accident, leaders may have to take full charge and issue orders to reduce the unfortunate consequences of the incident. It would be inappropriate to discuss these instructions with the staff concerned before they were put into effect.

Paternalistic leaders

paternalistic leadership: a type of fatherly style typically used by dominant males where their power is used to control and protect subordinate employees who are expected to be loyal and obedient

A **paternalistic** management style is a form of management whereby managers pay more attention to the social aspects of their employees; they are concerned with keeping them happy and motivated, and act as a sort of father figure to the employees. With this leadership style, decisions are made with the best interests of the workers at heart – as perceived by the management. Feedback is invited, improving morale, but the final decisions are still taken by senior management. Employee loyalty and motivation might be higher than in cases where autocratic leadership is adopted. However, there is no true participation in management decisions and this could lead to a sense of frustration in employees especially if their feedback seems to have been ignored when important decisions are made.

Democratic leaders

democratic leadership: a leadership style that promotes the active participation of workers in taking decisions

Democratic leaders will engage in discussion with workers before taking decisions. Communication links will be established on the two-way principle, with every opportunity for staff to respond to and initiate discussion. Managers using this approach need good communication skills themselves to be able to explain issues clearly and to understand responses from the workforce. Full participation in the decision-making process is encouraged. This may lead to better final decisions, as the staff have much to contribute and can offer valuable work experience to new situations. In the light of research by Herzberg, this style of management should improve motivation of staff, as they are being given some responsibility for the objectives and strategy of the business. Workers should feel more committed to ensuring that decisions that they have 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.

Democratic – or participative – leadership is increasingly common, for a number of reasons. Working people are better educated than ever before and have higher expectations of their experience from work – they expect higher-level needs to be partly satisfied at work. Many managers have realised that the rapid pace of change at work, as a result of technological and other factors, has increased the need to consult and involve workers 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 will still avoid consultation and staff participation, perhaps because they find it very difficult to adapt to these ways. Others may so doubt their own ability to discuss and persuade that they would rather issue instructions that do not allow for any feedback from staff.

Laissez-faire leadership

Laissez-faire literally means 'let them do it' – or allow workers to carry out tasks and take decisions themselves within very broad limits. This is an extreme version of democratic management. There will be very little input from management into the work to be undertaken by subordinates. This style could be particularly effective in the case of research or design teams. Experts in these fields often work best when they are not tightly supervised and when they are given 'free rein' to work on an original project. Many scientific discoveries would have been prevented if the researchers concerned 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 they are never sure if what they are doing is 'right'.

laissez-faire leadership: a leadership style that leaves much of the business decision-making to the workforce – a 'hands-off' approach and the reverse of the autocratic style

Situational leaders

Situational leaders will adapt their style of leadership to the task or job that needs to be undertaken and the skills and experience of the group being led. If the group contains workers who lack specific skills and are unable or unwilling to accept responsibility for the task, then a high level of directive leadership will be needed. If, however, the workers are experienced and willing and able to perform a task and take responsibility for it, then a more participative or democratic style of leadership will be appropriate.

situational leadership: effective leadership varies with the task in hand and situational leaders adapt their leadership style to each situation

Leadership style	Main features	Drawbacks	Possible applications
Autocratic	• Leader takes all decisions • Gives little information to staff • Supervises workers closely • Only one-way communication • Workers only given limited information about the business	• Demotivates staff 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

Table 2.3.3 Summary of leadership styles [*table continues over*]

Leadership style	Main features	Drawbacks	Possible applications
Paternalistic	• Strong 'father-like' figure takes key decisions but in interests of employees • Some feedback and consultation encouraged – but not participative decision-making	• Low staff motivation if loyal connection to leader is not established • Increasing dependency of employees on the leader, leading to more supervision required • Employee dissatisfaction if bad decisions are made	• Family-owned businesses where leaders still want to take decisions themselves but value employee loyalty and low labour turnover • In a business with a formal and hierarchical structure where creative thinking is not required of employees
Democratic	• Participation encouraged • Two-way communication used, which allows feedback from staff • Workers given information about the business to allow full staff involvement	• Consultation with staff can be time-consuming • On occasions, quick decision-making will be required • Level of involvement – some issues might be too sensitive, e.g. job losses, or too secret, e.g. development of new products	• 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, then staff input can be very valuable
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 will not be closely monitoring 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
Situational	• Style of leadership used will depend on the nature of the task and the work group's skills and willingness to accept responsibility	• Varying the style of leadership may be difficult for some workers to accept and they may become uncertain of how they will be led in different situations	• By allowing flexibility of leadership style, different leadership approaches can be used in different situations and with different groups of people

Table 2.3.3 *Continued*

Effectiveness of leadership styles

There is not one leadership style which is best in all circumstances and for all businesses. The style used will depend on many factors, including:

- the training and experience of the workforce and the degree of responsibility that they are prepared to take on
- the amount of time available for consultation and participation
- the management culture and business background of the managers, e.g. whether they have always worked in an autocratically run organisation
- personality of managers – do they have the confidence and strength of character to lead by persuading and motivating people to follow them or must they hide behind the authority of their role to 'dictate' what needs to be done?
- the importance of the issue – different styles may be used in the same business in different situations; if there is great risk to the business when a poor or slow decision is taken, then it is more likely that management will make the choice in an autocratic way.

ACTIVITY 2.3.2

DISASTER AT THE BAKERY

The fire at the bakery was a disaster for T & S Provisions Ltd. Eli Tarranto, the chief executive, had been called by the fire services officer, at 3 a.m. 'The whole building is up in flames – we have not been able to save anything,' he had shouted down the phone. The next day, as Eli waited for his staff to turn up for work outside the burnt-out bakery, he was starting to form a plan. He contacted his friend who owned a small competing bakery and the estate agent from whom he had bought the land for the bakery four years ago. The bakery owner agreed to allow Eli to use one of his spare ovens if he sent his own workers to operate it. This would give him about 50% of his normal capacity. The estate agent suggested that Eli rent an empty depot on the other side of town for three months. He thought it would take around two weeks to have this equipped as a temporary bakery.

When workers started to arrive, Eli gave them clear instructions. They were shocked by the state of the building, but they were willing to help in this crisis. Six of them were sent to the friend's bakery to start organising production. Two were sent to the vacant depot and had instructions to start cleaning the premises. The remaining three workers were to help Eli salvage what he could from the office records of the burnt-out building. Before this could start, Eli telephoned all of his major customers – he did not leave it to his sales manager – to explain the extent of the problem and to promise that some production would be back on stream as soon as possible. He then contacted suppliers to inform them of the disaster, to reduce order sizes and give them the new, temporary address for deliveries.

Even the most 'democratic' leader may act in authoritarian ways when dealing with a disaster that requires a quick response

14 marks, 28 minutes

1. Outline the characteristics of an autocratic leadership style. [2]
2. Explain why an autocratic leadership style would be suitable in this situation. [4]
3. Discuss the advantages and disadvantages of Eli Tarranto using an autocratic leadership style. [8]

Exam tip: When answering a question based on 'the best' or 'most appropriate' leadership style, remember that this will *depend on* the nature of the task being performed, the importance of it and the skills and experience of the workers being led.

ACTIVITY 2.3.3

Identify, in groups, what might be the most appropriate leadership style to adopt in each of the following situations. Explain and justify your answer in each case to the class:

- **a.** Training of staff in applying the company's ethical code of conduct
- **b.** Trying to find a solution to a long-standing quality problem on a bread production line
- **c.** An oil company responding to an environmental disaster resulting from a spillage involving one of its tankers
- **d.** Teams of IT software designers working on major new IT developments.

Ethical considerations and leadership styles

ethical leadership: leading by knowing and doing what is 'right'

Ethical leadership has two components. First, ethical leaders must act and make decisions ethically. Secondly, ethical leaders must also lead ethically – in the ways they treat people in everyday interaction, in their attitudes to people and situations, in the ways they motivate, and in the directions in which they lead their organisation.

Ethical leadership has both tangible and intangible qualities. The tangible part is in the way the leader works with and deals with customers, suppliers and employees, in his or her statements and actions. The intangible aspects of ethical leadership lie in the leader's character, in the decision-making process, in the set of values and principles that underpin the leader's decisions and in their courage to make ethical decisions in challenging situations.

Here are some indicators of ethical leadership:

- The ability to ignore personal interests for the sake of the organisation, the needs of the employees and the greater good of the community
- A willingness to encourage and consider seriously feedback, opinions different from the manager's own, and challenges to the manager's ideas and proposed decisions
- The encouragement of leadership in others
- Making the consideration and discussion of ethics and ethical questions and issues part of the culture of the organisation
- Understanding the importance of leadership and sharing it as much as possible and exercising it carefully to the benefit of employees, the business and society.

These points suggest that ethical leaders are likely to be more paternalistic or democratic than autocratic. However, it will be essential for leaders who want to see ethical standards adopted throughout the organisation – which might cover many branches, divisions and even countries – to insist on the adoption by all of the ethical code of the business. This will require firm and prescriptive leadership to discourage the temptation that junior managers might have to 'break the ethical rules'.

THEORY OF KNOWLEDGE

Ethics

More than half of UK managers are being 'pressured' into using unethical behaviour at some point in their career, according to research published by the Institute of Leadership and Management (ILM) and Business in the Community (BITC).

The report on the importance of ethical leadership found that 9% of managers have been asked to break the law at work, while one in ten have left their jobs as a result of being asked to do something that made them feel uncomfortable. In the survey of more than 1000 managers across the public and private sectors, 93% said their organisation had a values statement but more than two-fifths (43%) had been pressured to behave in direct violation of it, with 12% of managers saying that the correlation between employee behaviour and company values was not close 'at all' in their workplace.

It also revealed 27% of respondents were concerned their career would suffer if they were to report an ethical breach, with whistle-blowing fears higher among more junior managers than directors (9%).

Source: www.hrmagazine.co.uk

Discuss in small groups possible reasons why managers in organisations might act unethically.

Cultural considerations and leadership

Do leadership styles vary from one country or region of the world to another? There is some evidence to suggest that leaders in different countries are admired for different qualities and styles. According to the *International Journal of Cross Cultural Management*, leadership traits result partly from cultural norms and partly from the needs of the leadership task. National cultures differ regarding the use of power. Strong, self-motivated managers who act to maximise their personal gain behave as individualists. Collectivists, on the other hand, are expected to act to help the community – or the whole business organisation in the case of business leaders.

By acknowledging these differences in cultural outlook, leaders should be able to improve their ability to operate effectively while conducting business in a global context. In collectivist cultures, employees expect leaders to focus on tasks but also show concern towards people. For example, Gregorio Billikopf, labour-management adviser at the University of California, observes that Latin Americans make more eye contact and face each other more than people from, for example, northern Europe. Leaders from countries with a collectivist culture tend to be less autocratic and more sensitive to employees' needs. Bureaucratic leaders set up rules and want them followed precisely. For example, according to the *Cambridge Handbook of Culture, Organisations, and Work*, employees in Western countries, such as the USA and Germany, have an independent and powerful belief in themselves. Leaders tend to distance themselves from their employees. They tend not to nurture employees nor accept mistakes. In these individualistic cultures, leaders prefer to maintain professional relationships and may adopt a more bureaucratic or autocratic style.

Democratic leaders involve their subordinates in decision-making processes. By encouraging participation, they typically increase an employee's job satisfaction and commitment to the job. Team members feel like they have some control over their work. Democratic leaders motivate their employees to solve problems themselves. Collectivists, such as the Japanese, tend to sacrifice individual needs for those of the whole group. Leaders in these cultures rely on an employee's sense of duty to produce quality products and services.

ACTIVITY 2.3.4

LEADERSHIP STYLES AT McNUGGETS

Fast Nuggets, a large fast food chain in Asia, has a reputation for cheap meals of consistent quality with rapid customer service. Surveys suggest that the public appreciate that, no matter which restaurant they are in, they can always depend on buying exactly the same range of dishes, at similar prices with the same quality standards. This reputation is built on a detailed training programme for staff – failure to pass the end-of-course test or failure to observe the methods and practices taught leads to demotion or dismissal. Every activity of the workers is laid down in company regulations. For example:

- all customers to be greeted with the same welcome
- chicken nuggets to be cooked for exactly two minutes in oil at 100 degrees C
- a portion of French fries to contain 150 grams, to be salted with 4 grams of salt and to be kept for no more than five minutes before sale – they would then have to be disposed of
- staff to be trained to specialise in undertaking two tasks within the restaurant.

The managers at Fast Nuggets believe they have 'thought of everything' and that workers do not have to show initiative – there is a set procedure to deal with any problem. Workers are well looked after. The pay rate per hour is competitive, there are free uniforms and staff meals, and bonus systems are paid to staff who, in the manager's view, have given the best customer service each month. Regular meetings with staff are held at which information about branch performance is discussed with them. They are encouraged to air their views but are told that they cannot, under any circumstances, change the method of working laid down by Fast Nuggets' head office. Despite what the managers consider to be good working conditions, the staff turnover is very high and absenteeism is a problem.

24 marks, 48 minutes

1. Explain the leadership style that most closely fits Fast Nuggets. [4]
2. Analyse **one** problem for Fast Nuggets of using this leadership style. [4]
3. Evaluate the consequences for Fast Nuggets of changing its leadership style. [8]
4. To what extent might Fast Nuggets have to adapt its leadership style if it opened branches in Japan and Europe? [8]

OVER TO YOU

Revision checklist

1. Explain what you consider to be **three** functions of managers.
2. Outline **two** personality characteristics that you think are important for a successful leader to have.
3. Explain the autocratic (authoritarian) style of management.
4. Under what circumstances might this style of management be necessary?
5. Under what circumstances would the laissez-faire style not be an appropriate style of management?

6. Explain the differences between democratic and laissez-faire leadership styles.
7. Would all workers prefer to operate under democratic management? Explain your answer.
8. Explain how the manager of a multinational business operating in your country might need to adapt the leadership style used to local culture.
9. Give examples to explain why one manager may need to adopt different styles of management in different circumstances.
10. Explain how ethical considerations can influence leadership styles.

Exam practice question

CATERING AT LE MENU

Le Menu is a catering company which was founded in 2003 by brothers Oscar and Pierre Decaux. The business specialises in providing high-quality catering for corporate hospitality and private clients. This is a high-pressure operation. A client company will, for example, hire Le Menu to cater for 200 guests at a race meeting. This will involve setting up a mobile kitchen at the racecourse the day before the event and then producing 200 five-course meals, along with canapés and drinks on the day. Apart from Oscar and Pierre the business has four other permanent staff including a head chef, an assistant chef, an administrative assistant and a driver. When Le Menu is catering a large function, such as the racecourse event, it hires temporary staff from an agency. Some of the temporary staff will have regularly worked for Le Menu, but often there will be new staff as well.

Oscar is a tough, direct manager, who tells workers exactly what he wants and then expects them always to meet his high standards. If they don't, he is quick to let them know; he has a reputation for dismissing temporary workers part way through an event. Pierre is much calmer, preferring to consult with his staff. While Oscar takes the lead during events, Pierre is more involved with strategy. Pierre will, for example, work with Le Menu's chefs on the type of food to prepare for an event.

Le Menu currently faces two major problems:

- It struggles to recruit agency staff because temporary workers do not like Oscar's management.
- The company often overspends on food at its catering events.

20 marks, 40 minutes

1. Explain the types of leadership style Pierre and Oscar most closely represent. [6]
2. Analyse the possible reasons why Le Menu's managers might be advised to adopt different leadership styles if the business expanded to other countries. [6]
3. Discuss the advantages and disadvantages to Le Menu of Oscar's style of leadership. [8]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, evaluate the importance of strategy and ethics in the way managers lead an organisation. [20]

2.4 Motivation

On completing this chapter you should be able to:

Analyse and apply:

- Different types of financial rewards (AO2)
- Different types of non-financial rewards (AO2)
- How financial and non-financial rewards may affect job satisfaction, motivation and productivity in different cultures (AO2)

Evaluate:

- The motivation theories of Taylor, Maslow, Herzberg, Adams and Pink (AO3)

Setting the scene

HOW IMPORTANT IS PAY FOR MOTIVATING WORKERS?

Many studies have been undertaken to try to explain what motivates workers. There seems to be some agreement that pay and benefits are important in encouraging staff to work well, but these are not necessarily the most important factors. Work enjoyment, work challenges and recognition for work well done – these are the factors most frequently quoted by employees when asked what keeps them with their current employer. Compared to job satisfaction and pay, benefits (financial and non-financial) have a smaller role in terms of recruitment, retention and motivation.

Research carried out by the mobile phone company O2 found that 85% of employees would be more loyal to their company if they were praised for their work and 100% suggested that they would stay in their jobs longer if thanked more often. Just under 50% of workers either had never been thanked by their companies or could not remember the last time they were. Finally, managers should take note that 71% of workers would be willing to work harder if they got more recognition for the work they did.

Points to consider

- Why do you think that pay and bonuses are not the most important factor for *all* workers?
- Explain why 'loyalty' and 'working harder' are important to a business of your choice.
- Why do you think 'recognition' is important to many workers? Is it important to you?

Key concept link

Motivation strategies depend greatly on the culture of the business as well as national culture. Globalisation has been blamed for driving down wages of low-skilled workers in developed economies. How ethical is it for businesses to reduce wages in response to low-cost competition from foreign competitors?

Introduction

Well-motivated workers will help an organisation achieve its objectives as cost-effectively as possible. Motivated workers will also be trying to reach their own personal goals by satisfying their own needs. Employers need to be aware of **extrinsic** needs, such as pay, which can provide **motivation** even if the job itself does not. **Intrinsic motivation** stems from the nature of the job itself but this does not mean that employers can pay workers doing interesting work nothing at all! Some rewards will be needed even for workers driven by the fulfilment of intrinsic needs.

Unmotivated or demotivated staff will not perform effectively, offering only the minimum of what is expected. Motivation levels have a direct impact on productivity levels and the competitiveness of the business – highly motivated workers have high productivity and this reduces unit costs. Motivated staff will be keen to stay with the firm, reducing the costs of labour turnover. They will be more likely to offer useful suggestions and to contribute in ways other than their contractual obligations. They will often actively seek promotion and responsibility. In contrast, some indicators of poor staff motivation are shown in Table 2.4.1.

extrinsic motivation: comes from external rewards associated with working on a task, for example pay and other benefits

motivation: the intrinsic and extrinsic factors that stimulate people to take actions that lead to achieving a goal

intrinsic motivation: comes from the satisfaction derived from working on and completing a task

Indicator	Explanation
Absenteeism	Deliberate absence for which there is not a satisfactory explanation; often follows a pattern
Lateness	Often becomes habitual
Poor performance	Poor-quality work; low levels of work or greater waste of materials
Accidents	Poorly motivated workers are often more careless, concentrate less on their work or distract others, and this increases the likelihood of accidents
Labour turnover	People leave for reasons that are not positive; even if they do not get other jobs, they spend time in trying to do so
Grievances	There are more complaints raised within the workforce and there might be more union disputes
Poor response rate	Workers do not respond well to orders or leadership and any response is often slow

Table 2.4.1 Some indicators of poor staff motivation

Motivation theories

F. W. Taylor and scientific management

Taylor made the first serious attempt to analyse worker motivation. He aimed to advise management on the best ways to increase worker performance and productivity. The techniques he used – of establishing an idea or hypothesis, studying and recording performance at work, altering working methods and re-recording performance – are still used in modern industry. This approach has become known as 'scientific management' due to the detailed recording and analysis of results that it involves.

Taylor's main aim was to reduce the level of inefficiency that existed in the US manufacturing industry. Any productivity gains could then, he argued, be shared between business owners and workers. The scope for efficiency gains in early twentieth-century manufacturing plants was huge. Most workers were untrained and non-specialised. They were poorly led by supervisors and managers with little or no formal training in dealing with people. There was usually no formal selection or appraisal system of staff and many were recruited on a daily or weekly basis with no security of employment.

Ford factory in the 1930s – early mass production manufacturers adopted Taylor's approach

How to improve worker productivity

Taylor's scientific approach identified seven steps to improving worker 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 the quickest method and do not allow them to make 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 theory of 'economic man'.

Taylor believed in the theory of 'economic man', which stated that humans were driven or motivated by money alone and the only factor that could stimulate further effort was the chance of earning extra 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' and that the amount 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 and then higher rates become payable if output targets are exceeded. Table 2.4.2 summarises the relevance of Taylor's approach to modern industry and identifies its limitations.

Taylor's approach	Relevance to modern industry	Limitations
Economic man	Some managers still believe that money is the only way to motivate staff.	A more commonly held view is that workers have a wide range of needs, not just extrinsic needs of money, which can be met, in part at least, from work.
Select the right people for each job	Before Taylor there had been few attempts to identify the principles of staff selection. The importance he gave to this is still reflected in the significance given to careful staff selection in nearly all businesses.	This requires an appropriate selection procedure.
Observe and record the performance of staff	This was widely adopted and became known as 'time and motion study'. It is still employed as a technique but often with the cooperation and involvement of staff.	Taylor's autocratic use of this technique was regarded with suspicion among workers who saw it as a way of making them work harder.

Table 2.4.2 Evaluation of how relevant Taylor's views and methods are today [*table continues over*]

Taylor's approach	Relevance to modern industry	Limitations
Establish the best method of doing a job – method study	This is still accepted as being important as efficiency depends on the best ways of working being adopted.	The Taylor approach of management, which involved giving instructions to workers with no discussion or feedback, is considered to be undesirable. Worker participation in devising best work practices is now encouraged.
Piece-rate payment systems – to maximise output through motivating workers to produce more	This is often of limited relevance as it has become difficult to identify the output of each worker.	This is not now a widely used payment system. Quality may be sacrificed in the pursuit of quantity – workers will vary output according to their financial needs at different times of year and it discourages them from accepting changes at work in case they lose some pay. In most of modern industry, especially service industries, it has become very difficult to identify the output of individual workers.

Table 2.4.2 *Continued*

Maslow's hierarchy of human needs

Abraham Maslow's research was not based solely on people in the work environment and his findings have significance for students of psychology and sociology too. He was concerned with trying to identify and classify the main needs that humans have. 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 we can satisfy some or all of our needs at work, then we will become more productive and satisfied. Maslow summarised these human needs in the form of a hierarchy – see Figure 2.4.1 and Table 2.4.3.

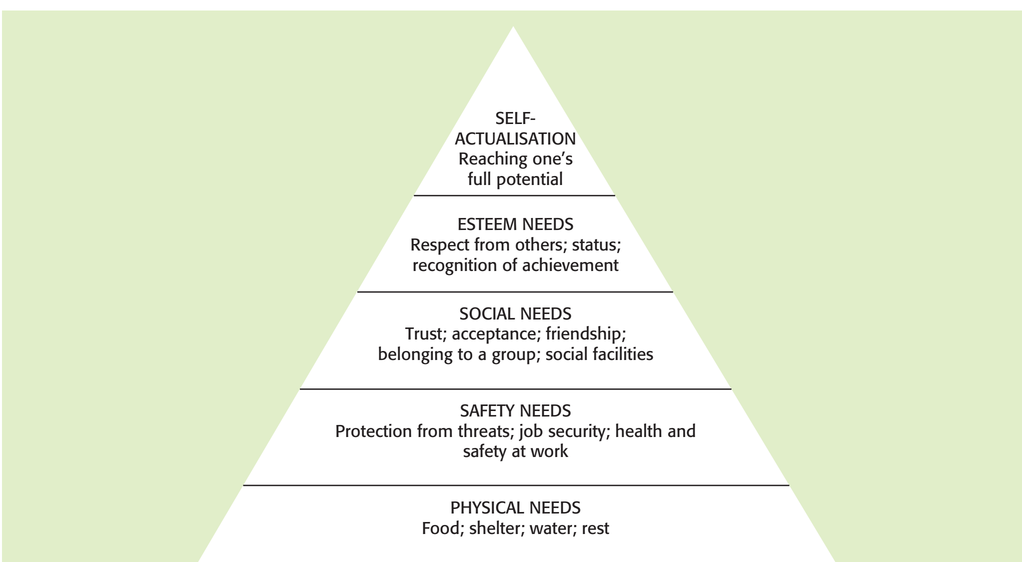


Figure 2.4.1 Maslow's hierarchy of needs

Level of need	Business conditions which could allow for the needs to be met
Self-actualisation – fulfilment of potential	Challenging work that stretches the individual – this 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 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 2.4.3 Significance of the hierarchy of needs to business

This hierarchy was interpreted by Maslow as follows:

- Individuals' needs start on the lowest level.
- Once one level of need has been satisfied, humans will strive to achieve the next level.
- **Self-actualisation** 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 – thus, when material needs have been satisfied, the offer of more money will not increase productivity.
- Reversion is possible – it is possible for satisfaction at one level to be withdrawn, e.g. a loss of job security, and for individuals to move down a level.

self-actualisation: a sense of self-fulfilment reached by feeling enriched and developed by what one has learned and achieved

Limitations of Maslow's approach

Criticism of Maslow's hierarchy includes:

- Not everyone has the same needs as are 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, such as status and esteem.
- Self-actualisation is never permanently achieved – as some observers of the hierarchy have suggested. Jobs must continually offer challenges and opportunities for fulfilment, otherwise regression will occur.

Herzberg and the 'two-factor theory'

Despite basing his research on just 200 professionally qualified workers, Herzberg's conclusions and famous two-factor theory have had the greatest impact on motivational practices since Taylor's work almost 60 years earlier. Herzberg used worker questionnaires to discover:

- those factors that led to them having very good feelings about their jobs
- those factors that led to them having very negative feelings about their jobs.

These were his conclusions:

- Job satisfaction resulted from five main factors – achievement, recognition for achievement, the work itself, responsibility and advancement. He called these factors the '**motivators**'. He considered the last three to be the most significant.

motivating factors (motivators): aspects of a worker's job that can lead to positive job satisfaction, such as achievement, recognition, meaningful and interesting work and advancement at work

- Job dissatisfaction also resulted from five main factors – company policy and administration, supervision, salary, relationships with others and working conditions. He termed these '**hygiene factors**'. These factors surround the job itself (extrinsic factors) rather than the work itself (intrinsic factors). Herzberg considered that the hygiene factors had to be addressed by management to prevent dissatisfaction, but even if they were in place, they would not, by themselves, create a well-motivated workforce.

hygiene factors: aspects of a worker's job that have the potential to cause dissatisfaction, such as pay, working conditions, status and over-supervision by managers

Consequences of Herzberg's theory

1. Pay and working conditions can be improved and these will help to remove dissatisfaction about work; but they will not, on their own, provide conditions for motivation to exist. Herzberg argued that it was 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 – that would require motivation. Motivation to do the job, and to do it well, would only exist if the motivators were in place. Herzberg did not claim that pay did not matter, but that it moves people to do a job and does not motivate them to do it well.
2. The motivators need to be in place for workers to be prepared to work willingly and always to give their best. Herzberg suggested that motivators could be provided by adopting the principles of '**job enrichment**'. There are three main features of job enrichment:
   - Assign workers complete units of work – typical mass-production methods leave workers to assemble one small part of the finished product. This is not rewarding, can be boring and repetitive and prevents the worker from appreciating the importance of what they are doing as part of the overall production system. Herzberg argued that complete and identifiable units of work should be assigned to workers, and that 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 assembly in a car plant. In service industries it could mean that a small team of multi-skilled people, such as waiters, chefs and technicians for IT/video equipment, provide all of the conference facilities in a hotel for a business conference rather than many people doing just one small and relatively unimportant task before moving on to another part of the hotel. 'If you want people motivated to do a good job, give them a good job to do,' said Herzberg.
   - Provide feedback on performance – this type of communication could give recognition for work well done and could provide incentives to achieve even more.
   - Give workers a range of tasks – to challenge and stretch the individual, a range of tasks should be given, some of which may be, at least initially, beyond the workers' current experience. This, in quite a large measure, ties in with the 'self-actualisation' level in Maslow's hierarchy.
3. 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 will not be motivated to offer their full potential whatever the pay level offered to them.

job enrichment: aims to use the full capabilities of workers by giving them the opportunity to do more challenging and fulfilling work

ACTIVITY 2.4.1

APPLYING THE MOTIVATIONAL THEORIES

Corie Jones joined Index Computers after working for IS Computers (ISC) for several years. At ISC, Corie had been paid a high salary, but he did not find the work rewarding. He was given specific programming tasks to perform but was not involved in designing complete software solutions to clients' problems. He worked to tight deadlines. He was not assigned to a team and worked alone on most tasks. He felt that Index offered better career prospects as well as the opportunity to take on more responsibility. He joined Index as a senior programmer on a higher salary – but this was less important to him than the chance to work as a team member. He was appointed to Daveena Davis's five-member team of programmers. Corie had met her already and his team colleagues seemed friendly and were appreciative of Daveena's leadership. She recognised talent and achievement and wanted colleagues to reach their full potential. She allowed team members to take control of complete software solutions – not just a small section of them.

22 marks, 44 minutes

1. Explain which level of Maslow's hierarchy Corie seemed to be on:
   a. at ISC
   b. at Index Computers. [6]
2. Explain why team working might be important to Corie's motivation. [6]
3. Evaluate, using this case study as a starting point, how Herzberg's research on 'hygiene and motivating factors' can be effectively applied within a work environment. [10]

Evaluation of Herzberg's work

- Team working is now much more widespread as a consequence of Herzberg's findings, 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 a quality-controlling inspectorate.
- Most firms are continually looking for ways to improve effective communication, and group meetings allowing two-way communication are often favoured.

Adams and equity theory

John Adams' equity theory is built on the belief that employees become demotivated towards their jobs and employer if they feel that their inputs are greater than their outputs. Inputs include effort, loyalty, commitment and skill. Outputs include financial rewards, recognition, security and sense of achievement.

While many of these factors cannot be quantified, Adams argued that employers should attempt to achieve a fair balance between what the employee gives an organisation and what they receive in return. If workers consider that their inputs are greater than the outputs received, they will move to try to redress this imbalance. When a balance is reached, then employees will consider their treatment to be fair and will respond with positive attitudes and high levels of motivation.

Daniel Pink

Daniel Pink, in his book *Drive: The Surprising Truth About What Motivates Us*, suggests that there are three elements of intrinsic motivation: autonomy, mastery and purpose. In situations where people are paid fairly, he believes this trio drives, engages and stimulates people to do their best work.

Autonomy

According to Pink, our self-direction is a natural inclination. Pink points to the simple example of how children play and explore all on their own. He claims that all humans are built with inner drive.

In a recent study of workers at an investment bank it was found that managers who offered 'autonomy support' – which means helping employees make progress by giving meaningful feedback, choice over how to do things, and encouragement – resulted in higher job satisfaction and better job performance. Pink claims that workplaces can support autonomy by giving people real control over various aspects of their work – whether it is deciding what to work on or when to do it.

Mastery

Pink maintains that everyone wants to get better at doing things. Perhaps this is why learning a language or an instrument can be so frustrating at first. If people feel that they are not getting anywhere, interest flags and they may even give up. A sense of progress, not just in work, but in an individual's capabilities, contributes to humans' inner drive.

One application of this view is that employers could look at measuring what people must do by looking at what they can do. If the essential tasks they have been given are too difficult, employees will become worried and feel out of their depth. If the essential tasks are too easy, employees may get bored and have no sense of achievement.

The essential tasks (referred to as 'must-tasks' by Pink) should be set at just the appropriate level of difficulty and challenge. So Pink concludes that we should work on 'Goldilocks tasks', which are neither too difficult nor too easy. The crucial lesson for managers is not to give tasks fitting a person's exact capabilities, but to give them space and support to reach a little higher to encourage improvement, continual mastery, and growth. This requires employers to pay more attention to how employees are doing and feeling about their tasks in order to avoid keeping people who are clearly unsuited to certain work from continuing to try to master it.

Purpose

Pink suggests that people who find purpose in their work unlock the highest level of motivation. Pink says that it is connecting to a cause larger than yourself that drives the deepest motivation. Purpose is what gets people out of bed in the morning and into work without groaning and grumbling – something that they just cannot fake.

That also means people who have purpose are motivated to pursue the most difficult problems. Rosabeth Moss Kanter, Professor at Harvard Business School, has formulated her own trio of motivating factors; one of these is 'meaning', which helps people go the extra mile and stay engaged. 'People can be inspired to meet stretch goals and tackle impossible challenges,' she writes, 'if they care about the outcome.'

What can employers do to create more purpose in employees' working lives? The aim must be to help employees connect to something larger than themselves. To shift the focus from mere measurement by numbers and figures, connect work to people and values. Pink cites the case of a hospital manager providing patient photos to radiologists, who have little direct contact with patients, which led to an improved work performance.

Why is this motivational approach especially relevant?

According to Pink, the old-school model of carrots and sticks is becoming increasingly outdated, and according to lots of research, just clearly ineffective.

It makes sense that outdated focus on mere productivity or financial rewards does not provide the required motivational stimulus in this age when knowledge work, creativity and problem-solving are required to stand out and succeed. Pink urges all managers to focus on building more autonomy, mastery and purpose into employees' working lives to produce not just a more productive and effective workforce, but a happier one.

ACTIVITY 2.4.2

WHAT PEOPLE WANT FROM WORK

'I was asked by the principal of my university to help form a committee of ten lecturers to discuss holiday dates, student enrolment and ways to check on the quality of lectures. He told us that it was a very important committee, that we would receive recognition for our time and that our views would influence future decisions. We had many meetings, agreed and wrote a report and sent it to the principal. We heard nothing back – no feedback, no thanks and no decisions made on our recommendations. I would not do it again if I was asked.'

Can you understand how demotivated these lecturers were? They had been misled about the degree to which the extra effort they put into attending these meetings would be responded to by the principal.

According to Bob Nelson, a reward and motivation guru, giving people what they want from work is quite easy – even though it depends on the type of work situation and on the individual person. He thinks that people want:

- some control of their work – job enrichment; responsibility for a well-defined task, recognition for achievement
- to receive feedback and to understand how managers take decisions – good communications from management and some participation opportunities
- the opportunity for growth and development – education, career paths, team working
- leadership – providing clear expectations, structure and appropriate rewards if these expectations are met.

Of course, money is important, but once workers have satisfied their essential needs from money, they look for other things from work – according to Susan Heathfield (http://humanresources.about.com), 'Most people want involvement in decisions that affect their work. People who contribute ideas should be recognised and rewarded. True employee involvement is based on the expectation that people are competent to make decisions about their work every single day on the job.'

22 marks, 44 minutes

1. Analyse how the two sets of views can be applied to the work of Herzberg or Pink. [8]
2. Discuss how the views contained in the case study could be applied in practice to:
   a. a hospital
   b. a clothing factory
   c. teaching staff at a school or college. [14]

Exam tip: When there is a question about motivational theorists, try to do more than just list their main findings – apply their ideas to the business situation given.

Motivation in practice

Payment or financial reward systems

The most common payment systems are:

- salary
- wage: time-based wage rate and piece rate
- commission
- performance-related pay and bonuses
- profit-related pay
- employee share-ownership schemes
- fringe benefits (perks).

Salary

salary: annual income that is usually paid on a monthly basis

A **salary** is the most common form of payment for professional, supervisory and management staff. The salary level is fixed each year and it is not dependent on the number of hours worked or the number of units produced. The fixing of the salary level for each job is a very important process because it helps determine the status of that post in the whole organisation. Job evaluation techniques may be used to assist in deciding the salary bands and the differences between them. In most organisations, all jobs will be put into one of a number of salary bands and the precise income earned within each band will depend upon experience and progress. It is always possible to gain promotion to another job in a higher salary band. Firms that are interested in creating a 'single status' within their organisation are now increasingly putting all staff – manual and managerial – on to annual salaries to give the benefits of security and status to all employees (see Table 2.4.4). The advantages and disadvantages of a salary system are outlined in Table 2.4.5.

Job grade	Salary band (per year)
E, e.g. regional heads	$50 000–$75 900
D, e.g. departmental heads	$30 000–$49 900
C, e.g. office managers	$20 000–$29 900
B, e.g. secretaries	$10 000–$19 900
A, e.g. junior clerical staff	$5000–$9900

Table 2.4.4 Salary bands – typical example

Advantages	Disadvantages
• Salary gives security of income. • It gives status compared to time-rate or piece-rate payment systems. • It aids in costing – the salaries will not vary for one year. • It is suitable for jobs where output is not measurable. • It is suitable for management positions where staff are expected to put in extra time to complete a task or assignment.	• Income is not related to effort levels or productivity. • It may lead to complacency of the salary earner. • Regular appraisal may be needed to assess whether an individual should move up a salary band, although this could be an advantage if this becomes a positive form of worker appraisal.

Table 2.4.5 Advantages and disadvantages of salary system

LEARNER PROFILE

Principled

Howard Schultz made $117 million in 2013. He is the CEO of the coffee-shop giant Starbucks. With revenues of over $10 billion and 16 000 outlets worldwide he has quite a job on his hands – surely he's worth the salary!

It is argued that these huge remuneration packages are needed to attract the best and retain them. Money seems to be a big motivating force here.

The average full-time 'barista' (staff who serve the coffee) at Starbucks in the USA makes about $20 000 a year: a fraction of Schultz's pay. Surely the argument that high pay is needed to 'attract and retain' holds for baristas as well?

If you were a principled CEO, how would you reconcile yourself with such a big difference between your pay and those who work for you?

Time-based wage rate

hourly wage rate: payment to a worker made for each hour worked

An **hourly wage rate** or 'time rate' is set for the job – perhaps by comparing with other firms or similar jobs. The wage level is determined by multiplying this by the number of hours worked and is usually paid weekly. Although there is more income security than with piece rate, speed of work is not rewarded with this payment system – indeed, the opportunity to earn overtime might encourage workers to stretch work out unproductively.

Piece rate

piece rate: a payment to a worker for each unit produced

A rate is fixed for the production of each unit, and 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. The level of the rate can be very important. If set too low, it could demotivate the workers, but, if too high, it could reduce the incentives – because workers will be able to meet their target wage level by producing relatively few units (see Table 2.4.6).

Advantages	Disadvantages
• It encourages greater effort and faster working. • The labour cost for each unit is determined in advance and this helps to set a price for the product.	• It requires output to be measurable and standardised – if each product is different, then piece work is inappropriate. • It may lead to falling quality and safety levels as workers rush to complete units. • Workers may settle for a certain pay level and will therefore not be motivated to produce more than a certain level. • It provides little security over pay level, e.g. in the event of a production breakdown.

Table 2.4.6 Advantages and disadvantages of the piece rate

Commission

commission: a payment to a sales person for each sale made

Commission can make up 100% of the total income of direct sales staff – it reduces security as there is no 'basic' or flat-rate payment if nothing is sold during a particular period – or it can be paid in addition to a basic salary. It has the same advantages and disadvantages as the piece rate used in production industries, except that the potential drawback of low quality of production may be replaced by the risk of high-pressure selling, where sales staff try so hard to convince a customer to buy a product or service that they simply create a bad impression of the company. Commission-based pay also does not encourage teamwork – each individual sales person will be keen to hold on to each new customer for themselves to earn more commission!

Performance-related pay (PRP)

performance-related pay: a bonus scheme to reward staff for above-average work performance

Performance-related pay is usually in the form of 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:

- regular target setting, establishing specific objectives for the individual
- annual appraisals of the worker's performance against the preset targets
- paying each worker a bonus according to the degree to which the targets have been exceeded.

The main aim is to provide further financial incentives and to encourage staff to meet agreed targets. 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.

There are problems with PRP schemes (see Table 2.4.7). The main issue is one that Herzberg would recognise – does the chance of additional pay 'motivate' or just temporarily 'move' a worker to perform better? As there is no change in the nature of the work being undertaken most of the 'motivators' recognised by Herzberg would not be satisfied by PRP. In addition, the concentration on individual performance can create divisions within teams and groups. There is also a widely held view that PRP bonuses are often inadequate, even to achieve short-term productivity gains or improvements in effort. The last problem concerns the style of management that PRP can lead to. By giving senior managers the power to decide which subordinates have achieved performances above target, it can lead to claims of favouritism and the ability to control staff by means of the 'carrot' of extra rewards.

Advantages	Disadvantages
• Staff are motivated to improve performance if they are seeking increases in financial rewards. • Target setting can help to give purpose and direction to the work of an individual. • Annual appraisal offers the opportunity for feedback on the performance of an individual, but as it tends to occur only once a year this is not usually sufficient to achieve a key feature of job enrichment.	• It can fail to motivate if staff are not driven by the need to earn additional financial rewards. • Team spirit can be damaged by the rivalry generated by the competitive nature of PRP. • Claims of manager favouritism can harm manager–subordinate relationships. • It may lead to increased control over staff by managers because of the danger that bonuses may not be awarded if workers do not 'conform'.

Table 2.4.7 Advantages and disadvantages of performance-related pay

Profit-related pay

profit-related pay: a bonus for staff based on the profits of the business – usually paid as a proportion of basic salary

The essential idea behind profit-sharing arrangements is that staff will feel more committed to the success of the business and will strive to achieve higher performances and cost savings (see Table 2.4.8). Some shareholder groups, however, claim that profits should only be considered as being the return to the owners of the business and are a reward to them for taking risks with their own capital.

Employee share-ownership schemes

Some profit-sharing schemes do not offer cash but shares in the business to each worker when the firm declares a profit. This is designed to establish the workers as part-owners of the business and reduce the conflict that might exist between 'them' (the owners and managers) and 'us' (the workers). In practice, many of the shares in such schemes are quickly sold by the workers, thus reducing the hoped-for long-term impact on motivation (see Table 2.4.8).

Fringe benefits (perks)

These are non-cash forms of reward – and there are many alternatives that can be used. They 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. Some of these fringe benefits are taxed, but others are not and that gives the employees an added benefit, because to purchase these 'perks' from after-tax income would be very expensive. It is very difficult to assess the impact of these benefits on productivity.

Non-financial methods of motivation

It is now widely recognised that businesses cannot use money alone to create the necessary motivation for employees to complete jobs efficiently. Non-financial motivators include:

- job enlargement
- job enrichment
- job rotation
- team working
- empowerment.

Advantages	Disadvantages
• Potential conflict between owners and workers is reduced as everyone now has an interest in higher profits. • They are designed to lead to higher worker effort levels and a greater preparation to accept cost-reduction measures and changes that benefit the business. • The business is likely to attract better recruits drawn by the chance of sharing profits or owning shares in the firm. • As the bonuses are paid out of profits, the scheme does not add to business costs, unlike a normal increase in pay levels. • If successful in increasing motivation, then the schemes could lead to an increase in overall business profitability.	• The reward offered is not closely related to individual effort – why should one worker put in greater effort when everyone will be benefiting? • The schemes can be costly to set up and operate, especially in large firms with many employees. • Small profit shares paid at the end of the financial year are unlikely to promote motivation throughout the year. • Profit-sharing schemes will reduce profits available to be paid to owners (reducing dividends) and to be reinvested in the business (retained profits). • Worker share-ownership schemes can increase the total number of shares issued and 'dilute' the value of existing shares.

Table 2.4.8 Advantages and disadvantages of profit sharing and employee share ownership

ACTIVITY 2.4.3

Look at the job adverts and then answer the questions that follow.

DIFFERENT JOBS, DIFFERENT PAY SYSTEMS

SIX-FIGURE SALARY (AT LEAST $100 000) + SUBSTANTIAL FRINGE BENEFITS
CAR, INSURANCE, PENSION, HEALTH CARE

Human Resources Director – Singapore

Diverse Portfolio of International Businesses

Our client is an undisputed leader in the private equity market. It has financed the acquisition of a wide variety of businesses with a presence in more than 50 countries, an annual turnover in excess of $3.5 billion and 50 000 employees. Key to the group's success has been its close financial management and the assistance it has given portfolio companies in areas such as human resources and IT.

Due to continuing growth, an HR Director is now sought to add value across the group.

THE POSITION

- Optimise the deployment of HR to add value within the portfolio businesses and support the group's overall objectives.
- Provide business and HR support to operating company management teams. Emphasis on management development, leadership teams and compensation.
- Active involvement in evaluation of potential acquisition targets. Provide critical analysis of management strengths and weaknesses.

QUALIFICATIONS

- Outstanding HR professional with a minimum of 15 years' experience, a demonstrable record at group and divisional levels in an international business.
- Practical understanding of business drivers and HR issues within large and small organisations. Highly influential with outstanding business management tool kit.
- Specific experience in Asia is required, with fluency in an Asian language a distinct advantage.

Please send full CV and current salary details to S. Amm at the address below.
Alternatively email: samm@partnership.com

THE PACIFIC RECRUITMENT AGENCY

DRIVER WANTED

- Must have clean driving licence
- Light removal work
- $5 per hour
- Overalls provided
- Ring: 0837 5108 if interested

12 marks, 24 minutes

1. Explain the different pay systems operated by these two businesses for these jobs. [4]
2. Why do you think that these pay systems are different? [4]
3. Why do you think that the higher-paid post also carries a range of other benefits? [4]

Job enlargement

job enlargement: attempting to increase the scope of a job by broadening or deepening the tasks undertaken

job enrichment: attempting to motivate employees by giving them opportunities to use the full range of their abilities

cell production: a lean method of producing similar products using cells, or groups of team members to facilitate operations by eliminating setup time between operations

job redesign: involves the restructuring of a job – usually with employees' involvement and agreement – to make work more interesting, satisfying and challenging

Job enlargement can include both job rotation and job enrichment, but it also refers to increasing the 'loading' of tasks on existing workers, perhaps as a result of shortage of staff or redundancies. It is unlikely to lead to long-term job satisfaction, unless the principles of job enrichment are adopted.

Job enrichment

This involves the principle of organising work so that employees are encouraged and allowed to use their full abilities – not just physical effort. The process often involves a slackening 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. Its three key features are not always easy to apply in practice, but employers are increasingly recognising the benefits to be gained by attempting to implement them:

- complete units of work so that the contribution of the worker can be identified and more challenging work offered, e.g. **cell production**
- direct feedback on performance to allow each worker to have an awareness of their own progress, e.g. two-way communication
- challenging tasks 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. Gaining further skills and qualifications is a form of gaining status and recognition – see Maslow's hierarchy of human needs.

To introduce job enrichment into many traditional businesses, a process known as **job redesign** is often necessary (see Figures 2.4.2 and 2.4.3).

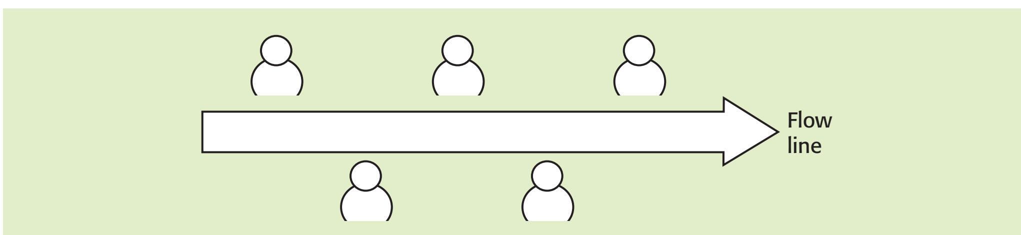


Figure 2.4.2 Traditional mass production – each worker performs a single task

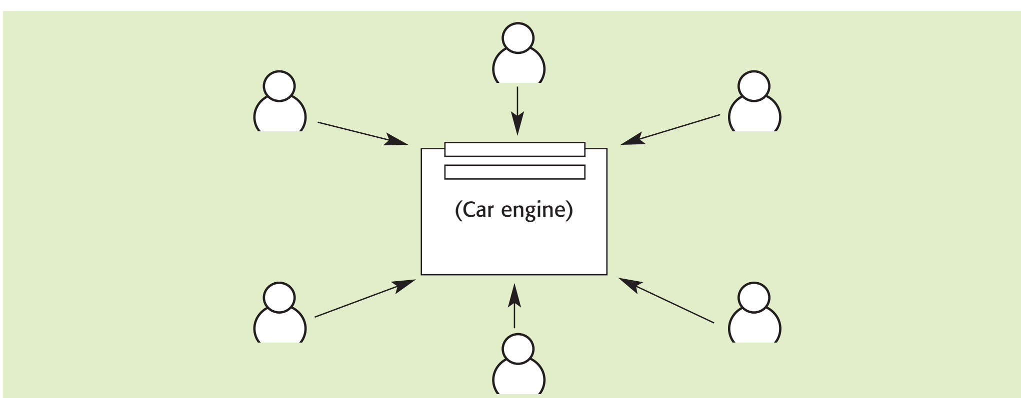


Figure 2.4.3 Team production allowing for job enrichment – all workers contribute to producing the completed unit

Job rotation

The practice of **job rotation** is widespread in businesses that have production processes where several different jobs – of similar degrees of difficulty and challenge – exist. Workers are less likely to become bored, it is argued, if they are given a range of different tasks to undertake.

Although this approach can increase variety and, possibly, the number of skills workers are required to use, it does not offer true challenge or enrichment from the work experience.

job rotation: the practice of moving employees between different tasks to promote experience and variety

Exam tip: Do not confuse job enlargement with job enrichment/redesign. Job rotation offers variety but does not necessarily provide more stimulating or challenging work.

Team working

The **team working** approach to work places each member of staff into a small team of employees. Some traditionalists argue that moving away from 'pure division of labour', where one worker performs just one simple task all the time, will result in lower productivity and time-wasting 'team' meetings. Supporters of job enrichment would respond by claiming that more challenging and interesting work, as allowed by team working or 'cell' production, will lead to:

- lower labour turnover
- more and better ideas from the workforce on improving the product and the manufacturing process
- consistently higher quality, especially when total quality management (TQM) is incorporated.

team working: production is organised so that groups of workers undertake complete units of work

Table 2.4.9 summarises the advantages and disadvantages of team working.

There are a number of benefits to the organisation from team working:

- Team spirit should improve motivation of staff.
- Teams are more flexible than hierarchical systems.
- New teams can be formed and redundant teams disbanded as the needs of the organisation change.
- Management costs may be reduced as fewer middle managers and supervisory staff are required.

Exam tip: Team working might not always be a suitable way of organising a workforce – remember to relate any suggestions made to the business featured in the case study.

Advantages	Disadvantages
• Workers are likely to be better motivated as social and esteem needs (see Maslow) are more likely to be met. By empowering workers within teams, job enrichment can be achieved (see Herzberg). • Better-motivated staff should increase productivity and reduce labour turnover – both will help to reduce business costs. • Team working makes fuller use of all of the talents of the workforce. Better solutions to problems will be found as those most closely connected with the work participate in suggesting answers. • Team working can reduce management costs as it is often associated with delayering of the organisation – fewer middle managers will be required. • Complete units of work can be given to teams – a key feature of job enrichment.	• Not everyone is a team player – some individuals are more effective working alone. When teams are formed, this point must be considered and 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 the team meetings unless efforts are made to involve and encourage all team members. • Teams can develop a set of values and attitudes which may contrast or conflict with those of the organisation itself, particularly if there is a dominant personality in the group. Teams will need clear goals and assessment procedures to ensure that they are working towards the objectives of the organisation at all times. • The introduction of team working will incur training costs and there may be some disruption to production as the teams establish themselves.

Table 2.4.9 Advantages and disadvantages of working in teams

THEORY OF KNOWLEDGE

So you get out of bed, come to school, concentrate in lessons, do a lunchtime club, start some coursework, squeeze in some service hours after school, get home and work on your extended essay . . .

You're a well-motivated IB student but what motivates you?

Discuss with your class the factors that motivate you to do well at school.

Consider some of the knowledge issues associated with knowing what motivates people in their working lives.

Delegation and empowerment

These methods of staff motivation were fully examined in Chapter 2.2. Delegation involves the passing down of authority to perform tasks to workers. Empowerment goes further, by allowing workers some degree of control over how the task should be undertaken and the resources needed to complete it.

Evaluation of financial and non-financial motivational methods

If it is accepted that pay is not the only motivating factor for people to work effectively and to be satisfied in their jobs, then managers need to take a critical look at all of the payment and non-financial methods of motivating staff. What works for some groups of workers will not be effective with others. Managers need to be flexible and adapt the methods and approaches that are available to motivate staff to the particular circumstances of their business and their workforce. The main factors that influence the different degrees of emphasis on pay and non-pay factors include the leadership style of management and the culture of the organisation.

If managers have the attitude that workers are naturally lazy and cannot be trusted, then a 'piece rate or payment by results' system with close supervision will be adopted. If the culture views workers as partners or associates in the business, then production will be organised to give workers a chance to accept responsibility and to participate. A monthly salary payment system is likely under these circumstances. As with so many important decisions made within a business, a great deal depends on the attitudes and beliefs of senior managers – and the business culture they adopt.

Cultural differences and reward systems

Is it appropriate to use the same reward systems in divisions of a business that operate in different countries around the world? Do employees everywhere respond in the same way to changes in financial and non-financial reward systems?

If they do not, then managers of multinational corporations need to adapt these systems to those which are most likely to be effective within the different cultures that the business operates in.

Much detailed research has been undertaken into the impact of cultural differences on incentive systems. That cultural differences exist between different parts of the world is not in doubt. The Global Leadership and Organisational Behaviour Effectiveness Research Program (GLOBE) has extended the work of the most famous writer on cultural factors in business, Geert Hofstede. Three cultural differences that seem to have the most impact on the reward systems used are:

Performance orientation – the extent to which performance improvement, innovation and striving for excellence is encouraged. This cultural feature is strongest in Germanic Europe, the UK and China but weakest in Latin America.

In the countries where 'performance orientation' is strongest, we would expect to find much greater emphasis on performance-related pay, bonus payments and share purchase schemes.

Future orientation – the degree to which individuals are focused on delaying immediate reward and engaging in future-oriented behaviour such as planning and investing for the future. The same regional differences were noted as above and, again, help to explain the use of individual-incentive schemes based on future business performance such as share ownership schemes of management.

Institutional collectivism – the degree to which organisations reward or encourage the distribution of resources to groups and focus on collective action. This cultural feature was found to be strongest in Nordic Europe and Germanic Europe and lowest in Asia. In the countries where this is a powerful cultural force, the use of team-based incentives and employee profit-sharing schemes has been found to be particularly significant.

Fringe benefits and cultural differences

Any reward system – even one including fringe benefits – needs to consider local differences in culture. What constitutes a recognition award varies in different cultures. For instance, an organisation based in Canada that provided branded fleece jackets could be seen as culturally insensitive by its employees based in warmer countries, such as Spain, Italy, Egypt or Morocco. A multinational business varies its rewards: in India, one of the most popular recognition incentives is a ticket for a Bollywood film; in France, vouchers for a gourmet food chain are popular; and in the UK, vouchers for DIY stores are in demand.

Clocks or watches given as incentive rewards are not acceptable in Asian cultures. In this culture, a watch or clock means the boss is watching the time and an employee is not putting in the effort.

Programme should have local feel

Derek Irvine, vice-president of strategy and consulting services at Globoforce, suggests that, 'The reality these days is that there are multi-country and multicultural teams, as well as locals and expatriates. It is important there is a consistency in recognising one employee compared to another.'

Cultural differences will often throw up challenges in aligning recognition schemes globally, particularly when deciding which rewards are appropriate in which country. Language can also be an issue for employers aligning recognition schemes. Global organisations will generally use English as their international business language, so the recognition scheme's website can use a single language. However, more employers now require programmes to be language-specific to each country.

Irvine adds: 'Employees want to receive recognition in their local language. We are up to 17 languages as the largest requirement of one employer.'

Local distribution of rewards

Once the type of reward and the language that will be used to deliver the scheme in each country has been determined, employers must ensure the rewards can be distributed locally as required. Varying import duties can apply to differing types of goods, which can impact on the cost-effectiveness of the programme. One solution is to use reloadable, prepaid reward cards that can be company branded and used worldwide.

Cultural differences – non-financial rewards

There seem to be important cultural differences when non-financial factors are considered too. Recognition of an employee's contribution is considered to be an important motivator but different cultures may prefer to be recognised in different ways. In individualistic cultures such as the USA and Australia, employee-of-the-month schemes are widely adopted and employees are praised as individuals through intranet postings. However, this approach could be counterproductive in Asia where employees prefer to be recognised for their hard work as part of a team. Being singled out could be embarrassing and damage the dynamics of the group.

Exam tip: You should be able not just to describe and explain different methods of financial and non-financial motivation but to suggest which ones might be most suitable in different business situations and different cultures – and why.

In relationship-focused cultures, motivators are likely to be based on personal and professional factors such as how well supported by managers employees feel and how good relationships are with superiors.

In some parts of the world it is more acceptable to use the 'stick' approach as well as the carrot to motivate employees. In some Asian cultures it is common to use demotions when performance is considered below acceptable standards. This approach is more likely to lead to an employee in a Western culture starting to look for alternative employment rather than feeling motivated to perform more effectively.

OVER TO YOU

Revision checklist

1. What do you understand by the term 'motivation'?
2. Why is a 'motivated workforce' important for a manufacturing business?
3. Explain how a high-quality clothing shop might be badly affected by low motivation of sales staff.
4. State **three** features of Taylor's research that might be relevant to manufacturing industries.
5. Explain why studying intrinsic and extrinsic needs is an important part of motivation theory.
6. Give an example of how an individual might revert to a lower level of Maslow's hierarchy of human needs.
7. Consider **two** different levels of Maslow's hierarchy. Explain how these needs could be satisfied at work.
8. Differentiate, using examples, between Herzberg's motivators and hygiene factors.
9. Why did Herzberg consider it important to differentiate between 'movement' and 'motivation'?
10. Outline the **three** key features of Pink's work on motivation.
11. Outline the **three** key features of job enrichment.
12. Examine **two** problems of using the piece-rate payment system for each individual in a business that uses a flow-line production system.
13. Explain how the payment of a fixed monthly salary could help to satisfy some of the needs identified in Maslow's hierarchy.
14. Assume that you are the manager of a computer shop. Which payment system would you use for your staff: commission only, time-based wage rates or a combination of the two? Justify your choice.
15. Explain to the directors of a private limited company the advantages and disadvantages of introducing a profit-sharing system for the workforce.
16. Do you believe that performance-related pay should be introduced for the teachers in your school or college? Justify your answer.
17. Explain **two** benefits to the firm that might be gained from adopting teamwork in a factory making computers.
18. Explain **two** benefits to workers from being organised into teams.
19. How might business culture influence the motivational methods adopted by managers?
20. Outline the benefits to a business of using non-financial methods of motivation.
21. Give **two** examples of fringe benefits that might be offered to senior managers in a bank.
22. Analyse the potential benefits of employee empowerment in a busy fast-food restaurant.
23. How might national/regional culture influence the motivational methods used by managers of a multinational business?

Exam practice question

WHY WOMEN ARE HAPPIER IN THEIR WORK THAN MEN

The world of work is a better experience for women than it is for men, according to a survey. Asked to rate their job satisfaction on a scale of one to seven, they scored an average of 5.56, while males scored 5.22. Experts appear divided over the reasons why women appear to get more out of their work than men do. Many women work part time and have job-sharing schemes, which, the survey found, increased job satisfaction as they could pursue other interests too. In addition, older workers get the greatest satisfaction from their jobs, while university graduates are the most dissatisfied of all, according to the survey of 30 000 employees. Employees generally enjoy their first years at work, but then job satisfaction falls between the ages of 30 and 40. However, employees over 60 gain the greatest satisfaction from their work. Professor Andrew Oswald of Warwick University, who conducted the survey, said, 'The young are just happy to have a job. As they grow older they realise that ambitions and needs may not be so easily fulfilled.' It seems that we all begin thinking we will reach the top in our careers, but most of us are forced to adjust. 'The older we get, the more settled and content with our role at work we get,' he added. Graduates are often frustrated by the lack of challenging work on offer. They are often forced to take low-skilled jobs for which they are over-qualified in order to pay off debts. The survey also revealed that long hours at work did not turn people off their jobs.

Employees of small businesses and non-profit-making organisations, such as charities, were more motivated and happier at work than those working for big companies. David Hands, of the Federation of Small Businesses, said, 'There is a greater camaraderie (friendship) in small firms than in big companies.' Workers feel less involved and less secure in bigger firms. He added, 'It is more relaxed in small firms and people enjoy it more. Many also get more responsibility which adds to their satisfaction.'

20 marks, 40 minutes

1. Define what you understand by the terms:
   a. motivation
   b. responsibility. [4]
2. Identify **two** factors that seem to influence job satisfaction and explain them in terms of Maslow's hierarchy of needs. [4]
3. Explain in terms of the features of job enrichment why it might be easier for small firms to motivate staff than big businesses. [4]
4. Discuss the extent to which it might be possible for large firms to use Herzberg's motivators to improve the level of worker motivation. [8]

Key concept question

20 marks, 40 minutes

With reference to two organisations that you have studied, discuss how approaches to motivating employees have been affected by their differing cultures. [20]

2.5

H

Organisational (corporate) culture

On completing this chapter you should be able to:

Know and understand:

- The meaning of organisational culture (AO1)

Analyse and apply:

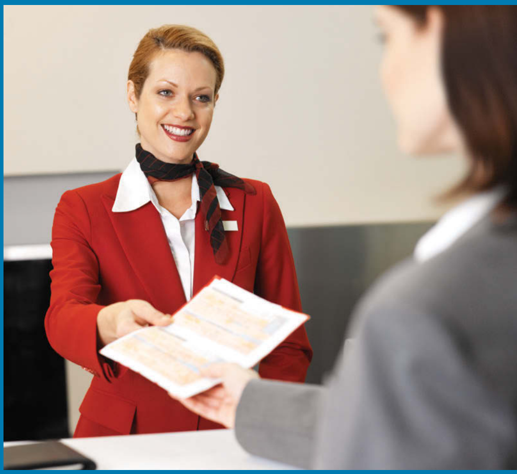
- Elements of organisational culture (AO2)
- Types of organisational culture (AO2)

Evaluate:

- The reasons for and consequences of cultural clashes (AO3)
- How individuals influence organisational culture and how organisational culture influences individuals (AO3)

Setting the scene

CULTURE CHANGE TO MEET INCREASED COMPETITION



The culture of an organisation such as an airline will influence its competitiveness

DLM is a European airline that underwent a spectacular turnaround. Under a new chief executive the company switched from a product- and technology-focused business to one that is market- and customer service-orientated. Under the old organisational culture, pilots, technicians and autocratic managers were the company's heroes. Planning and sales were based on maximising flight hours using the most modern aircraft. With customer numbers and profits falling, the chief executive realised that the increasingly competitive air-travel market required the company to refocus its approach to concentrate on the needs of customers. He believed these needs were best understood by front-line staff who had face-to-face contact with customers – the cabin crew and ground staff. However, they had never before been asked for their opinions. The new approach required a restructuring of the organisation to support front-line staff. Managers now act as advisers, there is regular simulated training in customer relations and staff are given considerable independence in dealing with problems on the spot. Customer numbers and profits have been on a steady upward flight path since these changes were introduced.

Points to consider

- What do you understand by the term 'organisational culture' from this case study?
- Explain why the new chief executive officer decided to make changes to the organisational culture.
- Why did these changes seem to have been introduced so successfully?

Key concept link

Business culture underpins all decisions and activities. 'The way in which things are done around here' is an expression that sums up the idea of business culture. It can be assessed by monitoring:

- the ways the organisation conducts its business and treats its employees, customers and the wider community
- the extent to which employees are involved in decision-making and developing new ideas
- how authority and information flow through its hierarchy
- how motivated employees are towards helping achieve business objectives.

Introduction

A commonly used definition of **organisational culture** is 'the way we do things around here'. This means, how people within the organisation view the world and respond to it in trying to achieve certain goals.

It is widely understood that different organisations have distinctive 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, for example. Similarly, some schools' culture is driven by the need for better examination results while others maintain that educating the 'complete person' is more important. The culture of an organisation gives it a sense of identity and 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 staff in a business will 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.

organisational (corporate) culture: the shared values, attitudes and beliefs of the people working in an organisation that control the way they interact with each other and with external stakeholder groups

Exam tip: Culture is such a powerful force in any organisation that you should take every opportunity in your answers to refer to it as a factor that helps explain managers' decisions and behaviour.

Elements of organisational culture

Indications of the culture of an organisation can be gained through:

- mission and vision statements – these inform staff about what the business is trying to achieve
- the record of senior staff, e.g. in handling ethical issues – the directors and other senior managers will be one of the main influencing factors in an organisation's culture
- the organisation's ethical code of conduct – this lists the dos and don'ts that must be observed by staff when dealing with external stakeholders
- strategies on social and environmental issues – these will provide a clear guide to the organisation's social and environmental values and beliefs
- the example set by senior managers, e.g. how they treat subordinates, how they take decisions and how these are announced and introduced.

The industry the business operates in will also influence the values and beliefs of the organisation. For instance, the culture of a weapons manufacturer or a tobacco company is likely to be very different from that of a workers' cooperative or a business operating homes for the elderly.

The legal constraints, social norms and cultural values of countries vary markedly and these are likely to be reflected in the culture of organisations that are based there.

Types of organisational culture

Many management writers have used different ways to identify and classify different types of organisational culture. Below are the most widely identified culture types, based on the writings of Charles Handy.

Power culture

power culture: concentrating power among a few people

Power culture is associated with autocratic leadership. Power is concentrated at the centre of the organisation. Decisions can be made swiftly as so few people are involved in making them. Managers are judged by results rather than the means they used to obtain them. Autocratic leadership and hierarchical structures are features of organisations with a power culture.

Handy uses the analogy of a spider's web – the spider at the centre of the web has all of the power and the web has little purpose without the spider. Motivational methods are likely to focus on financial incentives and bonuses to reward exceptional performance – and this can encourage risky and, in the longer term, inappropriate decisions.

Role culture

role culture: each member of staff has a clearly defined job title and role

Role culture is usually associated with bureaucratic organisations. Staff 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. Decision-making is often slow and risk-taking is frowned upon.

Tall hierarchical structures are used in organisations with a powerful role culture. Handy uses the image of a substantial building to represent this form of culture – solid and dependable but not going anywhere fast.

ACTIVITY 2.5.1

The world 'credit crunch' and resulting economic downturn have been blamed on the 'power culture' and excessive risk-taking by some of the world's leading banks. Find out as much as you can about the 2008–10 credit crunch and resulting recession and assess whether you agree that the banks' culture was a major contributing factor.

Task culture

Groups are formed to solve particular problems, and lines of communication are similar to a matrix structure (see Chapter 2.2). Such teams often develop a distinctive culture because they have been empowered to take decisions. Team members are encouraged to be creative and there may be a strong team spirit, which can lead to a very motivating environment – based on meeting workers' intrinsic needs.

task culture: based on cooperation and teamwork

Handy uses the image of a net to represent **task culture** – the net's strength is derived from the many strands.

Person culture

person culture: when individuals are given the freedom to express themselves and make decisions

There may be some conflict between individual goals and those of the whole organisation, but **person culture** is the most creative type of culture. There is no emphasis on teamwork as each individual is focused on their own tasks and projects. This type of culture might be found in a scientific research environment or in a professional partnership such as lawyers and architects. Individuals who thrive in this type of environment will often find it difficult to work effectively in a more structured organisation.

Handy depicts this type of culture as a constellation of stars – each person is different from everyone else and operates alone.

Entrepreneurial culture

In this culture, success is rewarded, but failure is not necessarily criticised since it is considered a consequence of enterprise and risk-taking. Although Handy did not specifically identify **entrepreneurial culture**, other theorists consider it to be important for certain types of organisations. This type of culture is usually found in flexible organisational structures. Motivation levels are likely to be high among people who enjoy the challenge of innovative risk-taking.

entrepreneurial culture: encourages management and workers to take risks, to come up with new ideas and test out new business ventures

Exam tip: As with leadership styles, there is no one right or wrong culture for a business. The appropriate culture will depend on the firm's objectives, the type of market it operates in and the values and expectations of managers and employees.

Exam tip: Do not expect all departments in a business to have the same culture. They may be very different. A team working with IT all day will be unlikely to have the same jargon, patterns of behaviour, values and beliefs as HR staff or marketing teams.

ACTIVITY 2.5.2

For each of the cultures above, suggest one business situation where it would be the most appropriate culture to adopt.

LEARNER PROFILE

Caring

As Walmart grew into the world's largest retailer, its staff were subjected to a long list of dos and don'ts covering every aspect of their work. Now the firm has decided that its rules-based culture is too inflexible to cope with the challenges of globalisation and technological change, and is trying to instil a 'values-based' culture, in which employees can be trusted to do the right thing because they know what the firm stands for.

Source: Adapted from www.economist.com

Consider the rules of your own school or college.

Discuss in your class a change in culture where rules are replaced with a 'values-based culture' and students are trusted to do the right thing.

By changing from a rules-based culture to a values-based culture, does an organisation become more caring?

Reasons for and consequences of cultural clashes

The existing culture of a business can become inappropriate and clash with new objectives needed to achieve growth, development and success. Further conflict – or clashes – can arise when:

- a business grows rapidly and there is conflict between the established employees and the new managers and other employees who are recruited; this can be a particular problem for family businesses when they start to recruit external professional managers
- a business merges with or acquires another business – examples are given below
- a new leader is appointed or the existing leaders adopt a new style of leadership – the values and beliefs of a new leader may differ from those of the former 'boss'.

Here are some examples:

- A traditional family firm, which has favoured members of the family for promotion into senior posts, converts to a public limited company. New investors demand more transparency and recognition of natural talent from recruited employees. A different leadership style may lead to a clash with the existing culture of the business – hence the need to change existing values and beliefs.
- A product-led business needs to respond to changing market conditions by encouraging more staff involvement. A team or task culture may need to be adopted.
- A recently privatised business, formerly run on bureaucratic principles, needs to become more profit-orientated and customer-focused. An entrepreneurial culture may need to be introduced for the first time and existing employees may find this very difficult to cope with.
- A merger or takeover may result in one of the businesses having to adapt its culture to ensure consistency within the newly created larger business unit. The danger of culture clashes as a result of mergers and takeovers is very real, particularly when the integration involves companies from different countries. The culture clash between the management team at Mercedes (Germany) and Chrysler (USA) is often used as an example of how cross-border integration sometimes fails. See Activity 2.5.3.
- Declining profits and market share may be the consequences of poorly motivated staff and a lack of interest in quality and customer service. A person culture may help to transform the prospects of this business but existing employees will need to be trained in taking responsibility and in participating in decision-making.

ACTIVITY 2.5.3

Hewlett Packard (HP) and Compaq

In 2001, struggling computing giant HP announced it would acquire similarly struggling competitor Compaq. The merger was ill-fated from the start, as critics pointed out how the HP engineering-driven culture was based on consensus and the sales-driven Compaq culture on rapid decision-making. This poor cultural fit resulted in years of bitter infighting in the new company, leading to a loss of an estimated $13 billion in the value of the merged business. Though the merger itself was widely regarded as a failure, the company has taken steps to deal with the causes and consequences of the culture clash. Significant cultural and leadership changes have resulted in long-term success.

Source: www.globoforce.com

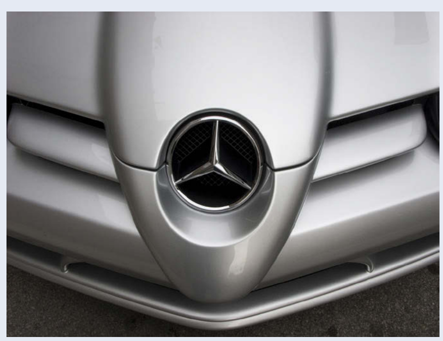
18 marks, 36 minutes

1. Explain **one** reason why there could have been a clash of corporate culture between HP and Compaq. [4]
2. Analyse **one** possible consequence of a clash of corporate culture between HP and Compaq. [4]
3. Discuss whether it is inevitable that mergers/acquisitions between two large businesses like HP and Compaq will result in damaging culture clashes. [10]

ACTIVITY 2.5.4

PORSCHE CULTURE CONTRIBUTES TO SUCCESS

Perhaps one of the reasons for the astonishing success of the Porsche motor-manufacturing business is the culture embodied by the views of its former boss, Wendelin Wiedeking. 'The Porsche philosophy is that first comes the client, then come the workers, then the suppliers and finally the shareholders. When the first three are happy, then so are the shareholders.' Compare this with the typical view in US- and UK-based businesses that often promotes 'shareholder culture' as being most important. These differences in outlook and culture help to explain why high-profile integrations between BMW and Rover Cars and then Chrysler and Mercedes-Benz were such disasters.



The collapse of the merger between car giants Chrysler and Mercedes-Benz was largely due to differences in corporate culture

20 marks, 40 minutes

1. Define the term 'corporate culture'. [2]
2. Outline **two** factors that may have affected Porsche's corporate culture. [4]
3. Analyse **one** reason why Porsche's philosophy of focusing on the needs of clients, workers and suppliers will ultimately satisfy shareholders. [4]
4. Discuss the problems of adapting the corporate culture of a car manufacturer when it is taken over by or merges with a foreign car manufacturer. [10]

THEORY OF KNOWLEDGE

Copy Solutions is one of the most successful photocopier suppliers in the business. It is a medium-sized supplier of copiers to businesses and it operates at a national level. It is famed for its aggressive, uncompromising corporate culture. The sales staff are paid mainly on commission, and the financial rewards for their successful sales people are considerable. But it is a hard culture. People who struggle to cope with the pace of the organisation and do not meet their targets are often humiliated by Copy Solutions managers and their fellow workers and they are fired if they fail to meet their targets. There have also been stories of sexist behaviour by the male staff and some institutionalised bullying. As one employee said, 'The pay's great but it's a terrible place to work'.

To what extent is it ethical for managers to run a business that is financially successful but has a corporate culture that is so challenging to the employees?

How leaders can influence and change organisational culture

Changing the value system of a business and attitudes of all staff who work for it is never going to be an easy task. The process could take several years before all staff and processes have been fully 'converted'. It means changing the way people think and react to problem situations. 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.

The key common elements in effective cultural change are:

- Concentrate on the positive aspects of the business and how it currently operates and enlarge on these. This will be much easier and more popular with staff than focusing on, and trying to change, negative aspects.
- Obtain the full commitment of people at the top of the business and all key personnel. If they cannot or will not change, it might be easier to replace them altogether. Unless the key personnel model 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 that are to be adopted – these also need to be communicated to all staff.
- Encourage 'bottom-up' participation of workers when defining existing problems or when devising new solutions. The biggest mistake could be to try to impose a new culture on workers without explaining the need for change or without giving them the opportunity to propose alternative ways of working.

- Train staff in new procedures and new ways of working to reflect the changed value system of the business. If people believe in the change and understand the benefits of it, then it will become more acceptable to them.
- Change the staff reward system to avoid rewarding success in the 'old ways' and ensure that appropriate behaviour that should be encouraged receives recognition. People need to be reassured that if they adjust to the new approach, then they will gain from it.

ACTIVITY 2.5.5

'UNCOMFORTABLE READING': KEY EXTRACTS FROM THE SALZ REPORT INTO BARCLAYS' CULTURE

The Salz Review – a report into Barclays Bank's cultural shortcomings after well-publicised financial scandals at the bank – makes for 'uncomfortable reading', according to the bank's current CEO. The report suggests that if there were company values at Barclays, no-one knew about them.

There was no sense of common purpose in a group that had grown and diversified significantly in 20 years:

- There were no clear and understood shared values.
- Pay was emphasised above any other aspect of people management.
- People management was considered mainly as a tool to increase business profits.
- Barclays attracted senior employees who measured their personal success principally in levels of pay.

The new CEO says it could take up to a decade to fully revise the culture at the bank. He has made a start by introducing the 'Barclays Way' – a code of how employees should do business in future. It contains statements such as:

Our Purpose

'Helping people achieve their ambitions – in the right way.'

'We act fairly, ethically and openly in all we do.'

'We put our clients and customers at the centre of what we do.'

'We are passionate about leaving things better than we found them.'

18 marks, 36 minutes

1. Analyse the problems Barclays had faced as a result of not having 'shared values'. [8]
2. Evaluate the most significant steps that the new CEO might have to take in order to influence and change culture effectively at the bank. [10]

ACTIVITY 2.5.6

A housing development for disabled workers has been owned and operated by a profit-making private company for many years. A charity has just been successful in buying the development from the company.

4 marks, 8 minutes

Explain one step the new management might have to take to change the culture of the organisation. [4]

How organisational culture influences individuals

An organisation's culture performs certain social functions and these have an impact on the individual employees. As with many organisational structures, culture is difficult to observe or measure or chart. In some cases, the structure of an organisation supports or reinforces its culture – for example, when a business with an entrepreneurial culture adopts a very flat/horizontal structure. One of the main impacts of culture on people within an organisation is that it should reduce 'behavioural variability'. In other words, if a culture is strong and easy to identify, employees, especially managers, should all react in similar ways when confronted with decision-making situations. The following are the most commonly discussed influences of organisational culture.

Behavioural control

Most business organisations attempt to control the variability of employee behaviour. This helps to: prevent conflicting decisions being taken; ensure that the ethical code is observed in the same way by all employees/divisions of the organisation and present a united and focused business to the outside world. Whether it is a business organisation, a club, community or nation, social organisations need to limit certain types of behaviour and encourage others. At one level organisations set up rules, procedures and standards along with various consequences for not following these. This system of formal rules and sanctions is part of the organisation's formal structure. However, social studies have found a high degree of consistent behaviour in businesses and other organisations without a strong formal set of rules and regulations. In these cases, it is the organisational or corporate culture that provides informal direction. The unwritten culture of a business can act as a control device to help ensure consistent behaviour – for example, responding ethically to an environmental problem even if the risk of negative publicity is low.

Encourages stability

Labour turnover, new management appointments and other changes are experienced by all organisations. Despite changes in personnel and leadership many business organisations maintain certain characteristics, problems are handled in essentially the same way, and employee behaviour continues to be directed towards the same mission and goals. An organisation's culture – 'how things are done around here' – is often passed on from 'generation' to 'generation' of employees, creating a relatively high level of stability over time.

Source of identity

Nearly all individuals need to define their social identities. 'Who am I and what do I consider to be important' are questions most people ask at some point in their lives. Sometimes an individual's identity is defined by their role or profession. In other cases people define themselves through their membership of social organisations or the business that they work for. The pride of long-serving employees when the name of 'their' business is in the news suggests that people often take the organisation they work for as a source of identity. The culture of the organisation – its values and beliefs – helps to define the people who work for it.

Evaluating organisational culture

The significance and power of an organisation's culture to drive people's behaviour and attitudes should not be underestimated. The impact of culture goes beyond the desire of most people to conform to accepted values. The following examples reinforce the importance of organisational culture:

- The values of a business establish the norms of behaviour of staff – what is and what is not acceptable in certain situations. For example, is it acceptable in this organisation to offer bribes to attract large contracts 'as long as we are not found out'?
- Culture determines the way in which company managers and workers treat each other. For example, if the chief executive is open and receptive to new ideas and proposals from senior managers, then this approach is likely to filter through the whole organisation – to its potential long-term benefit.
- 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. Will this approach to business now change after its takeover by L'Oréal?
- Culture determines not just how decisions are made – with the participation of staff or by top managers alone – but also the type of strategic decisions that are taken. For example, the culture of the UK National Health Service in target setting and giving rewards for meeting short waiting times within Accident and Emergency departments is, it is claimed, encouraging hospital managers to decide to leave patients in ambulances for up to two hours. How different would it be if doctors were taking these decisions?
- Organisational culture has been clearly linked to the economic performance and long-term success of organisations. Businesses dedicated to continuous improvement with staff involvement have been shown to be more profitable in the long term. Toyota is the prime example of success based on this principle.

OVER TO YOU

Revision checklist

1. If you were appointed to a management position in a well-known business, what evidence would you need to identify the culture of the organisation?
2. Explain the possible problems of changing the culture of a business with a small but loyal staff and customer base.
3. How might a business attempt to establish a person culture?
4. Explain **two** reasons why the culture of a fast-food restaurant might need to be changed.
5. Explain **two** reasons why workers may resist attempts to change the culture of the organisation they work for.
6. Examine the differences between role culture and entrepreneurial culture. Include examples of different circumstances of when each culture might be appropriate.
7. Explain **two** likely causes of culture clashes in a rapidly growing family business.
8. Explain the likely consequences of the culture clashes identified in question 7 if no effective action is taken to reduce the conflicts.
9. Analyse how an individual can influence business culture.
10. Analyse how the culture of a business can influence individual workers.

Exam practice question

REGAL SUPERMARKETS – A CASE STUDY IN CULTURAL CHANGE

As one of the UK's largest family-owned chain of supermarket stores, Regal Supermarkets had established a culture among its staff that had contributed to its success and growth. Loyalty to the family managers was very high. Staff often commented on the whole business being like a 'big family'. Promotion was based on long service and loyalty. Relationships with suppliers had been built up over many years and long-term supply contracts were in place. Customer service was a priority and was especially important as Regal never intended to be the cheapest shop in the towns it operated in. However, profits were not high and the younger members of the owning family lacked the skills to take over.

It was clear to some industry experts that some of these values and attitudes had to change once it was sold by the family and converted into a public limited company. The new chief executive, Sally Harte, had experience in the USA as Walmart's chief food buyer. She announced on the first day of her appointment: 'This business is like a sleeping giant. There is so much shareholder value that I can unlock to allow for higher dividends and to underpin a higher share price.' Within five weeks, 50% of the directors and key managers had been replaced. Suppliers' terms were changed, on Sally's insistence, to '5% below the cheapest or we drop you' and the staff salary and pension scheme was replaced for new recruits with flexible pay and conditions contracts. Staff turnover increased sharply.

Sally had not predicted the adverse media coverage of these changes. She said, 'I am only trying to adapt the organisational culture of this business to one which allows us to be successful in a highly competitive national marketplace where consumers want low prices and fresh goods.'

20 marks, 40 minutes

1. Define the term 'corporate culture'. [2]
2. Explain **one** possible reason why Sally thought it necessary to change the organisational culture of Regal Supermarkets. [4]
3. Outline the type of culture that Sally seems to be introducing at Regal Supermarkets. [4]
4. To what extent can a new chief executive influence the culture of an organisation? [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, examine what changes globalisation brings to its corporate culture. [20]

2.6

H

Industrial/employee relations

On completing this chapter you should be able to:

Analyse and apply:

- The role and responsibility of employee and employer representatives (AO2)
- Sources of conflict in the workplace (AO2)
- Reasons for employee resistance to change (AO2)

Evaluate:

- Different industrial/employee relations methods (AO3)
- Different approaches to conflict resolution (AO3)
- Human resource strategies for reducing the impact of and resistance to change (AO3)
- How innovation, ethical considerations and cultural differences may influence employer–employee relations (AO3)

Setting the scene

CATHAY PACIFIC AVOIDS DAMAGING STRIKE JUST BEFORE BUSY HOLIDAY SEASON

Cathay Pacific has avoided a threatened strike by cabin crew after it agreed a compromise deal with the flight attendants' union. The union welcomed the deal, which gave it most of what it was asking for, and called off the strike. The industrial dispute was over a new money-saving health insurance scheme that Cathay wanted to introduce for its 10 000 workers that would have forced them to pay for visits to the doctor. Cathay has now agreed to drop these charges until May and then to allow ten free visits to the doctor each year. The company refused to say how much the compromise would cost. 'I hope that the management will now improve labour–management relations and continue to work with us,' said Becky Kwan, the chairwoman of the flight attendants' union.

Source: www.iht.com

Points to consider

- What was the cause of the conflict between employees and the employer?
- Suggest **three** other possible causes of conflict between an employer and its employees.
- Examine the likely reasons for Cathay Pacific agreeing to the costly compromise to solve this dispute.

Key concept link

Globalisation is making labour markets more 'global' with workers able to travel more freely for opportunities in many countries and migration increasing labour supply for many businesses. Is it ethical to pay workers less – or refuse to increase pay – due to the ability to recruit workers more cheaply from overseas?

Introduction

Industrial/employee relations can have a major impact on business success or failure. Avoiding or resolving conflicts, introducing change and reducing resistance to it and recognising ethical and cultural influences are important roles and responsibilities of human resources management. Conflict resulting from differing objectives may be inevitable between labour and management within business. How can these conflicts be resolved or at least reduced so that the disagreement is not so great that it prevents all forms of coordination and working together? How can positive cooperation be achieved between these two groups for the benefit of the business and all stakeholders?

The methods used by employees and employers to achieve their objectives will depend on the relative 'strength' of each side. Much also depends on the culture and legal structure of the country in which the organisation operates, as well as the culture of the business itself. In some countries, trade unions are still illegal or their operations are strictly controlled. At the other extreme, in the European Union, workers' rights over minimum pay levels, security of employment and working conditions are protected by laws that restrict quite substantially the independence of management in deciding on such issues.

The role and responsibility of employee and employer representatives

Employee representatives – trade unions

In most countries workers are allowed to join **trade unions** (labour unions). Officials of these unions often act as representatives of the workers' interests during negotiations with employers about pay levels, working conditions or other industrial relations issues. Many trade union negotiating teams are led by generalists who have to develop expertise on a wide area of subjects such as compensation practices, benefit schemes, pensions and safety and health conditions. They must also have some legal training for drafting language in agreements. There is a growing tendency for specialists to sit on negotiating teams. Thus one union representative will deal with pension issues, another with working conditions and so on.

trade union (labour union): an 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

Why workers join trade unions

- 'Power through solidarity' has been the basis of union influence and this is best illustrated by their ability to engage in 'collective bargaining'. This is when trade unions negotiate on behalf of all of their members in a business, putting workers in a stronger position than if they negotiated individually to gain higher pay deals and better working conditions.
- Individual **industrial action** – one worker going on strike, for example, is not likely 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 conditions of work.

Unions pressurise employers to ensure that all legal requirements are met, such as health and safety rules regarding the use of machinery.

industrial action: measures taken by the workforce or trade union to put pressure on management to settle an industrial dispute in favour of employees

trade union recognition: when an employer formally agrees to conduct negotiations on pay and working conditions with a trade union rather than bargaining individually with each worker

Union recognition

In many countries it is not a legal requirement to **recognise trade unions**. In the UK, employers did not have to 'recognise' a union in the workplace until the law was changed in 2000. This meant that the employer could choose not to bargain collectively with a union official representing the workforce. Instead, all workers would be treated individually and negotiations over pay and conditions and matters of discipline would only be dealt with between the employer and each individual worker. Since 2000, workers have been able to vote on whether they should demand employer recognition of their union. If a majority support this idea, then it will be illegal for an employer not to deal with union officials. Such a law is likely to boost union membership and influence.

ACTIVITY 2.6.1

TRADE UNION? INDIA'S BPO WORKERS SAY 'NO'

From Europe to North America, India's offshore workers (Business Process Outsourcing) – call-centre operators, data-entry clerks and telemarketers – may seem like the sweatshop labourers of the information age, toiling for long hours with modest pay, but an international alliance of unions that wants them to become union members is finding it very hard to recruit them. These workers think of themselves as members of a relatively well-paid, respected professional elite in no need of union protection. The back office outsourcing industry in India employs around 400 000 workers, yet the Union Network International (UNI) organisation has only recruited 500 of them so far. 'A union would make sense if we had no job security,' said KV Sudhakar, a technical support worker, 'but there are so many jobs and so few qualified staff that firms are trying all possible means to keep employees happy so they will not leave.'

A similar situation has arisen in the USA where unions have lost many members as traditional manufacturing industries decline. They find it very difficult to recruit white-collar workers and professional workers in the finance and other service industries.

An Indian worker who did join UNI is Raghavan Iyengar, a call-centre supervisor. He said companies give incentives to those who work beyond contracted time and young workers often ignore health problems, such as insomnia and bad backs, to earn extra money. 'The industry's motto is "shut your mouth and take your money"', he said, 'and we want to change that.'

Source: The Associated Press.

Most workers in call centres in India see little point in joining a trade union

20 marks, 40 minutes

1. Define the term 'trade union'. [2]
2. Outline **two** responsibilities trade unions have when they are representing their members. [4]
3. Explain **two** reasons why employers might not want their employees to join trade unions. [4]
4. Evaluate the benefits to call-centre workers in India of joining the UNI. [10]

Trade union recognition could also have benefits for the employers:

- Employers would be able to negotiate with one officer from the union rather than with individual workers.
- The union system could provide an additional, useful channel of communication with the workers – two-way communication in the sense that workers' problems could be raised with management by the union and the plans of the employers could be discussed via the union organisation.
- Unions can impose discipline on members who plan to take hasty industrial action that could disrupt a business – this makes such action less likely.
- The growth of responsible, partnership unionism has given employers an invaluable forum for discussing issues of common interest and making new workplace agreements. Very often, these will lead to increased productivity, which should help to secure jobs and raise profits.

Exam tip: You will need to know about trade unions in your own country. Are they legal? If so, do the majority of workers belong to them? What actions do unions take in your country?

ACTIVITY 2.6.2

Investigate a recent industrial dispute in your country. Analyse the causes of the dispute, what actions were taken by employees and employers to settle the dispute and how it ended.

Employer representatives

The trade union or employees' representative may negotiate with a single employer, who is typically representing a company's shareholders, or may negotiate with representatives from a group of businesses to reach an industry-wide agreement. In Austria, Sweden, Germany and the Netherlands it is common for collective employers' associations for each industry to engage in negotiations with union representatives.

In the case of a single employer, the team making up the negotiating body will depend on the size of the business. In small organisations, the team might be made up of just the senior manager or chief executive. In larger businesses, professionally qualified human resources managers are likely to be part of the team together with a financial officer or accountant, who will assess the financial impact on the business of any proposal made during collective bargaining. In very large companies with human resource management structures there are managers who specialise in different areas of industrial relations such as counselling, training, safety and health, pay negotiations, fringe benefits and personnel matters.

The role of the employer representatives will be to present the arguments for or against a particular proposal from the viewpoint of shareholders or business owners. They will want to achieve the lowest cost agreement possible – but also one that is likely to result in a mutually satisfactory agreement that will motivate employees to strive towards the organisation's goals. The responsibility of the employer's representatives is to reach an agreement that leads to satisfactory long-term employer–employee relations.

Collective bargaining

collective bargaining: the negotiations between employees' representatives (trade unions) and employers and their representatives on issues of common interest such as pay and conditions of work

Collective bargaining is widely used in business. It is the opposite of individual bargaining, where each worker discusses separately with his/her employer issues such as pay and conditions. This process becomes unwieldy in large organisations. Instead, many employees belong to trade unions or professional associations and these bodies bargain or negotiate on their behalf. In some countries, employers also belong to employers' associations that negotiate with unions and any agreements made will cover all firms that belong to the association.

The growing power and membership of trade unions in the twentieth century in the USA and Europe led to the widespread development of national collective bargaining. These collective negotiations can make trade union leaders very powerful as they may be able to threaten and actually call for strike action from all of their members, which could bring the entire industry to a halt.

This form of collective bargaining was never used in some countries where unions were weak or illegal. Even in Europe and the USA, national collective bargaining is now much less common as national agreements are not always suitable or affordable for smaller or less profitable businesses. Agreements are now often made by individual businesses or business units negotiating with employees' representatives regionally or locally.

Action taken by employees and employers

Unions

Trade union objectives include higher pay, improved conditions and security of employment. Union leaders can use a number of measures to 'encourage' employers to accept their demands for improvements in pay and conditions:

- Negotiations – and, possibly, agreeing to arbitration (see page 214).
- Go slow – a form of industrial action in which workers keep working but at the minimum pace as demanded by their contract of employment. Bonus payments may be lost by workers, but at busy times of the year this action can be very disruptive and costly for employers.
- 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 times of the year, this could lead to much 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. This may lead to production stopping completely. Strike action can lead to the business shutting down during the industrial action.

Employers

Settling disputes with unions can increase the long-term profits of the business. Settlement may be reached in a variety of ways:

- Negotiations – these aim to reach a compromise solution. If face-to-face negotiations with union leaders fail to reach an agreement, then the dispute may require arbitration (see page 214).
- Public relations – using the media to try to gain public support for the employer's position in the dispute. This may put pressure on the union to settle for a compromise solution.
- Threats of redundancies – these threats would, again, put pressure on unions to agree to a settlement of the dispute, but they might inflame opinions on the employees' side and could be looked upon as 'bullying' and lead to poor publicity for the employer.
- Changes of contract – if employees are taking advantage of their employment contracts to work to rule or ban overtime, then new contracts could, when the old ones are due for renewal, be issued that insist on higher work rates or overtime working.
- Closure – closure of the business or the factory/office where the industrial dispute takes place would certainly solve the dispute! It would lead to redundancy for all the workers and no output and profit for the business owners. This is a very extreme measure and would only be threatened or used if the demands of the union would, if agreed to, lead to a serious loss being made by the business or factory anyway.
- Lock-outs – short-term closure of the business or factory to prevent employees from working and being paid. Some workers who are not keen on losing pay for long periods may put pressure on their union leaders to agree to a reasonable settlement of the dispute.

Industrial action by airline employees - businesses may have to shut down while workers are on strike

LEARNER PROFILE

Reflective

Barclays is cutting 19 000 jobs in a radical overhaul of its business, including a dramatic scaling back of its investment bank. The 19 000 jobs going over the next three years include 12 000 cuts announced in February that were earmarked for this year. This year's total is now being raised to 14 000 as 2000 jobs will go in the investment bank. That leaves 5000 investment bankers facing redundancy by 2016. At least 4000 of the 19 000 jobs have already gone.

Barclays CEO, Anthony Jenkins, said the whole global banking arena was changing because of regulatory moves and he was embarking on a 'bold simplification of Barclays'. 'We will be a focused international bank, operating only in areas where we have capability, scale and competitive advantage,' he said.

Source: Adapted from www.theguardian.com

Imagine you are a CEO of an organisation that is going to make significant redundancies, which may have catastrophic effects on people's lives.

Discuss as a group the factors you would reflect on that allow you to make such a decision.

Which side is stronger?

The power and influence of employers and unions in an industrial dispute will depend on a number of factors as outlined in Table 2.6.1.

Union/employee power will be strong when:	Employer power will be strong when:
• most workers belong to one union • all workers agree to take the industrial action decided on • the business is very busy, operating close to full capacity, does not want to disappoint customers and profits are high • industrial action rapidly costs the employer large amounts of lost output/revenue/profits • there is public support for the union case, e.g. for very low-paid workers • inflation is high, so a high wage increase would seem 'reasonable' to maintain living standards • labour costs are a low proportion of total costs.	• unemployment is high – there are few alternative jobs for workers to take • the employer takes action, e.g. lock-out has a very quick impact on workers' wages • there is public support for the employer, e.g. when unions are asking for rises much higher than other workers receive • profits are low and threats of closure are taken seriously • threats of relocation to low-cost countries are taken seriously, e.g. the business has already closed other plants and relocated them.

Table 2.6.1 The relative strength of unions and employers

THEORY OF KNOWLEDGE

'That's it, we're going on strike next Tuesday for 24 hours because of irreconcilable differences between our position and the management position,' Eduard Perez told reporters. The union that represents transport workers on the city's buses, trams and metro system has been in dispute with their employers for 18 months regarding planned changes to their working conditions and redundancies.

Oscar Duran, the city mayor, has been on a media offensive with all the main news networks. 'We are going to completely computerise our ticketing system, replacing ticket offices across the network with fast payment machines. It is going to reduce operating costs by 12% and this saving will be passed on partly as lower fares and partly as pay increases to the city's transport workers.' He went on, 'The truth is nobody wants to pay with cash any more and we don't need ticket offices.' Mr Duran has promised there will be no compulsory redundancies.

You are a TV interviewer who has to interview both Eduard Perez and Oscar Duran. Prepare two questions you are going to ask each of them to challenge their positions in the dispute.

Reflect on the conflict between emotion and reason in industrial disputes like this one.

Sources of conflict in the workplace

It is often assumed that conflict at work is only between employers and employees (or 'management') and 'labour'. Employers aim to achieve satisfactory profit levels by keeping costs, including labour costs, as low as possible. However, workers – remember that wage costs are often a major part of total business costs – will seek to obtain high pay and shorter working hours.

There are obvious potential clashes of interest between these two groups – and some of the most common are explained in Table 2.6.2.

Cause of conflict	Common management view	Common employee view
Business change, e.g. relocation or new technology	Change is necessary to remain competitive and profitable.	Change can lead to job losses, may result in retraining in new skills that causes uncertainty over ability to cope. Demands for increased 'flexibility' from staff may reduce job security.
Rationalisation and organisational change	Business needs to cut overheads and be flexible and adaptable to deal with 'globalised' low-cost competition.	Cost cuts and rationalisation always seem to fall on employees – not the senior managers or owners of the business. Reduced job security will damage employee motivation.
Pay levels and working conditions	The market determines what the appropriate pay level should be. An increase in pay or costly improvements in working conditions might make the business uncompetitive.	If profits are rising and managers' bonuses too, then employees deserve pay increases – at least in line with inflation to maintain the real value of incomes.

Table 2.6.2 Common causes of labour–management conflict

Conflict can also occur between employees or between groups of employees. Here are four reasons why potentially damaging conflict might exist in the workplace between employees:

Poor communication

Poor communication can result in a difference in communication styles or a failure to communicate. For example, a manager reallocated an employee's task to the employee's colleague but failed to communicate this to the employee. This may cause the employee to feel rejected, which can lead to bad feelings between the two employees and the manager.

Difference in personalities

Employees come from different backgrounds and experiences, which play a role in shaping their personalities. When employees fail to understand or accept the differences in each other's personalities, problems arise in the workplace. For example, an employee may possess a confident personality that leads to him speaking his mind directly and leading discussions, even if the timing is poor. This employee could offend other workers who prefer a more cooperative and thoughtful approach to problem-solving and communication. The co-workers may feel that the employee is rude or they may feel they lack the authority to deal with this personality.

Different values

One cause of different values amongst employees is when a generational gap is present. Young workers may possess different workplace values from those of older workers. The difference in values is not necessarily the cause of employee conflict in the workplace, but the failure to accept the differences is. When employees fail to accept the differences, co-workers may insult each other's characters and experiences. This tends to intensify the conflict until the right solution is offered and accepted.

Competition

Excessive workplace competition is a cause of employee conflict. Some businesses deliberately foster competitive environments to encourage workers or teams to out-perform each other. When salary is linked to employee production, a workplace may experience strong competition between employees. Competition that is not properly managed for the good of the whole business can result in employees sabotaging efforts by other groups or not cooperating with them. This can create a hostile work environment, discouraging teamwork and promoting individualism.

Approaches to conflict resolution

Single-union agreement

Single-union agreements are one strategy to reduce conflict at work. Just 50 years ago, the UK still had more than 100 separate trade unions. This number is now much reduced, but it is still possible for the workforce of one business to have members in several different unions. This makes collective bargaining much more difficult and time-consuming. In addition, it can lead to inter-union disputes over which skills or grades of workers should get the highest pay rise. It can also reduce the flexibility of a workforce if members of one union are prevented from doing the work of other workers belonging to another union. This is called a demarcation dispute and reduces total productivity.

single-union agreement: an employer recognises just one union for purposes of collective bargaining

Many employers now insist on signing recognition deals with just one union. Two potential consequences of such deals are that the newly united workforce and its union representatives may be able to exert greater influence during collective bargaining, and that just one union may not effectively represent the range of skilled staff, and their needs at work, that exist in most businesses. The growth of single-union agreements has led to further mergers between unions to prevent smaller unions being gradually excluded from all such industrial deals.

No-strike agreements

At first glance, **no-strike agreements** seem rather unusual for a union to sign with an employer. Why should it give up the most effective form of industrial action? There are two main reasons:

no-strike agreement: unions sign an agreement with employers not to strike in exchange for greater involvement in decisions that affect the workforce

- It improves the image of the union as being a responsible representative body and this could encourage employees to become members.

- These deals are often agreed to in exchange for greater union involvement in both decision-making and in representing employees in important negotiations. This has led to union–employer agreements to change working methods and increase labour flexibility that lead to higher productivity, higher profits *and* higher pay and worker participation. This is sometimes referred to as a win–win settlement as both employer and employee will gain from this new partnership approach to industrial relations.

Conciliation and arbitration

In the UK, Acas (Advisory, Conciliation and Arbitration Service) has a primary function of reducing conflict in UK industry by improving employment relations between employers and employees. It gives advice to employers and employees and their representatives on issues likely to cause disputes between them. Most countries have similar organisations. As a **conciliator** in industrial disputes, Acas would listen to both sides of the argument – perhaps over pay or working conditions – and attempt to find common ground. This might then be used as a basis for an eventual compromise agreement.

conciliation: the use of a third party in industrial disputes to encourage both employer and union to discuss an acceptable compromise solution

arbitration: resolving an industrial dispute by using an independent third party to judge and recommend an appropriate solution

Arbitration is different. An Acas official will again listen to both sides of a dispute, but will now make a decision for resolving the disagreement. This might be a compromise between the opposing views of employer's and union's officials. If both parties agree to accept this, then this becomes a binding arbitration. The risk of the arbitrator setting the compromise closer to 'one side' than the other can lead to both groups establishing extreme negotiating positions. For example, in wage negotiations, a union might ask for a rise of 10% rather than a more realistic figure of, say, 5%. This is in the hope that the final decision of the arbitrator may be influenced by the high pay claim and will set a 'compromise' of 7.5% – which is what the union was hoping to achieve anyway.

An alternative form of arbitration, designed to prevent this union strategy (and also to discourage employers from offering a very low increase) is called 'pendulum arbitration'. In this case, both sides must accept the decision of the arbitrator and the arbitrator is forced to accept either the union's pay claim or the employer's pay offer because no compromise is allowed. Thus, if a union submitted a very high claim or if employers offered a very low rise, then the arbitrator would be tempted to 'swing' the decision towards the other side completely.

Employee participation and industrial democracy

These are attempts to reduce industrial conflict by achieving a closer working relationship between employees and employers. This then might lead to commonly agreed objectives. Participation at work by employees can take different forms:

- Industrial democracy, in its purest form, implies workers' control over industry, perhaps linked to workers' ownership of the business, e.g. producer cooperatives.
- Employee or trade union directors on the company's board of directors represent the workers' approach to major company issues at the highest decision-making level.
- Works councils, e.g. European Works Councils, discuss issues such as the employment situation, major investment projects planned by the business, major organisational changes and health and safety.
- Autonomous work groups and quality circles lead to employee participation in decision-making and help to avoid the 'us and them' environment. By involving workers in everyday decisions that impact on their working lives, such as work schedules, improvements in work practices and how to plan team working, the threat of industrial disputes is reduced.

Employee resistance to change

This is one of the biggest problems any organisation will face when it attempts to introduce changes. The managers and workforce of a business may resent and resist strategic change for any of the following reasons:

- **Interpretation of circumstances – 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 – this results in resistance.
- **Fear of failure** The changes may require new skills and abilities that, despite training, 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?
- **Self-interest – 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.
- **Misinformation – false beliefs about the need for change** To put themselves at ease and to avoid the risks of change, some people fool themselves into believing that the existing system will 'work out someday' without the need for radical change.
- **Low tolerance – lack of trust** Perhaps because of past experiences there may be a lack of trust between workers and managers who are introducing the change. Workers may not believe the reasons given to them for change or the reassurances from managers about its impact.
- **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 the 'resistance factors' will vary from business to business. In those firms where previous change has gone well, where workers are kept informed and even consulted about change and where managers offer support and training to the staff involved, resistance to change is likely to be low. In contrast to this is the likely resistance to change in businesses where there is a lack of trust and little communication.

Exam 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 contributory factor in determining the degree of resistance.

Strategies for implementing, managing and controlling change

1. Understand what change means

Change is the continuous adoption of business strategies and structures in response to changing internal pressures or external forces. Change happens whether we encourage and welcome it or not. To take control of it and to ensure that it is a positive and not a negative process, businesses must have a vision, a strategy and a proven and adaptable process for managing change.

Today, change in business is not the exception but the rule – it has become an accelerating and ongoing process. Table 2.6.4 gives some common causes of change. 'Business as usual' will become increasingly rare as global, economic and technological upheavals necessitate a business response. **Change management** requires firms to be able to cope with dramatic one-off changes as well as more gradual evolutionary change:

change management: planning, implementing, controlling and reviewing the movement of an organisation from its current state to a new one

- Evolutionary or incremental change occurs quite slowly over time – for example, the swing towards more fuel-efficient cars has been happening for several years. These changes can be anticipated or unexpected – the decision to increase the London congestion charge was announced months in advance, but a sudden oil-price increase may not have been expected. Obviously, incremental changes that are easy to anticipate tend to be the easiest to manage.

Exam 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.

- Dramatic or revolutionary change, especially if unanticipated, causes many more problems. Civil conflict in Egypt in 2012 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 using a 'clean slate'. This is called business process re-engineering.

Civil conflict in Egypt forced holiday companies to implement rapid changes

ACTIVITY 2.6.3

1. Identify and explain **three** recent changes in the external business environment that have occurred that have an **incremental** impact on businesses.
2. Identify and explain **three** other recent changes that have occurred, which have had a **dramatic** impact on business.

2. Recognise the major causes of change

Nature of change	Examples of change	Managing change
Technological innovation – leading to new products and new processes	• products – new computer games, iPads and iPhones, hybrid-powered cars • processes – robots in production; CAD in design offices and computer systems for stock control	• need for staff retraining • purchase of new equipment • additions to product portfolio – other products to be dropped • need for quicker product development, which may need new organisational structures and teams
Macro-economic changes – 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 – need for extra capacity or rationalisation	• need for flexible production systems – including staff flexibility – to cope with demand changes • explain the need for extra capacity or the need to rationalise • deal with staff cutbacks in a way that encourages staff who remain to accept change
Legal changes	• changes to what can be sold (raising age of buying cigarettes) or when (24-hour licences for restaurants)	• staff training on company policy on sale of cigarettes and alcohol • flexible working hours and practices

Table 2.6.3 Types of change [*table continues over*]

Nature of change	Examples of change	Managing change
Competitors' actions	• new products • lower prices – based on higher competitiveness/lower costs • higher promotion budgets	• encourage new ideas from staff • increase efficiency by staff accepting the need to change production methods • ensure resources are available to meet the challenge

Table 2.6.3 *Continued*

3. Understand the stages of the change process

Here is a checklist of essential points that managers should consider before attempting to introduce significant changes in an organisation:

- **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 – and 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.
- **Plan the timing of the change** Workers in particular should not be taken by surprise by change – this will increase their resistance to it. See section on 'Employee resistance to change' (page 215).
- **Involve workers in the plan for change and its implementation** This will encourage them to accept change and develop a sense of 'ownership' of it. This may also lead to proposals from them to improve the change process.
- **Communicate** The vital importance of communication with the workforce runs through all of these other stages – unless employees are kept up to date with the pace and scope of change then resistance will build against it.
- **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 staff to feel that they are able to make a real contribution to the changed organisation.
- **Sell the benefits** Staff and other stakeholders may benefit directly from changes – these need to be explained to them.
- **Always remember the effects on individuals** A 'soft' human resource approach will often bring future rewards in terms of staff loyalty when they have been supported and communicated with during the change process.
- **Check on how individuals are coping and remember to support them** Some people will need more support than others – a 'sink or swim' philosophy will damage the business if it leads to low-quality output or poor customer service because staff were poorly supported during the change period.

4. Lead change, 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 – finance and staff – need to be made available for the change to be implemented.
- Appropriate action needs to be taken – and checked on – to ensure that the planned changes are introduced.

Managing change effectively is important to successful implementation. However, 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 staff at all levels of the organisation so that change is looked upon as a positive force that could improve people's lives – this motivation will lead to significant changes in the behaviour of workers
- ensuring that acceptance of change is part of the culture of the organisation
- visible support of all senior managers who will help the change process to be accepted at all levels and within all departments of the business.

5. Use project champions

project champion: a person assigned to support and drive a project forward and who explains the benefits of change and assists and supports the team putting change into practice

A **project champion** is often appointed by senior management to help drive a programme of change through a business.

A project champion will come from within the organisation and be appointed from middle to 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, but they will not necessarily be involved in the day-to-day planning and implementation of the new scheme. They will smooth the path of the project team investigating and planning the change and they will remove as many obstacles as possible. For example, they will speak up for the changes being suggested at board or other meetings of senior managers, they will try to ensure that sufficient resources are put in place and they will try to make sure that everyone understands the project's goals and objectives.

ACTIVITY 2.6.4

PROJECT CHAMPIONS

Jane Moger is HR director within the restaurant business Compass Group. She has acted as a project champion for the implementation of an e-recruitment system within the organisation. 'Being a project champion in HR gives you an opportunity to get involved in complex, long-term and high-value-added activities. Project champions get a new project off the ground and give the team momentum to see the change through,' she said.

Source: www.personneltoday.com

A business is planning to adopt a new IT system that will allow many staff to work from home several days a week. Some senior managers are against this as it will 'reduce control over workers'. The IT manager in charge of implementing this strategy decides to appoint a project champion to smooth the changeover.

10 marks, 20 minutes

1. Define the term 'project champion'. [2]
2. Outline the role of a project champion. [4]
3. Analyse **two** factors that would make a project champion successful. [4]

6. Use project groups or teams

'Problem-solving through team-building' is a structured way of making a breakthrough on a difficult change situation by using the power of a team.

When a difficult problem arises regarding a major change in a business's strategy or structure, one of the most common ways to analyse it and suggest solutions is to organise a **project group**. Project groups should work with the manager responsible for introducing the change. A team meeting of experts should provide a rigorous exchange of views that may well lead to an appropriate action plan being developed and agreed. The responsibility for carrying the plan out still lies with the original manager. Now, though, he or she will be better equipped to solve the problem that was preventing change from being effectively implemented.

project groups: these are created by an organisation to address a problem that requires input from different specialists

Planning and promoting change

Planning and promoting change are important functions of management. The timing of change is important to gaining acceptance for it. Introducing big changes too quickly in response to a crisis within the business – such as a collapse in sales and profit – will lead to greater resistance than change which is planned for and explained in good time to all those affected by it.

Gaining acceptance of change – by both the workforce and other stakeholders – will be much more likely to lead to a positive outcome than imposing change on unwilling groups. According to John Kotter, a leading writer on organisational change, the best way to promote it 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 changes
8. build change into the culture of the organisation so that it becomes a natural process.

If change is not 'sold' or promoted to the people most affected by it so that they develop a sense of ownership of it, then it is almost certainly going to build up damaging resistance that could increase the chances of failure.

ACTIVITY 2.6.5

CONSTANT CHANGE: A FEATURE OF MODERN INDUSTRY

Britax has undergone many changes in recent years. The business grew out of a diverse group of companies. The Britax name and brand were adopted at the end of the 1990s when the business decided to concentrate its efforts and sold off some of its activities. It now focuses on child safety seats and designing and building aircraft interiors. The sales of the child safety seats have been boosted by recent changes in the law. Aircraft interiors are a niche market with four international competitors. Overall turnover of Britax's aerospace division has grown from £20 million to £150 million in six years, despite intense competition and an aircraft-building industry that fears a fall in aircraft orders.

Exam tip: Effective management of change should, where possible, focus on the positive benefits of change to the stakeholders most affected by it.

Britax has just introduced a new, complex and expensive computer system to manage its production-resource planning. Inventory levels have fallen dramatically and productivity has improved. However, the new system involved changes in many people's work practices and skills. As with all changes of this nature, the crucial key to success lies not with the product but with those who have to use it. 'People react in different ways to change,' said the business-systems manager. 'How people approach change is a critical factor. A big factor in managing this is to build a strong project team. The right people need to be involved from the start. The next step is training and communicating the need for change. We spent a great deal of time and effort in this area and it was well worth it'.

20 marks, 40 minutes

1. Define the term 'change management'. [2]
2. Explain **two** reasons why Britax will face constant change within its business. [4]
3. Analyse **two** ways in which Britax has reduced resistance to change. [4]
4. Evaluate the problems Britax will face as it tries to manage change in its organisation. [10]

Employer–employee relations and innovation

Product and process innovation can lead to conflicts between employees and employers. New products often require workers to acquire new skills to allow the innovative product to be assembled cost-effectively. Process innovation can result in significant changes in working methods and practices and these changes can be resisted by employees, especially if retraining, relocation or job losses are likely consequences. As explained in the examples given in the next section, the industrial relations models that seem to be best geared towards accepting innovation and ensuring that it can benefit both employer and employee are those based on cooperation and participation.

Employer–employee relations and cultural differences – international examples

The ways in which employer–employee relations are organised is very different in different countries. There are often cultural reasons for the differences in the ways in which employees and employers relate to each other and how they attempt to resolve disputes.

JAPAN: The impact of culture on the relationship between employees and employers is well illustrated by considering industrial relations in Japan – and comparing them with other nations. Shimada Haruo, a leading Japanese industrial relations researcher, suggests that one cannot understand Japanese industrial practices and employer–employee relations without recognising that Japanese managers regard human resources as the most critical asset affecting the performance of their enterprises. Therefore, managers in large Japanese companies are deeply committed to developing and sustaining effective human resource and industrial relations practices. Many Japanese observers go on to argue that this assumption grows out of Japanese culture and traditions. Japanese culture places a high value on family relations and responsibilities, and some analysts claim that this family model carries over into the workplace. Employers are expected to show the same regard for their workers as a parent shows for other family members. Unity through cooperation within the firm becomes a corporate objective. In return, employees are expected to show strong loyalty to their employer.

Unlike employees in the USA and most of Western Europe, workers in large Japanese firms do not display traces of individualism and place more emphasis on group relationships in the design of work and in their day-to-day workplace interactions. Direct conflict in organisational decision-making is discouraged in favour of a more informal group consensus-building. Low levels of conflict are a feature of the generally cooperative relationship between managers and workers in Japan's large private-sector firms. This may be the case because manual and professional workers belong to the same union, meaning that there are fewer lines of demarcation between these groups. In most enterprises, for example, the scale of management bonuses is tied to the size of bonuses for blue-collar workers. Many senior Japanese executives served as union leaders in their companies at earlier stages in their careers.

Lifetime employment security is not guaranteed by law or contract in Japan but it is a key part of the business and human resource planning of large firms. Recruitment, training, compensation and internal promotion policies are designed to facilitate lifetime employment. Growth in company size and stabilisation of employment are high priorities for Japanese executives. Most Japanese firms accept the stakeholder view of corporate objectives more readily than their American counterparts do.

SAUDI ARABIA: The Japanese model of industrial relations is not repeated in many countries. For example, in contrast, a recent report to the World Trade Organisation on the trade policies of Saudi Arabia found that the country is in violation of all core labour standards.

Sharan Burrow, General Secretary of the International Trade Union Confederation, reports that there is not a single trade union in Saudi Arabia, as the law does not allow them to exist.

'Employees are only allowed to organise so-called 'workers' committees' which must include the participation of the government and the employer. Unions, collective bargaining, strikes, even public demonstrations are banned. Despite the strike ban, some unauthorised strikes do take place. In October 2011, 16 Chinese workers were arrested for participating in a strike involving at least 100 Chinese workers in a rail construction project. The strikers demanded a salary increase and improved working and living conditions,' she said.

Source: Adapted from www.ituc-csi.org

GERMANY: Collective bargaining at industry level between individual trade unions and employers' organisations is still the main method for setting pay and conditions in Germany. Separate agreements between trade unions and specific companies are rare, although there are some exceptions such as the agreement covering the motor company Volkswagen.

This industry-wide bargaining has traditionally been seen as one of the strengths of the German system of employer–employee relations. Potentially it keeps conflicts on pay and conditions at national industry level between the unions and the employers' associations, while, at the factory/workplace level, individual employers and workplace employee representatives on works councils can develop more cooperative relations. These factory-based relations have proven to be a major factor in Germany's record of high productivity and willingness to accept change at work. Industrial relations in Germany reflect the rational and organised national culture – a respect for employee rights and a preference for talking and participation rather than open conflict or challenge to authority.

These examples highlight the importance of managers being conscious of cultural and legal differences between countries when attempting to establish effective employer–employee relations.

Employer–employee relations and ethical considerations

Ethical considerations are important in determining relations between employee and employer. Here are some ethical dilemmas concerning this relationship:

Is it ethical when:

- nurses and doctors take strike action?
- employers do not recognise trade unions, in countries where this is not a legal requirement?
- employers lower wages, against union opposition, in times of economic recession?
- major decisions about the future of the business are taken without consulting with employees?

These and many other issues can be discussed at length, and, as with all ethical dilemmas, there may not be one right or wrong answer. Increasingly, legal controls are governing actions that can be taken by both employees and employers over industrial relations matters. Even when the law does not govern these issues, employers and employees – perhaps through their representatives – may be influenced in their actions or decisions regarding their relations by ethical considerations.

ACTIVITY 2.6.6

WALMART WORKERS IN CHINA REMAIN RESOLUTE AND DEFIANT

Led by their trade union chairman, Huang Xingguo, around 78 Walmart employees are camped outside the delivery depot of Walmart store No. 2024, determined to prevent the company from removing goods from the shuttered building. The workers have been there since early March, protesting Walmart's unilateral decision to close the store in the central city of Changde, giving employees only minimal compensation. The workers demanded at least twice what the company is offering in terms of severance pay and have vowed to stay on the picket line until the company agrees to negotiate with the union.

They add regular updates on their blog, which has now become a valuable archive of an unprecedented effort by an enterprise trade union in China to stand up for workers' rights.

'I have chosen to safeguard workers' right until the end,' Huang Xingguo told the *Beijing News* on Wednesday – day 48 of the protest. Another worker, Xiao Hong, added: 'Colleagues, we must hold on, hold on and hold on. The victory is ahead, people from Changde will never give up.'

With the help of the labour law expert Chang Kai and a lawyer from the Changde Municipal Trade Union Federation, the workers and the store trade union are now filing a legal claim against Walmart at the local labour dispute arbitration committee.

The move came as another Walmart employee, Wang Shishu – who was fired by Walmart in Shenzhen in 2012, finally won his lawsuit against the company for illegal dismissal on 23 April 2014. Even though he won, Wang, a 54-year-old army veteran, turned down the 220 000 yuan severance payment offered by Walmart and continued to press for reinstatement.

Wang was one of several Walmart employees in Shenzhen who, in the summer of 2012, helped to organise co-workers and lobbied the store's trade union to initiate collective bargaining with management in a bid to resolve long-standing employee grievances. At the end of July 2012, Wang was dismissed on the grounds of 'seriously violating company regulations and damaging the company's image'. He staged a long-running protest outside Walmart's Xianmihu store demanding reinstatement, and later joined a labour rights organisation based in the city.

Source: China Labour Bulletin, April 2014

20 marks, 40 minutes

Evaluate the importance of ethics and culture to Walmart's managers when they are managing employees in China. [20]

OVER TO YOU

Revision checklist

1. Explain **two** reasons why good labour–management relations are important to a business.
2. Define 'collective bargaining'.
3. State **two** benefits to a business of collective bargaining with representatives of the workforce.
4. State **three** possible benefits to a worker from joining a trade union.
5. Would you advise a firm to sign a single-union deal with one particular union? Explain your answer.
6. Would you advise an employer to agree to pendulum arbitration when attempting to settle a pay dispute with a trade union? Explain your answer.
7. Why would a union sign a no-strike deal with employers? What would it expect in return?
8. There is an industrial dispute between the managers and the employees' trade union of a large hotel in your town/city. Discuss the factors that will influence whether the final agreement to settle the dispute is a better deal for the employer or employees.
9. Explain why senior managers in a multinational business should be aware of culture as an influence on employee relations.
10. Explain how ethical considerations can influence employer–employee relations in a business.

Exam practice question

SINGLE GLOBAL SUPER UNION WITHIN A DECADE?

An international trade union could be created within a decade, the leader of one of Europe's biggest trade unions has declared. The UK union Amicus has signed solidarity agreements with IG Metall in Germany and two unions in the USA. It is looking for agreements with other unions in other countries.

The general secretary of Amicus said, 'Our aim is to create a powerful single union that will cross international boundaries to challenge the global forces of capital. It will increase the collective bargaining power of unions.'

Trade union leaders are worried by the growth of globalisation that has weakened their power and reduced their membership. Because employers can now easily transfer production to low-cost countries, the unions' power to bargain and negotiate higher pay deals has been much weakened. The answer, according to Amicus, is to 'globalise trade unions' too. A single global union would be able to negotiate with multinationals on behalf of members throughout the world and this might prevent worker exploitation in very low-wage economies.

The general secretary added, 'Our aim is to match up to globalised industry. We will force multinational companies to sign deals with one single international union. This will stop them making changes to workers' pay and rights in one country without consulting unions elsewhere.'

20 marks, 40 minutes

1. Define the term 'single-union agreement'. [2]
2. Explain how a trade union's members might benefit from collective bargaining. [4]
3. Analyse a potential benefit to employees and a benefit to employers of a 'globalised union'. [4]
4. Evaluate how multinational companies might be affected by the development of one large international trade union. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, evaluate the importance of ethics and change in employee and employer relations. [20]

Unit

3

FINANCE AND ACCOUNTS

3.1

Sources of finance

On completing this chapter you should be able to:

Know and understand:

- Short-, medium- and long-term finance (AO1)

Analyse and apply:

- Role of finance for businesses: capital expenditure; revenue expenditure
- Internal sources of finance (AO2)
- External sources of finance (AO2)

Evaluate:

- The appropriateness of sources of finance for a given situation (AO3)

Setting the scene

TWO BUSINESSES – BOTH NEED FINANCE

There are many differences between Haldia Petrochemicals Ltd (HPL) and the six Khadki villagers who plan to build private water wells. However, there are two similarities – they are both situated in India and they both require finance. HPL is a large company that has operated at a loss for several years. It needed finance quickly to prevent the business from collapsing. Finance proposals include converting loans into shares (reducing interest payments) and selling more shares to existing shareholders (a rights issue). The latter option was chosen and 520 million shares were issued at 25.10 Rupees each.

The six Khadki villagers needed finance to dig water wells. These would have a social benefit as well as being potentially profitable. Although poor, they each saved Rupees 100 per month for a year. Their request for a loan of Rupees 25 000 was rejected by a commercial bank, as the villagers had no collateral (they had no property of value themselves). However they obtained the loan from a micro-finance bank. The interest rate was 6% per year. They repaid the loan within two years and they have since returned to borrow bigger amounts to finance even deeper wells. Without this 'micro-finance' their business would not have been started.

Points to consider

- Explain the different financial needs in these two cases.
- Why were commercial banks unwilling to lend money in both cases?
- Explain the two different sources of finance used.

Key concept link

Selecting appropriate sources of finance is an important strategic choice for businesses. Selecting inappropriate sources can impact on ownership and control and the ability of managers to meet the needs and wants of stakeholders.

Introduction

Finance is required for many business activities. Below are some examples:

- Setting up a business will require **start-up capital** of cash injections from the owner(s) to purchase essential capital equipment and, possibly, premises.
- Businesses need to finance their **working capital** – the day-to-day finance needed to pay bills and expenses and to build up stocks.
- Business expansion needs finance to increase the capital assets held by the firm – and, often, expansion will involve higher working capital needs.
- Expansion can be achieved by taking over other businesses. Finance is then needed to buy out the owners of the other firm.
- Special situations will often lead to a need for greater finance. A decline in sales, possibly as a result of economic recession, could lead to cash needs to keep the business stable; or a large customer could fail to pay for goods, and finance is quickly needed to pay for essential expenses.
- Apart from purchasing fixed assets, finance is often used to pay for research and development into new products or to invest in new marketing strategies, such as opening up overseas markets.

start-up capital: capital needed by an entrepreneur to set up a business

working capital: the capital needed to pay for raw materials, day-to-day running costs and credit offered to customers. In accounting terms: working capital = current assets – current liabilities

Some of these situations will need investment in the business for many years. Others will need only short-term funding – for around one year or less. Some finance requirements of the business are for between one and five years – medium-term finance. The important point to note about the list above is that all of these situations will need different types of finance. In practice, this means that no one source or type of finance is likely to be suitable in all cases.

Capital expenditure and revenue expenditure

Capital expenditure is the purchase of assets that are expected to last for more than one year, such as buildings and machinery. Revenue expenditure is spending on all costs and assets other than fixed assets and includes wages and salaries and materials bought for stock. These two types of spending will be financed in different ways as the length of time that the money is 'tied up' will be very different.

Sources of finance

This section deals initially with sources of finance for limited companies – and then considers sole traders and partnerships. Companies are able to raise finance from a wide range of sources. It is useful to classify these into **internal** and **external** sources.

internal finance: raised from the business's own assets or from profits left in the business (ploughed-back or retained profits)

external finance: raised from sources outside the business

Another classification is also often made, that of short-, medium- and long-term finance. The time period refers to the length of time that the finance is needed/used for. Short term is up to one year, medium term is one to five years and long term is more than five years. This distinction is made clearer by considering Figure 3.1.1.

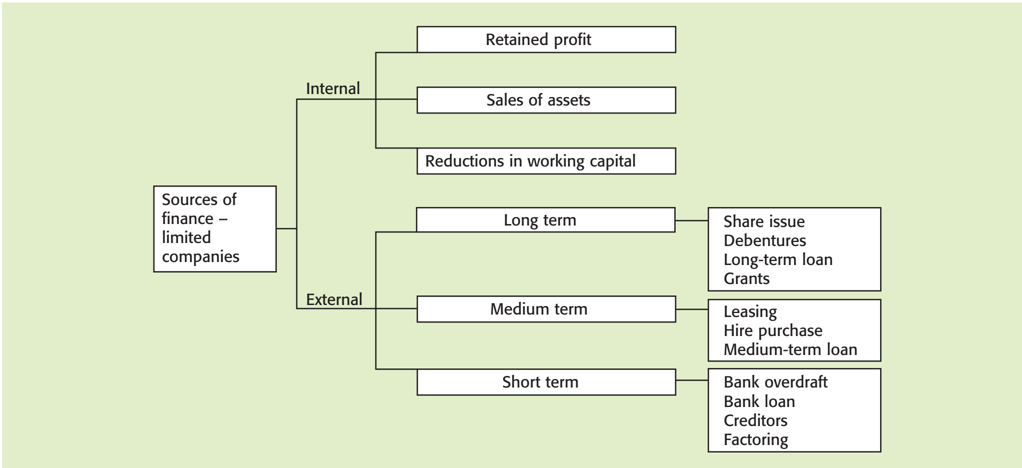


Figure 3.1.1 Sources of finance for limited companies

Exam tip: Do not assume that a profitable business is cash rich – and that it can use all of its profits as a source of finance for future projects. In practice, profits are often 'tied up' in money owed to the business by debtors or have been used to finance increased stocks or replace equipment.

Internal sources of finance

Personal finds (for sole traders)

Owner's savings are a commonly used source of finance for sole-trader businesses – especially for starting up new businesses. If the sole trader finances the business from his/her own resources it adds to the business risk for the entrepreneur. It also means that the finances of the firm, at least initially, are limited to the amount the owner has in the form of savings. Advantages of using this source include the lack of interest payments (although interest might be given up as an opportunity cost if the owner's savings were held in a bank account) and the control the owner has over the business, being the sole or main source of finance.

retained profit: the profit left after all deductions, including dividends, have been made; this is 'ploughed back' into the company as a source of finance

Profits retained in the business

If a company is trading profitably, some of these profits will be taken in tax by the government (corporation tax) and some is nearly always paid out to the owners or shareholders (dividends). If any profit remains, it is kept in the business and this **retained profit** 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 profits are a very significant source of funds for expansion – invested back into the business, these retained profits will not be paid out to shareholders, so they represent a permanent source of finance.

Coca-Cola finances most of its global expansion from retained profits

Sale of assets

Established companies often find that they have assets that are no longer fully employed. These could be sold to raise cash. In addition, some businesses will sell assets that they still intend to use, but which they do not need to own. In these cases, the assets might be sold to a leasing specialist and leased back by the company. This will raise capital – but there will be an additional fixed cost in the leasing and rental payment.

In 2014 the struggling smartphone manufacturer, Blackberry, considered the sale of property assets to raise finance to help the business over a difficult trading period caused by its loss of market share to iPhones and Android phones.

HSBC, a large international bank, recently sold its huge London headquarters for $2 billion, but will stay in the building and lease it back from the new owners – at an annual rent of $80 million.

Managing working capital more efficiently

When businesses increase stock levels or sell goods on credit to customers (debtors), they use a source of finance. When companies reduce these assets – by reducing their working capital – capital is released, which acts as a source of finance for other uses. There are risks in cutting down on working capital, however. Managing working capital by cutting back on current assets by selling stocks or reducing debts owed to the business may reduce the firm's **liquidity** – its ability to pay short-term debts – to risky levels.

liquidity: the ability of a firm to pay its short-term debts

Exam tip: Do not make the mistake of suggesting that selling shares is a form of internal finance for companies. Although the shareholders own the business, the company is a separate legal unit and, therefore, the shareholders are 'outside' it.

Internal sources of finance – an evaluation

This type of capital has no direct cost to the business, although there may be an opportunity cost, and if assets are leased back after being sold, there will be leasing charges. Internal finance does not increase the liabilities or debts of the business. There is no risk of loss of control by the original owners as no shares are sold. However, it is not available for all companies, for example newly formed ones or unprofitable ones with few 'spare' assets. Solely depending on internal sources of finance for expansion can slow down business growth, as the pace of development will be limited by the annual profits or the value of assets to be sold. Thus, rapidly expanding companies are often dependent on external sources for much of their finance.

External sources of finance

Short-term finance

There are three main sources of short-term external finance:

- bank **overdrafts**
- trade credit
- debt factoring.

overdraft: bank agrees to a business borrowing up to an agreed limit as and when required

Bank overdrafts

A bank overdraft is the most 'flexible' of all sources of finance. The amount of finance 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 writing cheques 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 firm 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 stocks 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 may lead to business failure.

Trade credit

By delaying the payment of bills for goods or services received, a business is, in effect, obtaining finance. Its suppliers, or creditors, are providing goods and services without receiving immediate payment. Many businesses aim to pay their suppliers within one to two months. Further lengthening of this trade credit period becomes, in effect, a source of finance for the debtor business. The downside to these periods of credit is that they are not 'free' – discounts for quick payment and supplier confidence are often lost if the business takes too long to pay its suppliers.

Debt factoring

When a business sells goods on credit, it creates a debtor. The longer the time allowed to this debtor to pay, the more finance the business has to find to carry on trading. One option is to sell these claims on debtors 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.

debt-factoring: selling of claims over debtors to a debt factor in exchange for immediate liquidity; only a proportion of the value of the debts will be received as cash

Medium-term finance

There are two main sources of medium-term external finance:

- hire purchase and leasing
- medium-term bank loan.

Hire purchase and leasing

These methods are often used to obtain fixed assets with a medium life span – one to five years. **Hire purchase** 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.

Leasing involves a contract with a leasing or finance company to acquire, but not necessarily to purchase, assets over the medium term. A periodic payment is made over the life of the agreement, but the business does not have to purchase the asset at the end. This agreement allows the firms to avoid 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. Neither hire purchase nor leasing is a cheap option, but they do improve the short-term cash-flow position of a company compared to outright purchase of an asset for cash.

hire purchase: an asset is sold to a company which agrees to make fixed repayments over an agreed time period; the asset belongs to the company

leasing: obtaining the use of equipment or vehicles and paying a rental or leasing charge over a fixed period. This avoids the need for the business to raise long-term capital to buy the asset; ownership remains with the leasing company

ACTIVITY 3.1.1

In each of the following cases, explain briefly why internal sources of finance might be unavailable or inadequate:

a. Business A needs to pay creditors after a period of making losses and the value of its assets has fallen

b. Business B has expanded rapidly, which requires expenditure several times greater than current profits

c. A retailing business purchases additional inventories (stocks) just before a major national festival.

Long-term finance

The two main choices here are debt or **equity finance**. Debt finance increases the liabilities of a company. Debt finance can be raised in two main ways:

- **long-term loans** from banks
- debentures (also known as loan stock or corporate bonds).

equity finance: permanent finance raised by companies through the sale of shares

long-term loans: loans that do not have to be repaid for at least one year

Long-term loans from banks

These 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.

ACTIVITY 3.1.2

EIB LOANS €30 MILLION FOR RESEARCH AND DEVELOPMENT IN AERONAUTICS

A French company specialising in high-precision screws and other fasteners for the aeronautical industry has applied for – and been granted – a massive €30 million loan by the European Investment Bank. The capital will be used to finance a long-term research and development project at the group's headquarters near Paris to design new fasteners using lighter and stronger materials. It was thought that, with interest rates falling due to the global downturn and share prices also very volatile and uncertain, this form of finance was the best one to use at this time. Investors in shares are understandably nervous at the present time with uncertain share prices but also with research and development projects in particular, which can take years before they see any profit returned to the business.

Source: http://bulletin.sciencebusiness.net

16 marks, 32 minutes

1. Outline the difference between internal and external sources of finance. [2]
2. Explain **one** source of internal finance that could be available to the company in the case study trying to raise finance. [4]
3. Evaluate whether loan capital was the best source of finance for this company for this project. [10]

LEARNER PROFILE

Inquirers

A survey of business owners shows that among the smallest businesses (those with less than $5 million in revenue) that sought a bank loan in the previous three months only 39% were successful. It continues to be harder for smaller businesses to get bank loans than it is for larger firms.

The survey found the top reason banks rejected a business loan application was the quality of the applicant's profits and cash flow. Insufficient collateral and high debt level were the next most common reasons.

Source: www.forbes.com

Imagine you are a bank manager and a small business approaches you for a loan.

As an inquirer, deciding whether to make the business a loan, what information would you look for?

In this lending situation, is there a conflict between the inquiring bank manager and the caring bank manager?

It is more difficult for smaller businesses to get bank loans than it is for larger firms

Debentures

A company wishing to raise funds will issue or sell these 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 do not wish to wait until maturity before getting their original investment back. Debentures are usually not 'secured' on a particular asset. When they are secured the debentures are known as mortgage debentures. Debentures can be a very important source of long-term finance – in 2013 alone, Coca-Cola Inc. issued loan stock amounting to US$7500 million. Convertible debentures can be, if the borrower wishes, switched into shares after a certain period of time and this means that the company issuing them will never have to pay the debenture back.

debentures or long-term bonds: bonds issued by companies to raise debt finance, often with a fixed rate of interest

Sale of shares – equity finance

All limited companies issue shares when they are first formed. The capital raised will be used to purchase essential assets. Both private and public limited companies are able to sell further shares – up to the limit of their authorised share capital – in order to raise additional permanent finance. This capital never has to be repaid unless the company is completely wound up 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 the same 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 would obviously have the potential to raise much more capital than from just the existing shareholders – but with the risk of some loss of control to the new shareholders.

In the UK, this can be done in two ways and these are quite typical for many countries:

- Obtain a listing on the Alternative Investment Market (AIM), which is that part of the London 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 London 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:
  - Public issue by prospectus – this advertises the company and its share sale to the public and invites them to apply for the new shares. This is expensive, as the prospectus has to be prepared and issued. The share issue is often underwritten or guaranteed by a merchant bank, which charges for its services.
  - Arranging a placing of shares with institutional investors without the expense of a full public issue – once a company has gained plc status, it is still possible for it to raise further capital by selling additional shares. This is often done by means of a **rights issue** of shares.

rights issue: existing shareholders are given the right to buy additional shares at a discounted price

By not introducing new shareholders, the ownership of the business does not change and the company raises capital relatively cheaply as no public promotion or advertising of the share offer is necessary. However, as the rights issue increases the supply of shares to the stock exchange, the short-term effect is often to reduce the existing share price, which is unlikely to give existing shareholders too much confidence in the business if the share price falls too sharply.

Debt or equity capital – an evaluation

Which method of long-term finance should a company choose? There is no easy answer to this question, and, as seen above, some businesses will use both debt and equity finance for very large projects.

Debt finance has the following advantages:

- As no shares are sold, the ownership of the company does not change and is not 'diluted' by the issue of additional shares.
- Loans will be repaid eventually (apart from convertible debentures), so there is no permanent increase in the liabilities of the business.
- Lenders have no voting rights at annual general meetings.
- Interest charges are an expense of the business and are paid out before corporation tax is deducted, while dividends on shares have to be paid from profits after tax.
- The gearing of the company increases and this gives shareholders the chance of higher returns in the future. This point is dealt with more fully in Chapter 3.6 (see page 292).

Equity capital has the following advantages:

- It never has to be repaid – it is permanent capital.
- Dividends do not have to be paid every year. In contrast, interest on loans must be paid when demanded by the lender.

Other sources of long-term finance

Grants

There are many 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 'strings 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.

Venture capital

Small companies that are not listed on the stock exchange can gain long-term investment funds from **venture capitalists**. These specialist organisations are prepared to lend risk capital to business start-ups or purchase shares in them. In addition, venture capitalists can provide finance to small to medium-sized businesses that might find it difficult to raise capital from other sources. This could be because of risks of the business. These risks could come from the new technology that the company is dealing in or the complex research it is planning, in which other providers of finance are not 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 certain 'high-tech' businesses has grown rapidly and many were financed, at least in part, by venture capitalists. Venture capitalists generally expect a share of the future profits or a sizeable stake in the business in return for their investment and this can mean that a successful business start-up, if it develops into a large company, will always have some control exercised over it by the original venture capitalist.

venture capital: risk capital invested in business start-ups or expanding small businesses, which have good profit potential, but do not find it easy to gain finance from other sources

Business angels

These should not be confused with venture capitalists although they perform a very similar finance function. **Angels** are wealthy individuals but venture capitalists are specialist institutions.

business angels: individual investors who put in their own money in a variety of businesses and are seeking a better return than they would obtain from conventional investments

Most of these are successful business people who would like to help other entrepreneurs start their own business. Generally they offer a link from the initial stage of the business and carry on to the point at which the business would require a greater level of funding than the business angel investors could offer.

Advantages of business angel investors

- The business angel investor can easily make an investment decision without difficult assessments. However, there will still be a need to draw up a professional and tailored business plan.
- The personal experience of these investors helps the business when taking critical decisions. Their prior knowledge of working in a small business or running their own business establishments can be utilised effectively.
- Angels usually concentrate their investments within a small geographical area hence have a better local knowledge.

Disadvantages of business angel investors

- Angel investors will want to share ownership and will require a certain part of the profit of the business. While to most entrepreneurs, this is more than compensated for by the finance and experience of the angels, to some entrepreneurs any loss of ownership would be resisted at all costs.
- Business owners still need to gain investors' trust. They might have to 'pitch' to get the funding they need – present, in person, the plans for the business and what benefits the angel is likely to receive from the investment.

THEORY OF KNOWLEDGE

A suitcase on wheels for kids to ride on

In 2006 entrepreneur Rob Law went on the reality TV programme *Dragon's Den*. The theme of the programme is entrepreneurs trying to raise money from a panel of business angels (venture capital) based on the potential of the entrepreneur's business proposition.

Rob Law's idea was luggage that was adapted for children to fulfil a luggage function but also to be fun for the children when travelling with their parents on holidays. Trunki's products were brightly coloured to attract children. They also had wheels and were shaped so children could ride on them.

In the end the Dragons did not back Trunki with their finance and Rob Law walked away without any funding. Since then, the business has sold over 1 300 000 Trunki suitcases in 1564 stores in 62 countries. Trunki has also won more than 50 product and design awards, cashing in on the Olympics with a 2012 London Olympics themed version of the children's suitcase.

Imagine you were faced with an idea like Trunki and had the opportunity to buy into a new company. Consider how reason, emotion and intuition would influence your decision to buy into the company.

Subsidies

Governments or groups of governments – such as the European Union – often provide financial support to businesses to allow a reduction in costs and to encourage increased output. **Subsidies** are most commonly offered to businesses which:

- might otherwise fail causing significant unemployment and regional imbalances
- need assistance to start up due to high costs or high risk of failure
- produce strategically important products e.g. agriculture
- need help to reduce costs to remain competitive against foreign rivals.

subsidies: financial benefits given by the government to a business to reduce costs and encourage increased production

Subsidies are criticised by 'free-market' economists as encouraging inefficiency as businesses do not have to pay the full costs of their operations. It is also argued that they might lead to poor allocation of resources if subsidies are paid from taxes on successful, profitable businesses that, as a result, have less capital for investment. Businesses should avoid becoming dependent on subsidies as they might be reduced or withdrawn due to government policy changes.

Exam tip: When answering case study examination questions, you should analyse what type of legal structure the business has and what sources of finance are available to it. Unincorporated businesses – sole traders and partnerships – cannot issue shares, for example.

ACTIVITY 3.1.3

SUBSIDIES FOR INDIAN LEATHER INDUSTRY

This scheme is aimed at enabling existing tanneries, footwear, footwear components and leather products units to:

- upgrade equipment leading to productivity gains
- increase capacity
- increase spending on design and development
- become more competitive against foreign companies.

The financial assistance offered by the scheme will include:

- investment grants of 30% of cost of plant and machinery
- Rs 5 million for technology upgrades/modernisation and/or expansion and setting up a new unit.

EUROPEAN FARM SUBSIDIES

In 2013 the European Union spent €60 billion on subsidies to European farmers. The main subsidy is called the 'Single Farm Payment' paid to all farmers in the EU. It is a large proportion of income for many farmers, who say they could not continue in business without subsidies. However, farm subsidies in developed countries push down food prices and impoverish farmers in undeveloped countries.

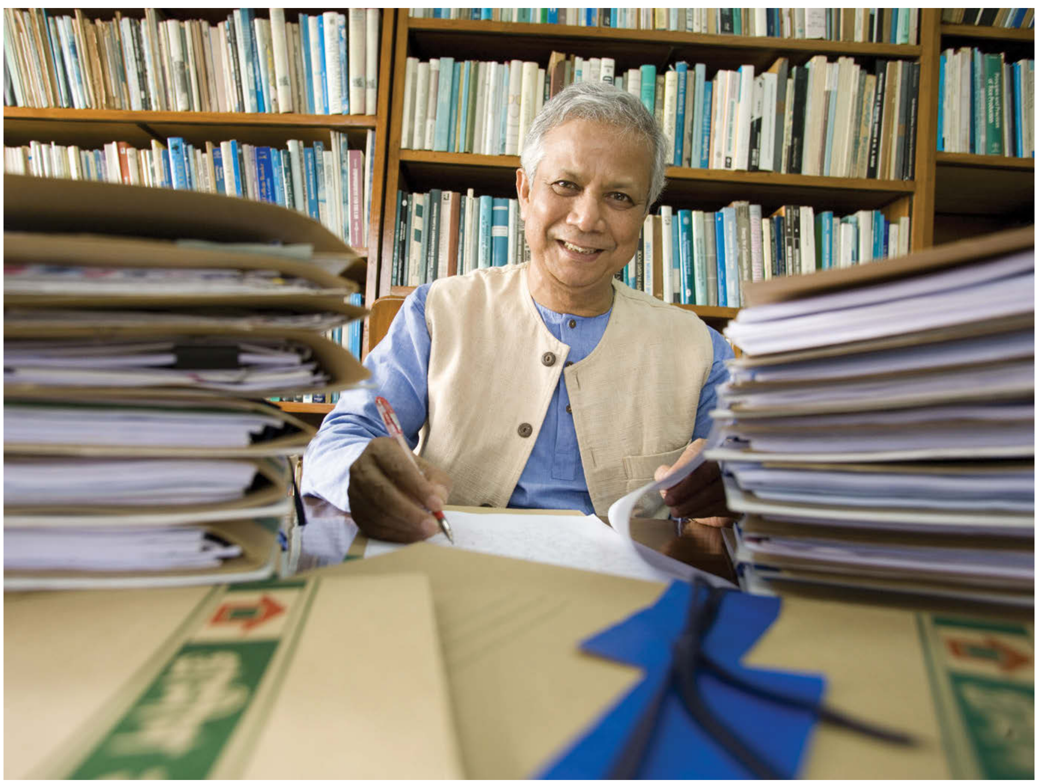
8 marks, 16 minutes

1. Explain **one** benefit of subsidies to Indian leather businesses and EU farmers. [4]
2. Explain why it might be unwise for such businesses to depend on these subsidies for their survival. [4]

Microfinance

This approach to providing small capital sums to entrepreneurs has grown in importance in recent years. In 1974, an economics lecturer at the University of Chittagong, Bangladesh, lent $27 to a group of very poor villagers. Not only did they repay this loan in full after their business ideas had been successful, but it led to the lecturer, Muhammad Yunus, eventually 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 over six million Asian people, many of whom have set up their own very small enterprises with the capital.

microfinance: the provision of very small loans by specialist finance businesses, usually not traditional commercial banks



Muhammad Yunus, founder of the Grameen Bank, which makes small loans to people with no bank accounts

Many business entrepreneurs in Bangladesh and other Asian countries have received microfinance to help start their business.

Choosing appropriate sources of external finance

Source of finance	Short-, medium- or long-term	Advantages	Disadvantages	Most appropriate for	Least appropriate for
Sale of shares	Long	Permanent capital No interest charges	Some loss of control by original owners Dividends will be expected by shareholders	Long-term expansion of the business Taking over another business	Buying inventories (stocks) Temporary increase in working capital needs
Sale of debentures	Long	Fixed interest paid	Must be repaid at end of term Interest payable has to be competitive	Long-term uses such as expansion or purchase of equipment expected to last several years	Short-term financing needs, e.g. paying for unforeseen maintenance
Leasing	Medium	Gives business full use of an asset without need to finance purchase	Asset is never owned/purchased Expensive	Vehicles Equipment Computers	Major expansion or takeover project
Debt factoring	Short	Releases liquidity from accounts receivable (debtors)	The full value of accounts receivable will not be recouped by the business	Short-term liquidity needs such as financing increase in sales on credit	Major expansion or takeover project Purchase of equipment
Bank overdraft	Short	Flexible amount can vary with daily needs	High interest Bank can call in overdraft if they are concerned about liquidity of the business	When the amount of finance needed varies on a regular basis, e.g. daily expenses might exceed daily cash revenue	Major expansion or takeover project Purchase of equipment (too expensive)
Subsidies	Time period fixed by government	No interest No repayment	Can be withdrawn at short notice, e.g. change of government	To make production of a product viable that would otherwise be unprofitable	Financing a long-term commitment of the business – because the subsidy could be withdrawn
Venture capital	Long	Provides finance when other sources might not be available due to risk	Some loss of ownership Share of profits payable to venture capitalists	To finance a relatively risky business start-up or expansion of a recently formed business	A profitable family business in which the family owners want to retain full control
Ten-year bank loan	Long	Fixed interest (usually)	Interest payments must be made on time or 'security assets' might be sold	Finance expansion that is expected to lead to higher revenue to allow for the loan to be repaid in the time limit agreed with the bank, e.g. new factory	Purchasing an increase in inventories to meet expected demand over a festival period
Trade credit	Short	Finances purchase of inventories with no interest costs	May be loss of discounts for rapid payment of invoices	To finance an increase in inventory held or sales – especially when the sales are on credit and cash will not be received quickly	Purchasing land on which to build an extension to the factory or offices of the business

Table 3.1.1 Advantages and disadvantages of different sources of finance

ACTIVITY 3.1.4

TATA RIGHTS ISSUE LEADS TO FALL IN SHARE PRICE

Shares in India's Tata Motors fell as much as 6.6% as volatile markets raised concerns that investors may reject its huge $885 million rights issue. Shares in India's top vehicle maker have taken a hit on the company's fundraising plans and the grim outlook for the car and commercial vehicles market where demand has slowed right down due to high fuel prices and the global economic slowdown. Some shareholders seem keen to take up the rights issue, but others are wary. They are worried about future share prices if the company's expansion plans are not successful.

Tata Motors has also said that it was looking at selling assets in some subsidiaries to raise capital, and independent investment analysts say that this is preferable to diluting ownership equity by the rights issue method. The company is offering one new ordinary share for Rupees 340 for every six currently held by shareholders. The capital raised will be used to pay off the loans taken out by Tata when it purchased Jaguar and Land Rover for $2.3 billion from Ford.

Source: http://uk.reuters.com

16 marks, 32 minutes

1. Define the term 'rights issue'. [2]
2. Explain why Tata used a rights issue of shares rather than continuing to use long-term loans. [4]
3. Evaluate the impact of Tata's decision to raise new finance through a share issue on different stakeholders in the organisation. [10]

Exam tip: You should be able to recommend appropriate sources of finance for businesses needing capital in different situations.

Making the financing decision – factors to consider

The size and profitability of the business are clearly key considerations when managers make a financing choice. Small businesses are unlikely to be able to justify the costs of converting to plc status. They might also have limited internal funds available if the existing profit levels are low. These and other factors that are considered before making the financing choice are analysed in Table 3.1.2.

Factor influencing finance choice	Significance
Use and time period for which finance is required	• It is very risky to borrow long-term finance to pay for short-term needs. Businesses should match the sources of finance to the requirement. • Permanent capital may be needed for long-term business expansion. • Short-term finance would be advisable to finance a short-term need to increase stocks or pay creditors.
Cost	• Obtaining finance is never 'free' – even internal finance may have an opportunity cost. • Loans may become very expensive during a period of rising interest rates. • A stock market flotation can cost millions of dollars in fees and promotion of the share sale.
Amount required	• Share issues and sales of debentures, because of the administration and other costs, would generally only be used for large capital sums. • Small bank loans or reducing debtors' payment period could be used to raise small sums.

Table 3.1.2 Factors to be considered in making the 'source of finance' decision [*table continues over*]

Factor influencing finance choice	Significance
Legal structure 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. Doing this runs the risk of the current owners losing some control – except if a rights issue is used. • If the owners want to retain control of the business at all costs, then a sale of shares might be unwise.
Size of existing borrowing	• This is a key issue – the higher the existing debts of a business (compared to its size), the greater the risk of lending more. Banks and other lenders will become anxious about lending more finance. • This concept is referred to as gearing and is fully covered in Chapter 3.6 (see page 292).
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 3.1.2 *Continued*

ACTIVITY 3.1.5

TELKONET RAISES $3.5 MILLION BY SALE OF DEBENTURES

Telkonet Inc., the provider of energy management systems, has arranged to sell $3.5 million of 13% three-year debentures. The company plans to use the finance to cover working capital needs and to invest in expansion of its range of products. The announcement was made as world share prices recorded another bad day with further falls in most of the major indices.

Source: Adapted from http://findarticles.com

CURAGEN RAISES $125 MILLION FROM THE SALE OF CONVERTIBLE DEBENTURES

This drug research and development company has issued $125 million of convertible debentures. The capital raised will be used to finance further long-term research into genomics-based drugs for medical purposes. The debentures offer a fixed 6% per year and are convertible into CuraGen's shares in seven years' time at a conversion price of $127 per share.

Source: http://bulletin.sciencebusiness.net

14 marks, 28 minutes

1. Define the terms:
   - **a.** convertible debentures [2]
   - **b.** working capital. [2]
2. Evaluate the benefits of raising long-term finance through selling debentures. [10]

OVER TO YOU

Revision checklist

1. State **three** examples of business situations that require additional finance.
2. Outline **two** ways in which businesses can raise finance from internal sources.
3. Explain the difference between long- and short-term finance.
4. Why might a new business find it difficult to raise external finance?
5. What is trade credit and why is it a source of finance?
6. Discuss whether a business would find debt factoring a suitable form of finance.
7. State **two** drawbacks to long-term loan finance.
8. Why might the managers of a private limited company be reluctant to apply for public limited company status for the business, despite the prospect of additional finance?
9. Why might a firm decide to lease new equipment rather than to purchase it outright?
10. Why is the management of working capital important to a firm's survival?
11. Examine the case for a company using a rights issue of shares rather than a full public offer of shares.
12. Why is increasing the long-term loans of a business beyond a certain level often described as being 'risky'?
13. State **two** factors that a manager should consider before deciding between loan and share capital to raise additional long-term finance.
14. Discuss the importance of the two factors you identified in question 13 in detail.
15. What information is a business angel likely to request before investing in a new business?
16. Explain **one** drawback to an entrepreneur of accepting finance from either a venture capitalist or a business angel.
17. Explain **two** reasons why a government might give subsidies to a business.

Exam practice question

STARJET TAKES OFF TO $3.42 SHARE PRICE

Shares in StarJet, the region's second-largest low-cost airline, performed strongly on its first day of trading as a public limited company yesterday, rising 10% to $3.42. The offering was priced at $3.10 a share with the issue of 63 million shares raising $195 million. The public issue of shares represented about 25% of the enlarged share capital. The stake held by Stavros, the founder and chairman of the company, is now valued at about $328 million. Stavros and his brother and sister still control a stake of about 75% in StarJet.

Investment bankers said the issue attracted strong interest. The performance of the shares has been helped by the strong rise in the share price of other 'low-cost' airlines and this has encouraged investors to buy into StarJet. Capital raised from the share issue will mainly be used to purchase new aircraft as part of the airline's plans for a rapid expansion during the next four years, which includes the addition of 32 new Boeing 787s, more than doubling the size of the fleet. Some of the capital raised will be used to pay back some of StarJet's substantial debts.

24 marks, 48 minutes

1. Define what is meant by the following terms:
   a. public limited company [2]
   b. share price. [2]
2. a. Calculate the share price on the second day of trading if it is increased by a further 15%. [2]
   b. Explain why the share prices of StarJet might continue to increase in future. [4]
3. Analyse why Stavros might be reluctant to sell a further 63 million shares in StarJet to raise additional capital. [4]
4. If StarJet planned to take over another airline in several years' time, evaluate the most appropriate sources of finance that the business could use. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, examine the impact ethics and culture have on raising finance. [20]

3.2

Costs and revenues

On completing this chapter you should be able to:

Analyse and apply:

- Different types of costs (AO2)
- Total revenue and revenue streams (AO2)

Setting the scene

CUTTING COSTS TO INCREASE PROFITS

Three important international businesses have recently announced cost reductions that will increase the chances of them making profits. Despite disappointing sales trends at its stores due to less consumer spending, Gap has reported an increase in quarterly net profit. This is the result of cost cuts – it is holding less stock, so variable costs are lower and fixed operational expenses such as management salaries have also been cut back.

Vodafone aims to save nearly $2 billion in costs after reporting a poor six-monthly performance. The mobile phone operator said UK profits over this period had halved to about $260 million. Jobs will be cut in the company. It will also spend less on promotion chasing new customers – it will instead focus on trying to get existing customers to use their phones more. This is a cheaper method of promotion.

Ryanair, Europe's leading low-cost operator, announced that it would just break even this year – no loss but no profit either – if the oil price stays below $100 a barrel. The recent fall in the price of oil – a huge variable cost for all airlines – means that Ryanair will not be forced to increase fares again.

Points to consider

- Using these cases, why is it important for a business to be able to identify and calculate its costs?
- Why do you think it is important for a company to cut costs during periods of low sales?
- Using Gap as a starting point, explain which are likely to be the easiest types of costs for a business to cut back on.
- If oil prices increased again, would you advise Ryanair to increase passenger fares to try to raise revenue? Explain your answer.

Key concept link

Planning new strategies must include an assessment of their likely costs and revenues. Delegating authority and accountability to managers of each profit/cost centre for the revenues earned and the costs incurred is common practice in business organisations. This helps to create a performance culture within the business. Is there a danger that this could lead to unethical business practices by managers who aim to ensure that their profit centre is a top performer?

Introduction

Management decisions can cover a wide range of issues and they require much information before effective strategies can be adopted. These business decisions include location of the operations, which method of production to use, which products to continue to make and whether to buy in components or make them within the business. Such decisions would not be possible without cost data. Here are some of the major uses of cost data:

- Business costs are a key factor in the 'profit equation'. Profits or losses cannot be calculated without accurate cost data. If businesses do not keep a record of their costs, then they will be unable to take profitable decisions, such as where to locate.
- Cost data are important to departments such as marketing. Marketing managers will use cost data to help inform their pricing decisions.
- Keeping cost records also allows comparisons to be made with past periods of time. In this way, the efficiency of a department or a product's profitability may be measured and assessed over time.
- Past cost data can help to set budgets for the future. These will act as targets to work towards for the departments concerned.
- Cost variances can be calculated by comparing cost budgets with actual data.
- Comparing cost data can help a manager make 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.
- Calculating the costs of different options can assist managers in their decision-making and help improve business performance.

LEARNER PROFILE

Caring

As a carer you 'show empathy, compassion and respect towards the needs and feelings of others.' You have a personal commitment to service, and act to make a positive difference to the lives of others and to the environment.'

Discuss with your class the following question: Can you be a 'carer' if you work for an organisation that grows its revenues in any of the following markets: alcohol, tobacco, fast food, firearms, coal-fired energy?

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 and allocating costs to each product is not usually very straightforward in a business with more than one product. Some costing methods require this allocation to be made, some do not.

Before we can begin to use cost data to assist in making important decisions, it is important to understand the different cost classifications. The most important categories are:

- **direct costs**
- indirect/overhead costs
- fixed costs
- variable costs
- semi-variable costs.

direct costs: these costs can be clearly identified with each unit of production and can be allocated to a cost centre

Direct costs

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. Examples are:

- One of the direct costs of a hamburger in a fast-food restaurant is the cost of the meat.
- One of the direct costs for a garage in servicing a car is the labour cost of the mechanic.
- One of the direct costs of the business studies department is the salary of the business studies teacher.

Indirect costs

indirect costs: costs which cannot be identified with a unit of production or allocated accurately to a cost centre – also known as overhead costs

Indirect costs are often referred to as overheads. Examples of indirect costs include:

- the purchase of a tractor for a farm
- promotional expenditure in a supermarket
- the rent towards a garage
- the cost of cleaning a school.

Overheads are usually classified into four main groups:

- Production overheads – these include factory rent and rates, depreciation of equipment and power.
- Selling and distribution overheads – these include warehouse, packing and distribution costs and salaries of sales staff.
- Administration overheads – these include office rent and rates, clerical and executive salaries.
- Finance overheads – these include the interest on loans.

Nuclear power station in France – indirect costs are a very high proportion of total costs in electricity generation by nuclear power

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** – these remain fixed no matter what the level of output, such as rent of premises. If a retail shop sold no items at all in one trading day, the costs of the shop such as rent and property tax would still have to be paid for that day. If the shop sold 1000 items, these costs would not change.
- **Variable costs** – these vary as output changes, such as the direct cost of materials used in making a washing machine or the electricity used to cook a fast-food meal. If nothing is produced or sold then variable costs will be zero.
- **Semi-variable costs** – these include both a fixed and a variable element, e.g. the electricity standing charge plus cost per unit used; sales person's fixed basic wage plus a commission that varies with sales.

fixed costs: costs that do not vary with output in the short run

variable costs: costs that vary with output

semi-variable costs: costs that have both a fixed and a variable cost element

ACTIVITY 3.2.1

THE CHALLENGE OF CUTTING COSTS

Dakota Inc. is a medium-sized footwear manufacturer. Its CEO is concerned about cost control and feels that both direct and indirect costs can be reduced to increase profit margins. There is, however, significant resistance to cost-cutting measures from the unions that represent Dakota's 200-strong workforce. Dakota's sales people are keen on any cost reduction which could lead to a cut in prices and the chance to increase sales.

16 marks, 32 minutes

1. State **two** examples of overhead/indirect costs Dakota would have. [2]
2. State **two** examples of direct costs Dakota would have. [2]
3. Explain why overhead/indirect costs are often considered to be fixed costs. [4]
4. Analyse **two** problems Dakota might encounter when trying to reduce its direct labour cost. [4]
5. Explain **two** benefits Dakota might derive from a reduction in costs. [4]

ACTIVITY 3.2.2

CLASSIFYING COSTS

The management of a furniture-manufacturing firm is trying to classify the costs of the business to help in future decision-making. It makes a range of wooden tables and chairs. You have been asked to assist in this exercise.

1. Classify these costs by ticking the appropriate boxes in the following table.
2. Explain why you have classified these costs in the way you have.

Cost	Direct	Indirect	Fixed	Variable
Rent of factory				
Management salaries				
Electricity				
Piece-rate labour wages of production staff				
Depreciation of equipment				
Lease of company cars				
Wood and other materials used in production				
Maintenance cost of special machine used to make one type of wooden chair				

revenue: the income received from the sale of a product

total revenue: total income from the sale of all units of the product = quantity × price

revenue stream: the income that an organisation gets from a particular activity

Revenue

Revenue is *not* the same as cash in a cash flow forecast *unless* all goods have been sold for cash. Revenue is recorded on a firm's accounts whether the cash has been received from the customer/debtor or not. Revenue is *not* the same as profit either. All costs of operating the business during a time period have to be subtracted from **total revenue** to obtain the profit figure. The selling price of a product is the revenue earned from that product. Total revenue can be calculated by multiplying the quantity of products sold by the selling price.

A business may develop a range of trading activities which can all result in **revenue streams**. For example, internet-based businesses could develop the following activities which could all lead to income:

- services requiring a subscription
- advertisement
- transaction fees
- syndication and franchise
- sponsorship and co-marketing.

The benefits of having more than one source of income include:

- it should lead to higher total revenue for the business
- it is a form of diversification, so other incomes could be used at times when one of the business's operations is struggling to gain customers.

The potential drawbacks to developing a range of income-generating activities include:

- Each activity needs to be managed and controlled and this makes more work – and this could be a significant drawback for an entrepreneur or sole trader
- A large number of activities can result in a business losing focus and being less likely to make a success of its central and original business activity
- Accounts need to be kept separate so that each activity's performance can be measured and monitored – this means separate profit centres will need to be established. An IT-based accounting system is likely to be essential.

Businesses may receive income from revenue streams other than their normal operating or trading activities, for example from:

- rent from factory or office space to another business
- dividends on shares held in another business
- interest on deposits held in a bank.

ACTIVITY 3.2.3

FACEBOOK'S NEW REVENUE STREAMS STILL UNDER TESTING

The world's no. 1 internet social network recently reported its strongest revenue growth in several years – up 72% in one year to US$2.5 billion in the first quarter. This news helped to increase the company's share (stock) price by 3% in just one day. However, despite this good news, the company made it clear that other planned revenue streams such as video ads and ads within its Instagram photo-sharing app would not produce much income in the near future. These new activities were still in development and would not make a meaningful contribution to revenue in the next 12 months, Sheryl Sandberg, Facebook's Chief Operating Officer announced. This news disappointed some investors who had expected Instagram to start generating revenue two years after Facebook acquired it for US$1 billion.

PEPSI'S DIVERSIFIED REVENUE STREAMS GIVE IT ADVANTAGE OVER COKE

Although PepsiCo is most commonly recognised for its flagship cola drink, the company has diversified product lines of well-established drinks and foods. Despite losing market share to Coca-Cola in the cola drinks market segment, PepsiCo's revenues continue to grow due to the success of its other products. Sales for snack foods such as Doritos increased by 6% last year and the sales of ready-to-drink teas (Lipton), juices, sport drinks and bottled water all increased as average spending per head on these drinks products increased. Pepsi is also 'leveraging' its Quaker Oats brand by introducing a line of packaged oatmeal cookies and spending US$500 million on promoting Gatorade and Tropicana.

10 marks, 20 minutes

1. Define the term 'revenue stream'. [2]
2. Using PepsiCo and Facebook as examples, explain why it is expensive to develop a range of revenue streams. [4]
3. Analyse **two** benefits to Facebook of developing a range of potential revenue streams based around Instagram. [4]

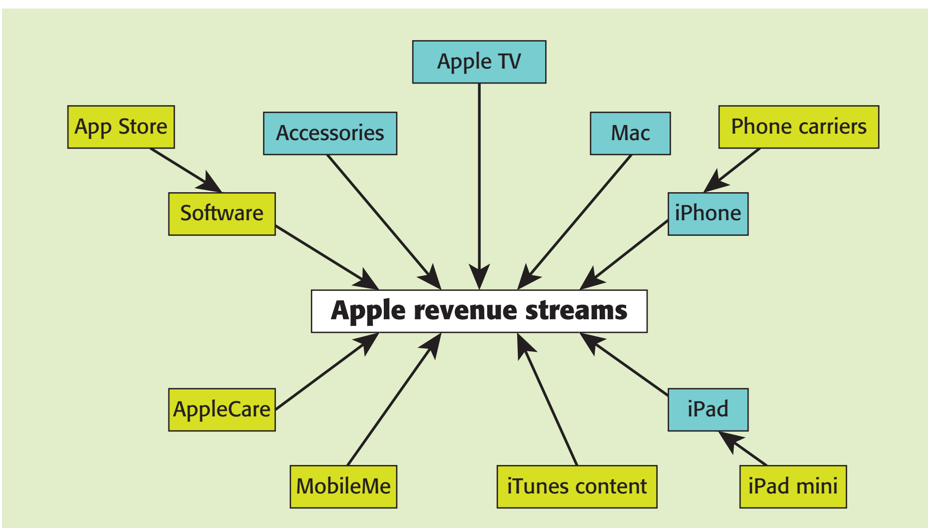


Figure 3.2.1 Apple has many revenue streams

THEORY OF KNOWLEDGE

Vodka reigns supreme

'Vodka continues to grow strongly in the US, ahead of the broader spirits market,' analysts at Bernstein Research said in a note on Friday. Ten of the top 24 spirits brands in the US are now vodka, according to Bernstein, which quoted a 'hit brands' poll by *Impact Magazine*. The list highlights the fast-growing spirits brands which have had robust growth over the last three years. All top five positions in the poll are vodkas. More specifically, dessert-style flavoured vodkas have taken up key positions in the rankings, with Sweden's Svedka – owned by New York's Constellation Brands – taking the top spot.

Source: Adapted from www.cnbc.com

To what extent is it unethical for organisations to grow their revenues by selling products they know will harm the consumers that buy them?

OVER TO YOU

Revision checklist

1. Explain **two** reasons why cost data would be useful for operations managers.
2. Distinguish between direct and indirect costs.
3. Distinguish between fixed and variable costs.
4. Explain the differences between: revenue, cash flow and profit.
5. Explain the term 'overheads' and give **three** examples.
6. Explain the term 'profit centre'.
7. Explain **two** benefits to an entrepreneur of developing more than one revenue stream.
8. Explain **two** possible limitations to a small business from having more than one revenue stream.

Exam practice question

TWITTER'S NEW REVENUE STREAMS LOOK PROMISING

When Twitter announced its proposals to sell shares to the public (to 'go public') analysts were surprised not only by the forecast of rising total revenue of US$200 million that it reported – but also by the forecast loss it expected to make. What Twitter did not draw attention to was the surprise that it has for new investors: it has eight new revenue streams that could grow hugely over the next few years. Currently, Twitter has three main revenue streams: promoted tweets, promoted accounts and promoted trends.

Here are eight new ones the company is developing:

- self-serve adverts in international markets
- video adverts on Vine
- Big Data – data licensing
- mobile adverts – has just acquired MoPub for US$100 million
- real time bidding on adverts
- TV advert targeting
- Amplify – Twitter's video advert product
- custom audiences.

In preparation for this expansion in revenue-earning activities, Twitter has massively increased its staffing – it now has 2000 employees, adding substantially to the overhead costs of the business. It is also well funded – US$1.1 billion from venture capitalists and US$1 billion from the sale of shares.

20 marks, 40 minutes

1. Define the term 'total revenue'. [2]
2. Explain how Twitter can report an overall loss when total revenue is rising. [4]
3. Analyse **two** advantages to Twitter of developing new revenue streams. [4]
4. Evaluate Twitter's decision to increase its scale of operations so quickly. [10]

Key concept question

20 marks, 40 minutes

With reference to one or two organisation(s) that you have studied, evaluate different strategies businesses can adopt to increase revenue in a globalised business environment. [20]

3.3

Break-even analysis

On completing this chapter you should be able to:

Analyse and apply:

- Total contribution and contribution per unit (AO2)
- Break-even charts and break-even analysis (AO2)
- The effects of changes in prices and costs on break-even (AO2)

Evaluate:

- The benefits and limitations of break-even analysis (AO3)

Calculate and construct:

- Break-even charts, break-even point, profit, margin of safety, target: profit, output, price (AO4)
- The effects of changes in prices and costs on break-even (AO4)

Setting the scene

BURJ DUBAI TOWER SETS RECORDS AND MAKES PROFITS

'As of today we have sold 90% of the building,' said Mohamed Ali Alabbar, chairman of the construction company that built the world's tallest building. 'Originally we thought that we would be lucky to break even.'

Completing such a huge building during one of the world's biggest economic downturns was not ideal, but the revenue from the sold apartments and office space is on target. Selling only around 80% of the space available would have meant that the construction company, Emaar, would have just broken even. But by attracting and retaining the interest of enough corporations so that only 10% of space was vacant, the Burj Dubai was already profitable – in the week it was completed.

Points to consider

- What is the difference between 'revenue' and 'profit'?
- What do you think 'breaking even' means?
- If only 80% of the Burj Dubai office space and apartments had been sold, would you have advised the developers to reduce prices of the remaining space?

Key concept link

Profit is not the only business objective but no organisation will deliberately aim to record a loss. The level of output/sales at which a business 'breaks even' is an important measure for managers when they consider any new strategy or the introduction of a new innovation.

break-even: the level of output at which total costs equal total revenue

Introduction

If a business is able to calculate the **break-even** quantity that must be sold to cover all costs, it will be easier to make important production and marketing decisions. At the break-even level of output and sales, profit is zero. This must mean that at break-even:

total costs = total revenue

No profit or loss is made.

LEARNER PROFILE

Thinker/carer

You are the CEO of a canning business that has been based in your hometown for 120 years. The business is the town's biggest local employer and many other local businesses depend on you to buy their components and service your organisation. But your business is struggling with profits down 7% this year and trending downwards for the last five years.

Your new marketing director places a file called 'relocation' firmly on your desk and says, 'This is our only option'. His argument is a compelling one. The break-even and profit figures for the new location are excellent and moving to a new location 50 kilometres away looks like a 'no-brainer'. Moving does, however, mean disastrous consequences for the town.

Discuss the following question in your class:

As a 'thinker' your decision pushes you towards the move but as a 'carer' you feel you should keep the business in the town.

Can thinking business people also be caring?

Calculating break-even – methods

Break-even analysis can be undertaken in three ways:

- table of costs and revenues method
- graphical method
- formula method.

The table method

Table 3.3.1 shows the cost and revenue data for a hamburger stall at a Premier League football match. The stall has to pay the club $500 for each match day – these are the fixed costs. Each hamburger costs $1 in ingredients and labour (variable costs) and they are sold for $2 each.

The break-even level of sales for the operator of the hamburger stall is 500 units. At this level of sales, total costs equal total revenue.

Quantity sold	Fixed costs ($)	Variable costs ($)	Total costs ($)	Revenue (Price × quantity) ($)	Profit / (Loss) ($)
0	500	0	500	0	(500)
100	500	100	600	200	(400)
200	500	200	700	400	(300)
300	500	300	800	600	(200)
400	500	400	900	800	(100)
500	500	500	1000	1000	0
600	500	600	1100	1200	100
700	500	700	1200	1400	200

Table 3.3.1 Cost and revenue data for sale of hamburgers

The graphical method – the break-even chart

The break-even chart requires a graph with the axes shown in Figure 3.3.1. 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
- sales revenue, obtained by multiplying selling price by output level.

Figure 3.3.2 shows a typical break-even chart. Note the following points:

- The fixed costs line is horizontal showing that fixed costs are constant at all output levels.
- The variable costs line starts from the origin (0). If no goods are produced, there will be no variable costs. It increases at a constant rate and, at each level of output shows that total variable costs = quantity × variable cost per unit. The line is not necessary to interpret the chart and is often omitted.
- The total costs line begins at the level of fixed costs, but then follows the same slope/gradient as variable costs.
- Sales revenue starts at the origin (0) as if no sales are made, there can be no revenue. It increases at a constant rate, and at each level of output shows that total revenue = quantity × price.
- 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.
- Profit is shown by the positive difference between sales revenue and total costs – to the right of the *BE* point.
- Maximum profit is made at maximum output and is shown on the graph.

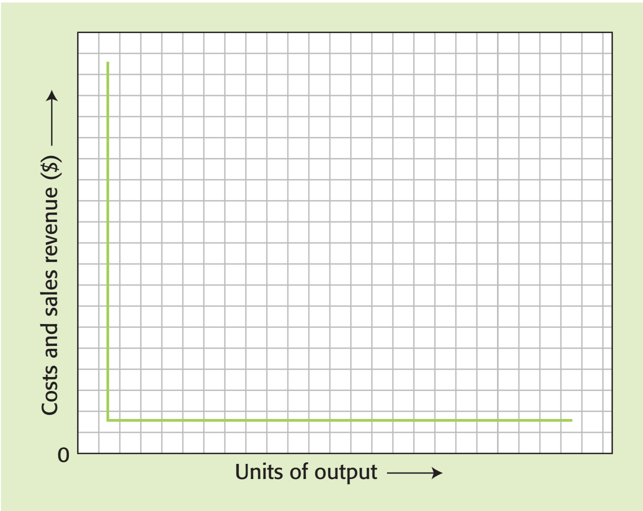


Figure 3.3.1 The axes for a break-even chart

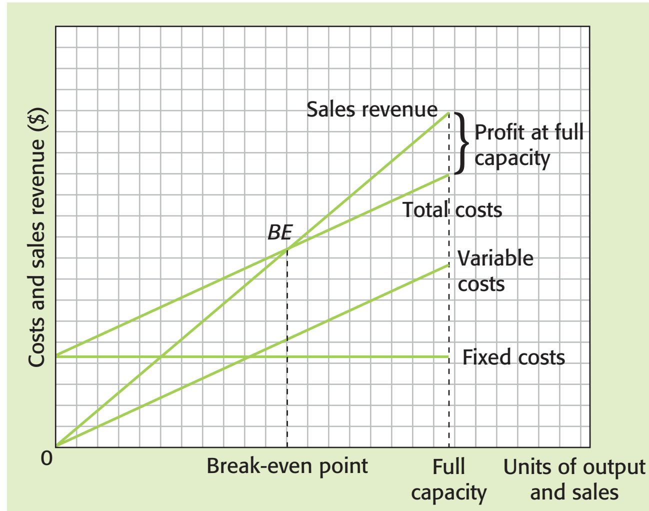


Figure 3.3.2 A typical break-even chart

ACTIVITY 3.3.1

10 marks, 20 minutes

1. Define the term 'break-even point'. [2]
2. Using the data given in Table 3.3.1 construct a fully labelled break-even chart and indicate the break-even level of output. [8]

Margin of safety

margin of safety: the amount by which the output level exceeds the break-even level of output

This is a useful indication of how much sales could fall without the firm falling into loss. For example, if 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:

production in excess of break-even point = 200 = 50.0%

If a firm is producing below 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

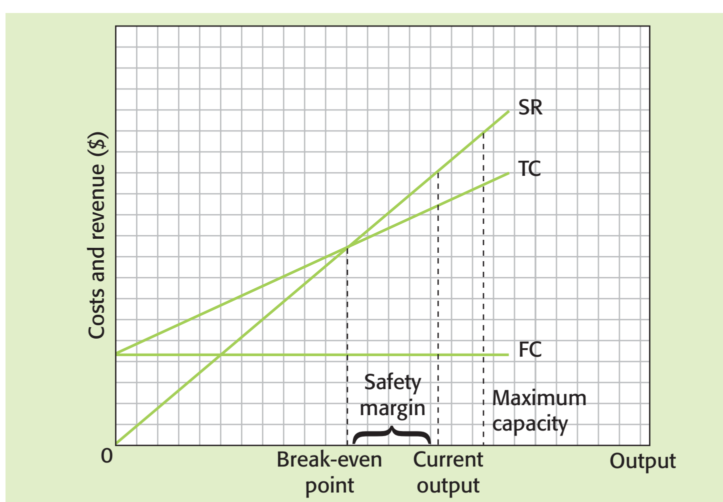


Figure 3.3.3 A break-even chart showing the safety margin

is producing at 350 units, it has a margin of safety of −50 (see Figure 3.3.3). The minus sign simply tells us that the production level is below break-even.

The break-even formula

Difference between total contribution and contribution per unit

Contribution is a very important concept in business and management. The **contribution per unit** is the amount each unit of production contributes towards the fixed costs and profit of the business. Each item produced will incur direct costs (mainly variable costs). If the selling price of each unit is *greater than* this direct cost, then a contribution is being made. This contribution is *not* profit – because the fixed costs have not yet been covered.

contribution per unit: selling price of a product minus direct costs per unit

total contribution: unit contribution × output

Total contribution is the total contribution of all units sold. If total contribution of a product *exceeds* the fixed costs for the period, then the surplus is profit. If total contribution is *less* than fixed costs, then a loss has been made.

Using contribution per unit to calculate break-even output

The following formula can be used to calculate break-even:

$$\text{break-even level of output} = \frac{\text{fixed costs}}{\text{contribution per unit}}$$

If fixed costs are $200 000 and the contribution per unit of output is $50, then the break-even level of production is:

$$\frac{200\,000}{50} = 4000 \text{ units}$$

This is an exact answer and, therefore, likely to be more accurate than many break-even graphs.

ACTIVITY 3.3.2

BREAK-EVEN CHARTS

The following data have been provided by the finance director of La Pitch which manufactures high-quality tents for the specialist outdoor market. The marketing director wants to reduce the price of the tents to $39.99 (he considers this to be a psychologically attractive price to consumers) to increase sales volume but there are concerns about reducing unit contribution and covering costs. There are also concerns about exceeding La Pitch's factory capacity.

- direct labour per unit $17
- direct materials per unit $18
- fixed costs $200 000
- current selling price $45
- maximum capacity of the factory is 30 000 units

20 marks, 40 minutes

1. Define the term 'unit contribution'. [2]
2. On the basis of La Pitch's financial information construct a fully labelled break-even chart. Calculate the break-even point, the margin of safety and profit from the sale of 25 000 tents. [8]
3. Examine advantages and disadvantages of the marketing director's proposal to reduce the price of the tents to $39.99. [10]

Break-even analysis – further uses

In addition to obtaining break-even levels of production and margins of safety, 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 three examples of further uses of the break-even technique:

1. A marketing decision – the impact of a price increase (see Figure 3.3.4). This raises the sales revenue line at each level of quantity sold. The assumption made in this example is that maximum sales will still be made. With a higher price level, this may well be unlikely.
2. An operations management decision – the purchase of new equipment with lower variable costs (see Figure 3.3.5). This will lower the variable costs line at each level of quantity.
3. Choosing between two locations for a new factory – with different fixed and variable costs.

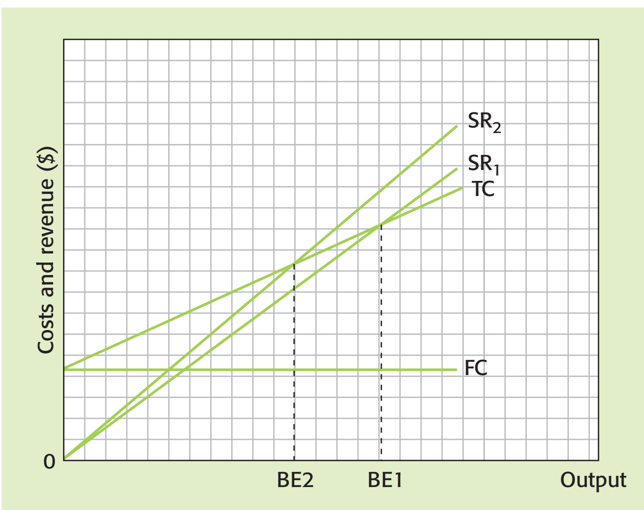


Figure 3.3.4 A break-even chart showing the effect on the break-even point and maximum total profit of a price rise (BE2)

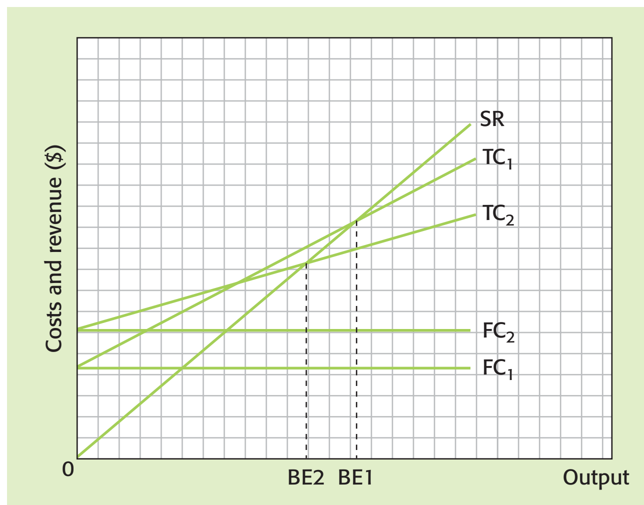


Figure 3.3.5 A break-even chart showing the possible impact of new equipment (raising fixed costs), but offering lower variable costs (BE2)

Calculating output to achieve target profit

An adapted version of the break-even formula can be used if a business wants to use target profit level to establish the level of output required to achieve it. This might be used by a business or a division of a business that has set a fixed rate of return as an objective and the purpose is to calculate what level of sales will be needed to achieve this aim.

The formula now becomes:

$$\text{target profit level of output} = \frac{\text{fixed costs} + \text{target profit}}{\text{contribution per unit}}$$

Suppose the target profit is $25 000, fixed costs are $200 000 and contribution per unit $50. The level of output needed to earn the target profit is:

$$\frac{\$200\,000 + \$25\,000}{\$50} = \frac{\$225\,000}{\$50} = 4500 \text{ units}$$

This can now be referred to as the 'target output' because, if this level of sales is reached – assuming the price and costs do not change – then the target profit and rate of return will be achieved.

Calculating target break-even revenue

Break-even revenue can be calculated using the following formula:

$$\text{break-even revenue} = \frac{\text{fixed costs}}{1 - (\text{direct cost/price})}$$

Here is an example: in service businesses, in particular, such as lawyers or surveyors, it is useful to be able to know how much income the business needs to cover all its costs. If the monthly fixed costs of a law practice are $60 000, lawyers are paid $15 per hour (variable costs) and clients are charged a price of $30 per hour, the **break-even revenue** will be:

$$\frac{\$60\,000}{1 - (\$15/\$30)} = \$120\,000$$

break-even revenue: the amount of revenue needed to cover both fixed and variable costs so that the business breaks even

Calculating target price

If a business wants to break even at a level of production of 1000 units each month and direct costs are $3 per unit and fixed costs $6000 per month, what price must it charge? This is quite a common question for business managers to ask if they want to set the break-even point to be quite low and if they believe that, to a certain extent, demand is relatively unresponsive to price.

The solution is to adapt the original break-even formula.

$$\text{break-even target price} = \frac{\text{fixed costs}}{\text{production level}} + \text{direct cost}$$

$$\text{break-even target price} = \frac{\$6000}{1000} + \$3 = \$9 \text{ per unit}$$

ACTIVITY 3.3.3

Marab Sports Ltd is a small specialist sports car manufacturer that has just been taken over by a private equity company. Marab has struggled over the last three years and the new owners have set the management a precise financial target for this year: to turn a $1.0 million loss into a $0.5 million profit. This is based on annual fixed costs of

$2.8 million; a selling price of $50 000 per car and a direct cost of manufacturing each car of $20 000. The finance director believes the business can achieve a higher target profit the following year if direct costs can be reduced by 10%.

20 marks, 40 minutes

1. Define the term 'direct costs'. [2]
2. Calculate the level of output needed to achieve the target level of profit this year and the following year assuming the 10% direct cost saving is achieved. [4]
3. Analyse **two** ways Marab Sports could reduce its direct costs. [4]
4. Discuss Marab Sports' possible decision to reduce costs to increase profits. [10]

Break-even analysis – an evaluation

Usefulness of break-even analysis

- Charts are relatively easy to construct and interpret.
- It 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 the example above, the 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.

Exam tip: It is very important to remember that a break-even graph or calculation is only accurate for a limited period of time, for example because of cost changes or changes in market conditions that mean the price has to be changed.

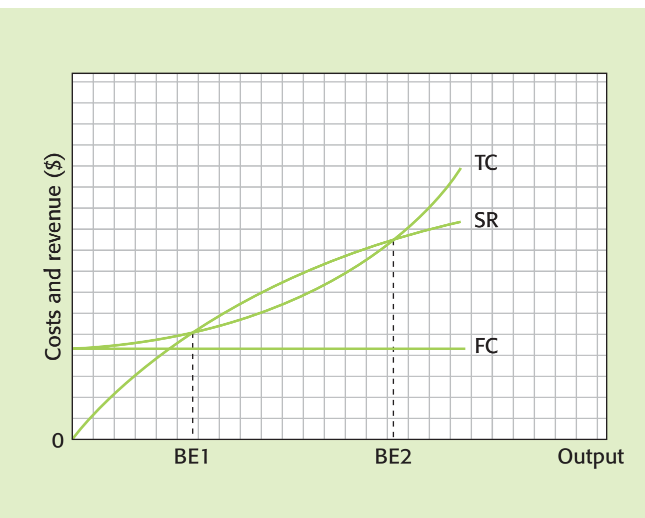


Figure 3.3.6 A break-even chart showing how non-linear assumptions can lead to two break-even points

Limitations of break-even analysis

- The assumption that costs and revenues are always represented by straight lines is unrealistic. Not all variable costs change directly or 'smoothly' with output. For example, labour costs may increase as output reaches maximum due to higher shift payments or overtime rates. The revenue line could be influenced by price reductions made necessary to sell all units produced at high output levels. The combined effects of these assumptions could be to create two break-even points in practice (see Figure 3.3.6).
- Not all costs can be conveniently classified into fixed and direct costs. The introduction of semi-variable costs will make the technique much more complicated.
- There is no allowance made for stock levels on the break-even chart. It is assumed that all units produced are sold. This is unlikely to always be the case in practice.

- Cost and price data are often estimated when break-even analysis is undertaken and the actual data might vary from those used in the break-even calculation.
- It is also unlikely that fixed costs will remain unchanged at different output levels up to maximum capacity.

THEORY OF KNOWLEDGE

'Apple's iPhone is the most expensive phone in the world and it doesn't appeal to business customers because it doesn't have a keyboard which makes it not a very good email machine . . .' Steve Ballmer, Microsoft's CEO, 2007.

'We don't like their sound, and guitar music is on the way out,' said Decca Records about the Beatles in 1962.

'Children just aren't interested in witches and wizards any more,' an anonymous publishing executive told J. K. Rowling in 1996.

'The FedEx concept is interesting and well-formed, but in order to earn better than a 'C', the idea must be feasible,' said the Yale University professor on the proposed overnight delivery service.

In light of the above quotes, discuss the following view:

'Precise mathematical models that forecast the future have no real value in business decision-making.'

ACTIVITY 3.3.4

SABER'S LOCATION DECISION

Saber Ltd is a small manufacturer of guitar strings. The lease on its current factory is coming to an end and it is considering two possible locations for a new factory. The finance director of Saber has produced the following financial information on each site:

	Fixed costs ($)	Direct costs per unit ($)	Forecast selling price per unit ($)	Maximum capacity due to space limits (units)
Site A	60 000	3	6	40 000
Site B	80 000	2.50	6	50 000

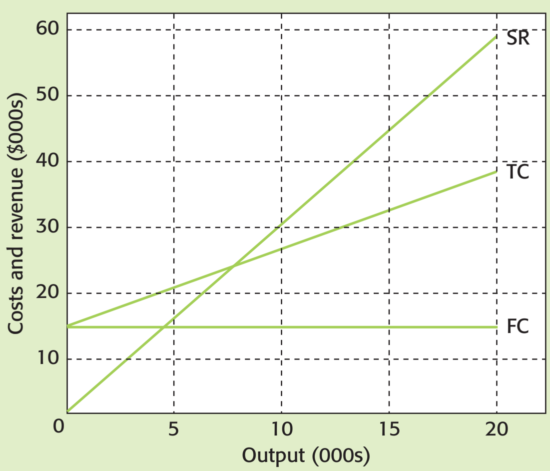
20 marks, 40 minutes

1. Using the data in the table construct fully labelled break-even charts for site A and site B. Indicate the break-even output and the margin of safety on each chart. [6]
2. Using the data in the table calculate the following for site A and site B:
   a. the break-even level of output
   b. the margin of safety
   c. the profit if the maximum capacity is sold. [6]
3. On the basis of the calculations you have made, explain which location Saber should choose. [4]
4. Outline **two** other factors Saber Ltd might take into account when making its location decision. [4]

OVER TO YOU

Revision checklist

1. Explain why it would be useful to an operations manager to know the break-even level of production for their factory.
2. From the graph below identify:
   - the break-even point
   - the margin of safety at output level of 15 000 units
   - the level of fixed costs.
3. Explain **two** business decisions that would be assisted by using break-even analysis; use sketches of graphs to aid your explanation.
4. Discuss, using graph sketches if necessary, **two** limitations of the break-even technique.
5. Explain why the assumptions that the lines in the break-even chart are straight are not realistic and will limit the usefulness of break-even analysis. Give examples to support your argument.



Exam practice question

WINDCHEATER CAR ROOFRACKS

The sole owner of Windcheater Car Roofracks needs to expand output as a result of increasing demand from motor accessory shops. The business uses batch production to produce its roof racks. Current output capacity has been reached at 5000 units per year. Each rack is sold to the retailers for $40. Production costs are:

- direct labour $10
- direct materials $12
- fixed costs $54 000.

The owner is considering two options for expansion:

Option 1 Extend the existing premises, but keep the same method of production. This would increase fixed costs by $27 000 per year and direct costs would remain unchanged. Capacity would be doubled.

Option 2 Purchase new machinery, which will speed up the production process and cut down on wasted materials. Fixed costs would rise by $6000 per year, but direct costs would be reduced by $2 per unit. Output capacity would increase by 50%.

20 marks, 40 minutes

1. Construct a fully labelled break-even chart for options 1 and 2. Calculate the break-even points and maximum profit for each option. [6]
2. On the basis of your calculations and break-even charts, explain which option Windcheater should choose. [4]
3. Evaluate the usefulness of break-even analysis to businesses such as Windcheater. [10]

Key concept question

20 marks, 40 minutes

With reference to one or two organisation(s) that you have studied, evaluate the usefulness of business models like break-even which organisations can use to support business strategy. [20]

3.4

H

Final accounts

On completing this chapter you should be able to:

Analyse and apply:

- Final accounts: profit and loss account and balance sheet (AO2)
- Depreciation methods: straight line and reducing balance (HL only) (AO2)
- Strengths and weaknesses of each depreciation method (HL only) (AO2)

Evaluate:

- The purpose of accounts to different stakeholders (AO3)
- The principles and ethics of accounting practice (AO3)

Calculate and prepare:

- Final accounts: profit and loss account and balance sheet (AO4)
- Depreciation methods (HL only) (AO4)

Setting the scene

SKY'S THE LIMIT FOR SATELLITE DISHES

Rashid sold and fitted ten TV satellite dishes in his first month of trading. He had bought 50 satellite dishes from a website specialising in stock sell-offs from failed businesses. He paid $100 each. This used up most of his start-up capital. He rented a small truck for $120 a month. A large advertising sign had cost him $120. Other advertising costs in his first month had been more than expected. The local newspaper had increased its classified rates – $150 was $30 more than planned. He sold the satellite dishes for $275 fully fitted. Rashid wanted to 'add value' to the dishes by doing the fitting too. Each fitting kit cost Rashid $10. Other costs – such as road tax and insurance on the truck – totalled $200 per month, just as predicted.

He started to work out his profit for the first month. His only real worry was that two of his customers had asked if they could delay paying him. When would they pay? Should he include these two satellite dishes when working out his first monthly profits?

Points to consider

- Why do you think it is important for Rashid to keep accurate financial records (accounts)?
- Do you think he made a profit in his first month of trading? How would you try to work this out?
- Which stakeholder groups would be interested in looking at the accounts of Rashid's business and why?

Key concept link

Ethics is an issue for accountants and some students are surprised by this. Accounting is not an exact mathematical science. Judgements have to be made over the valuation of stocks or the value of existing fixed assets and if the judgements made are designed to manipulate accounting data to benefit the business, this could be viewed as being unethical.

Introduction

All businesses have to keep detailed records of purchases, sales and other financial transactions. Table 3.4.1 lists some problems that would immediately arise if accounts were not kept. We can therefore say that accounts are financial records of business transactions, which are needed to provide essential information to groups both within and outside the organisation.

Problem	Groups affected
How much did we buy from our suppliers and have they been paid yet?	Managers and suppliers (creditors)
How much profit did the business make last year?	Managers, shareholders and the tax authorities
Is the business able to repay the loan to the bank?	Managers and the bank
Did we pay wages to the workers last week?	Managers and workers
What is the value of the fixed assets and by how much did they depreciate last year?	Managers and shareholders

Table 3.4.1 Accounts and the interests of stakeholders

Stakeholders and accounting information

There are internal and external stakeholder users of accounts. The managers, as internal users, will have access to much more detailed and up-to-date data than other groups. External users include banks, government, employees and shareholders and other stakeholders of the business. The list below identifies the main stakeholders and how they use business accounts.

Business managers

- Measure the performance of the business to compare against targets, previous time periods and competitors.
- Provide information for taking decisions such as new investments, closing branches and launching new products.
- Control and monitor the operation of each department and division of the business.
- Set targets or budgets for the future and review these against actual performance.

Workforce

- 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, if profits are rising, a wage increase can be afforded.
- Find out how the average wage in the business compares with the salaries of directors.

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 or a loan.

Creditors such as suppliers

- Assess whether the business is secure and liquid enough to pay off its debts.
- Assess whether the business is a good credit risk.
- Decide whether to press for 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.
- 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.

Investors and potential investors in a business

- 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 the profits investors are receiving.
- Decide whether the business has potential for growth.
- As potential investors, compare these details with those from other businesses before making a decision to buy shares in a company.
- As actual investors, decide whether to consider selling all or part of their holding.

Local community

- See if 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.

Limitations of accounting information to stakeholders

It is common for stakeholders to believe that, because accounts are based on 'numbers' and not descriptive words, they must be 'accurate and fair'. Unfortunately, this is often not the case. Although, in theory, there can be no secrets in these accounts, they show the 'headline figures' rather than the specific detail. This limits the usefulness of accounting information provided to stakeholders.

The following factors need to be remembered by stakeholders when they use the accounts provided by a business to make the judgements and assessment outlined above.

1. One set of accounts is of limited use

A series of accounts is needed to be able to compare the performance of a business over time and with other similar businesses. One year's accounts are of limited value as they provide no trend picture over time of whether the business is becoming more or less profitable and more or less liquid. External stakeholders such as investors should have access to the full set of accounts of a business for a number of years.

2. Accounts do not measure items which cannot be expressed in monetary terms

For instance, accounts do not indicate the state of technology within the business or the ability and skills of the management team. The reputation of the business cannot be valued but this is often the most important consideration for customers and potential creditors to the business. The absence of any 'valuation of employees' can be crucial when analysing a business where the creativity of staff is important. With an advertising agency, for example, its strength depends on its key creative staff. If they leave, the prospects for the firm are poor, even though the accounts, which are always historic, covering previous time periods, may not show this until it is too late for potential investors.

3. The accounts of one business do not allow for comparisons

Effective assessment of a business performance can only be made in comparison with other firms engaged in similar activities. One set of one business's accounts will not allow for these comparisons to be made.

4. Business accounts will only publish the minimum information required by law

Managers would not be impressed with their accountants if they published accounts data that was very detailed and specific, beyond legal requirements, as this could be of real assistance to competitors. So published accounts are a summary and they do not 'tell the whole truth' about a business.

5. Accounts are historic

Accounts can be up to six months out of date at the time of publication and they never contain the future financial plans or budgets of a business – these are not legally required. Accounts report what *has happened*, not what is going to happen. Only management accounts, which are intended for internal stakeholder use, look forward. These accounts are used as planning and budgeting documents for the management and are not available to the external stakeholders.

window dressing: presenting the accounts of a business in the best possible, or most flattering, way which could potentially mislead users of accounts

6. Window dressing

In public companies, this type of 'creative accounting' can amount to fraud – which is, of course, illegal. However, there is often a fine dividing line between illegal accounts reporting and 'trying to give a favourable gloss' to the accounts. The latter may be unethical but it may not be against the law.

There are several 'tricks of the trade' whereby companies try to make their businesses look more successful than they are. Accounts are produced on a single day at the end of the financial year. The position may be different the day before or the day after! The timing of various transactions can be manipulated to influence the appearance of the accounts just before they are prepared.

depreciation: the decline in the estimated value of a fixed asset over time

assets: items of monetary value that are owned by a business

Window-dressing methods

1. Recording revenue expenditure as capital expenditure. Revenue expenditure, like rent, is payable in the present year. Capital expenditure, e.g. spending on machinery, can be spread over several years through the process of **depreciation**. Spreading a payment over a number of years will increase profit in the current year.
2. Selling **assets** just before the end of the financial year to make it appear that the business is more liquid than it is. For example, sale and leaseback where a company sells some property but rents it back. This improves liquidity, but incurs a long-term liability for the rent. If this is done just before the accounts are due, the firm may seem to have a good cash, or liquidity, position but it now has an additional long-term expense. As a result, long-term profits may be lower.
3. Encouraging early debt payments by offering discounts before the end of the financial year, whilst delaying payment to creditors, to improve liquidity. The same effect can be achieved also by delaying purchases for even a week, so this cost does not appear in the present year's accounts.

4. Loans may be taken out just before the date of the accounts to improve the liquidity position, but may be repaid a few days later.
5. Inflating the value of intangible assets, such as brand names and patents owned by the business.

Using published accounts – an evaluation

Stakeholders will very often need to refer to a company's published accounts. The limitations explained above do not make these accounts useless but accounts users will be likely to make fewer incorrect judgements based on one set of company accounts if they always consider these limitations and seek to overcome them, e.g. by using accounts for several years and by referring to accounts from similar businesses.

The principles and ethics of accounting practice

The importance of reliable accounting information to individual groups of stakeholders requires that accountants should act ethically when recording financial transactions and when drawing up final accounts. Most professional groups of accountants have five key fundamental principles as part of their ethical code of conduct for members:

1. Integrity

This means that accountants should act honestly in all dealings with clients. However, the principle is not limited to clients. This principle requires accountants also to act honestly with tax authorities and all other stakeholder groups. Integrity means being straightforward, honest and truthful in all professional and business relationships. Accountants should not be associated with any information that is believed to contain a materially false or misleading statement, or which is misleading by omission.

2. Objectivity

Accountants should not allow bias, conflict of interest or the influence of other people to override their professional judgement. Perhaps the most common areas where conflicts of interest or undue influence can arise are when:

- recommending services, such as a business consultancy, simply because it pays a healthy fee to the accountant introducing the service
- giving in to pressure exerted by an important business client who wants the accountant to window-dress accounts, so as to avoid losing a large fee.

3. Professional competence and due care

Accountants are required to carry out their work with a proper regard for relevant technical and professional standards. This means that no-one should undertake professional work which they are not competent to perform. This principle also puts responsibility on accountants to continually update their level of professional knowledge – such as on government tax changes – and skill based on current developments in practice, legislation and techniques.

4. Confidentiality

Accountants should not disclose professional information unless they have specific permission or a legal or professional duty to do so.

5. Professional behaviour

This is the principle that, when breached, leads to most complaints to the professional accounting bodies. Clearly accountants should comply with all relevant legal obligations when dealing with a client's affairs and assist clients to do the same.

Crucially, even if there is no legal duty to act in a particular way, accountants should always act in a way that will not bring their professional body into disrepute. This implies an obligation to behave with courtesy and consideration towards all those with whom they come into contact in a professional capacity.

ACTIVITY 3.4.1

MALAYSIA TOURIST FLIGHTS LTD

Leroy is a qualified commercial pilot who leases a small, single-engine aircraft. Last year he formed a company offering small groups of tourists one-hour sightseeing flights over Malaysia. He employs a part-time office worker to help with marketing and administration. In his first year of operation, he took 45 groups on air trips. Leroy prepared his annual accounts for publication. They showed that the business had less cash in the bank than 12 months ago. This was despite the fact that the business had made a profit. Leroy was worried that he might have to ask for an increase in his bank overdraft and delay paying creditors such as the fuel supplier.

Another tourist flight business, FlyNow, operates from the same airfield used by Leroy with two medium-sized aircraft. It has been awarded a licence to operate two scheduled flights a week to Singapore. The owners of FlyNow have decided to sell the business. Leroy is interested in buying FlyNow but he is surprised by the price being asked for it. He asked to see FlyNow's latest accounts for the last four years. Both profit and cash in the bank had increased in recent months but some assets had been sold and a loan taken out. The value of the aircraft seemed to be high. Leroy met with FlyNow's accountant who told him:

'Recent maintenance work on the aircraft has increased their value and we have delayed payments to creditors as there are disputes over the quality of the materials supplied to us.' He assured Leroy that the FlyNow brand name had real potential to be worth a great deal in future years.

27 marks, 54 minutes

1. Identify **three** stakeholder groups that would be interested in the accounts of Leroy's business. [3]
2. Evaluate the usefulness of the accounts of Leroy's business to each of the stakeholder groups identified in question 1. [10]
3. **a.** Outline **two** ways in which accounts can be prepared ethically. [4]

   b. To what extent has Flynow's accountant acted ethically in preparing Flynow's accounts? [10]

LEARNER PROFILE

Inquirers

In July 2002 the American communications giant WorldCom filed for bankruptcy. A business that, at its peak, was worth over $100 billion failed. The reason for its failure: massive accounting fraud. WorldCom's accounts had fraudulent accounting entries worth $9 billion buried in them.

The driving force behind the fraud was WorldCom's CEO Bernie Ebbers' desire to grow the company through an aggressive acquisition programme. In order to generate the finance to fund new takeovers (like the acquisition of communication business MCI) the WorldCom share price had to be driven higher and higher. To drive the share price up WorldCom overstated its profits so that the company would seem attractive to potential share buyers. Thus WorldCom was involved in producing falsified accounts.

WorldCom's auditors at the time were accountants Arthur Andersen who claimed the companies' executives withheld information from them. The WorldCom scandal also saw the failure of Arthur Andersen later in 2002.

A key issue for stakeholders in WorldCom was the quality of the financial information they received.

In small groups consider the question:

As a business inquirer, what determines how trustworthy the accounting information you receive is?

The main business accounts

At the end of each accounting period, usually one year, accountants will draw up the financial statements of the business. For companies, these will be included in the annual report and accounts, which are not only sent to every shareholder but also in the public domain and can be accessed by any external stakeholder. Table 3.4.2 gives details of the financial statements of limited companies, as these are the accounts you are most likely to come across in IB Business and Management.

Recent layout changes

There have been many recent changes to the layout of published accounts to comply with the International Financial Reporting Standards (IFRS). These changes include different titles to important items on published accounts. This book employs the traditional layouts and titles, as used by the IB examinations, but you should be aware that accounts may be presented in slightly different ways and using slightly different terminology.

profit and loss account: records the revenue, costs and profit (or loss) of a business over a given period of time

liabilities: a financial obligation of a business that it is required to pay in the future

The account	What it shows	Other names for this account
Profit and loss account	The gross and net profit of the company Details of how the net profit is split up (or appropriated) between dividends to shareholders and retained profits	Income statement Statement of comprehensive income
Balance sheet	The net worth of the company: this is the difference between the value of what a company owns (assets) and what it owes (**liabilities**)	Statement of financial position
Cash flow statement	Where cash was received from and what it was spent on	Statement of cash flows

Table 3.4.2 Final accounts of limited companies – what they contain

The profit and loss account

When referring to published accounts from companies in many countries, the terms 'income statement' or 'statement of comprehensive income' will be used instead.

- A detailed profit and loss account is produced for internal use because managers will need as much information as possible. It may be produced as frequently as managers need the information – perhaps once a month.
- A less detailed summary will appear in the published accounts of companies for external users. It will be produced at least once a year. The content of this is laid down by the Companies Acts and provides a minimum of information to prevent competitors having insight into their rivals' strengths and weaknesses.

The version used in this chapter is one that was commonly used in published accounts before recent IFRS changes. However, additional information has been added where this aids understanding. An example is given in Table 3.4.3.

	Revenue	3060	Trading account
(minus)	Cost of sales	(1840)	
(equals)	Gross profit	1220	
(minus)	Overheads	(580)	Profit and loss account
(equals)	Net profit or profit before tax and interest	640	
(minus)	Interest	(80)	
(equals)	Pre-tax profits	560	
(minus)	Tax @ 20%	(112)	
(equals)	Profit after tax	448	
(minus)	Dividends to shareholders	(200)	Appropriation account
(equals)	Retained profit	248	

Table 3.4.3 Income statement for NERGEN plc for the year ended 31 March 2014 (£000s)

The three sections of a profit and loss account

1. The trading account

This shows how **gross profit** (or loss) has been made from the trading activities of the business.

It is important to understand that, as not all sales are for cash in most businesses, the **sales turnover** figure is not the same as cash received by the business. The formula for calculating sales turnover is: selling price × quantity sold. Therefore, if 120 items are sold at $2 each, the sales turnover is $240.

gross profit: equal to sales revenue less cost of sales

sales revenue (or sales turnover): the total value of sales made during the trading period = selling price × quantity sold

ACTIVITY 3.4.2

CALCULATING GROSS PROFIT

12 marks, 24 minutes

Cosy Corner Retailers Ltd has just completed its first year of trading. The managing director is keen to learn whether a profit has been made.

1. Calculate gross profit for Cosy Corner Retailers Ltd for the financial year ending 31 March 2015. Show all workings.
   a. 1500 items sold for $5 each; **cost of goods sold** = 1500 @ $2. [3]
   b. Explain **two** reasons why you think it is important for any business to make a profit. [6]
2. Cambridge Boxes Ltd sold 3500 units in the last financial year ending 31 December 2014. The selling price was $4. All boxes cost the company $2 each. Calculate the company's gross profit in 2014. [3]

cost of sales (or cost of goods sold): this is the direct cost of purchasing the goods that were sold during the financial year

operating profit (net profit or profit before interest and taxation): gross profit minus overhead expenses

profit after tax: operating profit minus interest costs and corporation tax

dividends: the share of the profits paid to shareholders as a return for investing in the company

retained profit: the profit left after all deductions, including dividends, have been made; this is 'ploughed back' into the company as a source of finance

2. Profit and loss section

This section of the profit and loss account calculates both the **operating profit** (or profit before interest and tax) and the **profit after tax** of the business.

Overheads are costs or 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, lighting costs and depreciation. Operating profit (sometimes called net profit or profit before interest and taxation) is the profit made before tax and interest have been subtracted, but after all costs of sales and overheads have been deducted from sales turnover. Limited companies pay corporation tax on their profits before paying **dividends**.

3. Appropriation account

This final section of the profit and loss account (which is not always shown in published accounts) shows how the profits after tax of the business are distributed between the owners – in the form of dividends to company shareholders – and as **retained profits**.

ACTIVITY 3.4.3

CALCULATING PROFITS

Rodrigues buys second-hand computers, updates them and then sells them in his small shop. He has many customers who are keen to buy computers at prices below those charged for new machines. Rodrigues took out a bank loan to buy his shop – he has since repaid half of this loan. He employs three electricians to help him with the computer work. He is the main shareholder in the business; three of his friends also invested in the company when it was first set up.

	$
Revenue (4000 items @ $3 each)	12 000
Cost of goods sold (@ $1 per item)	4000
Gross profit	*V*
Overhead expenses	3000
Operating profit (net profit)	*W*
Interest	1000
Profit before tax	*X*
Corporation tax @ 20%	800
Profit after tax	*Y*
Dividends paid	1200
Retained profit	*Z*

Profit and loss account for Rodrigues Traders Ltd for the year ending 31 October 2014

17 marks, 34 minutes

1. Calculate the missing values *V*–*Z* for the different types of profit for Rodrigues Traders Ltd. [5]
2. State **three** stakeholders in this business who would be interested in these profit figures. [3]
3. For each stakeholder group identified in question 2, explain why the accounts of this business are important. [9]

The use of profit and loss accounts

- They 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.
- The actual profit data can be compared with the expected profit levels of the business.
- Bankers and creditors of the business will need the information to help them decide whether to lend money to the business.
- Potential investors may assess the value of investing in a business from the level of profits being made. However, when doing this it is essential to try to differentiate between '**low-quality**' and '**high-quality**' **profit**. Low-quality profit – for example, the sale of an asset for more than its balance sheet value – cannot easily be repeated each year so this is a poor basis for making investment decisions.

low-quality profit: one-off profit that cannot easily be repeated or sustained

high-quality profit: profit that can be repeated and sustained

Exam tip: When answering questions that ask for amendments to existing profit and loss accounts and balance sheets, keep exactly the same layout and structure as contained in the case study.

ACTIVITY 3.4.4

ESTIMATED PROFIT AND LOSS ACCOUNT (INCOME STATEMENT) FOR KARACHI TRADERS LTD

	$
Revenue (5000 units @ $3.00)	15 000
Cost of goods sold (@ $1.00 per unit)	5000
Gross profit	10 000
Overhead expenses	4000

	$
Operating profit (profit before tax and interest)	6000
Finance costs (interest)	2000
Profit before tax	4000
Corporation tax @ 20%	800
Profit for the year	3200
Dividends paid	1200
Retained profit	2000

Profit and loss account for Karachi Traders Ltd for the year ending 31 December 2014

20 marks, 40 minutes

1. By amending this profit and loss account (income statement), calculate the new level of retained profits if the following changes actually occurred:

- each unit was sold for $4.00
- the cost of each unit sold rose to $1.60
- overhead expenses rose by 25%
- interest costs were reduced by 50%
- corporation tax rate rose to 25%.

Assume dividends remain unchanged. [10]

2. Amend the original profit and loss account to show:

- the number of units sold has increased by 20%, but the selling price remains unchanged
- the cost of goods sold per unit has fallen to $0.90
- transport costs (included in overheads) have increased by $500.

Calculate the new level of retained profit assuming no other change to overheads, interest, corporation tax and dividends. [10]

The balance sheet

The **balance sheet** 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 business's assets more than any increase in the value of liabilities. Shareholders' equity comes from two main sources:

- The first and original source was the capital originally invested in the company through the purchase of shares. This is called '**share capital**'.
- 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 are not reserves of cash.

Table 3.4.4 shows an example of a balance sheet with key terms and explanatory notes. The figures have been presented in two columns to help understanding of how subtotals are arrived at. In published accounts, all figures will be presented in one column. The IB format of the balance sheet is given, but the latest IFRS terminology is given in brackets.

balance sheet: an accounting statement that records the values of a business's assets, liabilities and shareholders' equity at one point in time

shareholders' equity: total value of assets *less* total value of liabilities

share capital: the total value of capital raised from shareholders by the issue of shares

	$m	$m	Key term	Notes
ASSETS				
Fixed (non-current) assets:			*assets to be kept and used by the business for more than one year*	*Previously referred to as fixed assets*
Property	300			
Vehicles	45			
Equipment	67			
Intangible assets	30		*items of value that do not have a physical presence, such as patents and trademarks*	
		442		
Current assets:			*assets that are likely to be turned into cash before the next balance sheet date*	
Inventories	34		*stocks held by the business in the form of materials, work in progress and finished goods*	
Debtors (accounts receivable)	28		*the value of payments to be received from customers who have bought goods on credit*	*Also known as 'trade receivables'*
Cash	4			*Also known as 'cash and cash equivalents'*
	66			
CURRENT LIABILITIES			*debts of the business that will usually have to be paid within one year*	
Creditors (accounts payable)	42		*value of debts for goods bought on credit payable to suppliers*	*Also known as 'trade payables'*
Short-term loans	31			*These loans will include the company's overdraft with the bank* *Other current liabilities might include provisions to pay for tax and dividends*
	73			
Net current assets		(7)	*current assets – current liabilities*	*Also known as 'working capital'*
NET ASSETS		**435**		
Non-current (long term) liabilities:			*value of debts of the business that will be payable after more than one year*	
Long-term loans		125		*Other long-term liabilities might include debentures issued by the company*
SHAREHOLDERS' EQUITY				*Definitions for all of the following terms have already been given*
Share capital	200			
Retained earnings	110			*Also referred to as 'retained profit'*
		310		
CAPITAL EMPLOYED		**435**		*This balances with net assets*

Table 3.4.4 Example of a balance sheet with key terms and explanatory notes

Note: all negative figures in accounting are denoted with ( ).

Further points to note:

- Companies have to publish the income statement and the balance sheet for the previous financial year as well in order to allow easy comparison.
- The titles of both accounts are very important as they identify both the account and the company.
- Whereas the income statement covers the whole financial year, the balance sheet is a statement of the estimated value of the company at one moment in time – the end of the financial year.

Fixed 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 and are expected to be retained and used by the business for more than 12 months. Businesses can also own intangible assets – these cannot be seen but still have value in the business.

Current assets

These are very important to a business, as will be seen when liquidity is assessed later in this chapter. The most common examples are inventories (stocks), accounts payable (**debtors** who have bought goods on credit) and cash/bank balance.

Current liabilities

Typical **current liabilities** include accounts payable (suppliers who have allowed the business credit), bank overdraft and unpaid dividends and unpaid tax.

debtors: customers who have bought products on credit and will pay cash at an agreed date in the future

current liabilities: debts of the business that will usually have to be paid within one year

ACTIVITY 3.4.5

UNDERSTANDING BALANCE SHEETS

Copy out this table and indicate in which category the following items would appear on a company's balance sheet.

	Fixed tangible assets	Fixed intangible assets	Current assets	Current liabilities	Non-current liabilities	Shareholders' equity
Company's car						
Work in progress						
Four-year bank loan						
Money owed to suppliers						
Issued share capital						
Dividends owed to shareholders						
Value of patents						
Payments due from customers						
Retained earnings						
Cash in bank						

Working capital

This is calculated by the formula: current assets − current liabilities. It can also be referred to as net current assets.

Shareholders' equity

This is sometimes referred to as shareholders' funds. It represents the capital originally paid into the business when the shareholders bought shares (share capital) or the retained earnings/profits of the business that the shareholders have accepted should be kept in the business. These are also known as reserves. Other reserves can also appear on the balance sheet if a company believes that its fixed assets have increased in value (revaluation 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 not be repaid to shareholders (unless the company ceases trading altogether), unlike loans that are repaid to creditors.

The most 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 which are not paid out in tax or dividends, but they have nearly always been invested back into the business through the purchase of additional assets. They 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 (long-term) liabilities

These are the long-term loans owed by the business. They are due to be paid over a period of time greater than one year and include loans, commercial mortgages and debentures. The value of non-current assets compared to the total capital employed by the business is a very important measure of the degree of risk being taken by the company's management.

ACTIVITY 3.4.6

MAURITIUS TELECOM

Study the simplified version of the 2013 balance sheet for Mauritius Telecom as at 31 December 2013 (millions Mauritian rupees).

	2013	2012
Non-current assets	8868	8649
Current assets:		
Inventories	372	321
Trade receivables and other receivables	1779	1795
Cash and cash equivalents	4786	5263
Total current assets	6937	7379
TOTAL ASSETS	**15805**	**16028**
Total non-current liabilities	1020	2083
Total current liabilities	5974	4678
Shareholders' capital and reserves (shareholders' equity)	8811	9267
TOTAL EQUITY AND LIABILITIES	**15805**	**16028**

26 marks, 52 minutes

1. Define the following terms in the balance sheet:
   - trade receivables
   - inventories
   - current assets
   - shareholders' equity. [8]
2. Using the financial data in the Mauritius Telecom balance sheet, analyse how the company's financial position has changed from 2012 to 2013. [8]
3. Discuss the usefulness of this accounting information for:
   a. a potential investor in Mauritius Telecom
   b. creditors of Mauritius Telecom. [10]

Different types of intangible assets

Intangible assets are assets that have no physical substance and are not financial instruments (such as bank accounts and accounts receivables). They include asset types such as copyrights and goodwill.

Marketing-related intangible assets

Marketing-related intangible assets are used to market or promote products or services. Trademarks, logos or trade names are words, phrases or symbols that distinguish or identify a company or its products. They can be renewed indefinitely for periods of ten years at a time. Internet domain names and companies' names also qualify as marketing-related intangible assets that no other businesses have the right to use.

Customer-related intangible assets

Customer-related intangible assets result from business relationships with outside parties. They include lists of regular and reliable customers and contracts gained through long term customer relationships.

Artistic-related intangible assets

Artistic-related intangible assets give ownership rights to plays, literary works, musical works, pictures, photographs, and video and audiovisual material. A copyright protecting these ownership rights can be granted for the life of the creator plus 70 years.

Contract-related intangible assets

Contract-related intangible assets come from the value of rights arising from contractual arrangements, such as franchises, licensing agreements, construction permits, broadcasting rights, and service or supply contracts.

Technology-related intangible assets

Technology-related intangible assets arise from patents taken out on innovations or technological advances. A patent gives its holder the exclusive right to use, manufacture, and sell a product or process for a period of 20 years without any interference or infringement by others. Accountants reduce the value of technology-related intangible assets on balance sheets over their legal life or useful life, whichever is shorter.

Goodwill

This is another intangible asset that can arise when buying out another company. **Goodwill** is the value paid for the company in excess of the fair market value of the net

goodwill: arises when a business is valued at or sold for more than the balance sheet values of its assets

assets acquired. For example, suppose that you're paying \$2 000 000 for a company with net assets worth \$1 600 000. Goodwill in the acquisition is equal to \$400 000 = \$2 000 000 − \$1 600 000). Goodwill may only be recorded as part of an acquisition of another company. Accountants never recognise internally generated goodwill.

Intangible assets – conclusion

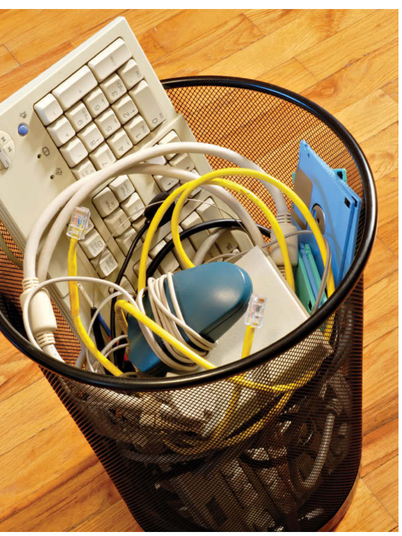
Intangible assets are difficult to put a value on as they are rarely bought and sold on the open market. In addition, unlike buildings or equipment which can be valued by specialist surveyors who can be fairly confident in their assessment, the value of intangible assets can fluctuate wildly. The damage to Toyota's brand image (and hence brand valuation) by the 2010 recall for safety reasons of millions of cars worldwide is a good example. Disputes can arise between accountants about the valuation of intangible assets and there is a current debate regarding the asset value of well-known brand names. There is scope for varying the value of these and other intangibles on the balance sheet 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.

intellectual property: an intangible asset that has been developed from human ideas and knowledge

market value: the estimated total value of a company if it were taken over

Balance sheets prepared under normally accepted accounting rules do not usually record these assets – often known as **intellectual property** – unless acquired through takeover or merger.

For many companies, intangible assets are their main source of future earnings, especially in a world increasingly dominated by the 'knowledge-based economy', e.g. scientific research companies, publishing and music companies, companies with famous brand names and so on. The **market value** of companies with many intangible assets will be much greater than the balance sheet or book value.



Assets decline in value due to wear and tear or technological change

Depreciation of assets

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 profit and loss account. The key principles of depreciation are:

- Annual depreciation attempts to record capital expenditure over the useful life of an asset and avoids recording this expenditure as a one-off cost when the asset is purchased.
- The assets will retain some value on the balance sheet each year until fully depreciated or sold off.
- The profits will be reduced by the amount of that year's depreciation and will not be under- or over-recorded.

Assets decline in value for two main reasons:

- normal wear and tear through usage
- technological change, making either the asset, or the product it is used to make, obsolete.

Technological change makes office equipment obsolete, even if it was purchased quite recently.

THEORY OF KNOWLEDGE

This company catches your eye. Its financial stats are excellent. Just read its annual report: rising gross and net profits, a very strong balance sheet and an excellent cash position. It's a leader in the industry and in a market that's growing very rapidly. As a potential share buyer why wouldn't you go for this well-run company with its excellent product and huge potential earnings?

But you have emotional misgivings about buying into this business.

In your class brainstorm what your emotional misgivings might be.

Discuss the single emotional reason that would stop you buying shares in a business.

Calculating depreciation

There are a number of different methods accountants can use to calculate depreciation – but only two will be tested by the IB examination papers: **straight line** and **reducing balance**.

straight-line depreciation: a constant amount of depreciation is subtracted from the value of the asset each year

reducing balance method: calculates depreciation by subtracting a fixed percentage from the previous year's net book value

Straight-line method of depreciation

The title of this method indicates the way in which depreciation is calculated.

To calculate the annual amount of depreciation the following information will be needed:

- the original or historical cost of the asset
- the expected useful life of the asset
- an estimation of the value of the asset at the end of its useful life – this is known as the residual value of the asset.

The following formula is then used to calculate the annual depreciation charge:

$$\text{annual depreciation charge} = \frac{\text{original or historic cost of asset} - \text{expected residual value}}{\text{expected useful life of asset (years)}}$$

Advantages of straight-line depreciation:

- It 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 plc and you will find a statement about the depreciation methods it has used – more often than not, it will have used this method.

Limitations of straight-line depreciation:

- It requires estimates to be made regarding both life expectancy and residual value. Mistakes at this stage will 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 of calculation – all annual depreciation charges are the same. The diminishing balance method of depreciation (see below) depreciates assets by a greater amount in the first few years of life than in later years.
- There is no recognition of the very rapid pace at which advances in modern technology tend to make existing assets redundant.
- 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 adjusted for by the fixed depreciation charge of the straight-line method.

Calculating depreciation using the straight-line method – worked example

A firm of lawyers purchases three new computers costing $3000 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:

$$\frac{\$900 - \$600}{4} = \frac{\$8400}{4} = \$2100$$

So an annual depreciation charge of $2100 will be made. This will be included in the firm's overhead expenses on the profit and loss account. On the balance sheet, the annual depreciation charge will be subtracted from the value of the computers. At the end of four years, each computer will be valued at $200 on the balance sheet. Table 3.4.5 shows how the value of the computers falls over the four-year period.

Year	Annual depreciation charge	Net book value of the three computers
Present	0	$9000
1	$2100	$6900
2	$2100	$4800
3	$2100	$2700
4	$2100	$600

Table 3.4.5 Net book value declines with each annual depreciation

Suppose that at the end of the fourth year, the computers are sold for more than their expected residual value. If they are sold for a total of $900, then the firm has made a surplus of $300. If, however, the computers were scrapped, because they had become so out of date compared with more recent models, the firm would have to record a loss, in the fourth year, on the disposal of these assets.

Reducing (diminishing) balance method

This method of calculating depreciation solves some of the problems identified by the straight-line method. It leads to higher levels of depreciation in the early years of an asset's life but lower depreciation as the asset ages. The rate of depreciation is calculated using the formula:

$$1 - \sqrt[n]{\frac{\text{residual value}}{\text{cost}}} \times 100$$

Calculating depreciation using the reducing balance method – worked example

A delivery company purchases a vehicle for $16 000. It estimates the residual value as $4000, with an expected lifespan of four years. Table 3.4.6 shows the depreciation and **net book value**.

net book value: the current balance sheet value of a non-current asset = original cost – accumulated depreciation

Year	Depreciation	Net book value
0	0	$16 000
1	$4800 ($16 000 × 30%)	$11 200
2	$3360 ($11 200 × 30%)	$ 7840
3	$2352 ($7840 × 30%)	$ 5488
4	$1646 ($5488 × 30%)	$ 3842

Table 3.4.6 Net book value declines with each annual depreciation

Note that:

- the *amount* of depreciation falls each year but the *rate* remains constant
- the residual value at the end of year 4 is just below the forecasted figure because the rate of depreciation used was rounded up from the 'true' rate of 29.29%.

Advantages of the reducing balance method:

- It is more accurate than the straight-line method, especially where assets lose more value in their early years.
- Another rationale for using this method is that many assets are more efficient and profitable when new; so it is more logical to 'match' a higher amount of the cost of the asset against this higher profit.

Limitations of the reducing balance method:

- It is slightly more difficult to calculate than the straight-line method.
- By calculating a 'precise' rate of depreciation it suggests a level of accuracy for the process of depreciation which is unjustified – the residual value and expected lifespan are always estimates and this detracts from the achievement of complete accuracy.

ACTIVITY 3.4.7

Hardy Engineering depreciates equipment using the straight-line method. The business has just bought a new lathe costing $3m. The makers claim it should have a useful life of ten years. Hardy's accountant estimates that, based on past experience, the machine could be resold for only $200 000 in ten years' time. He believes that this figure could be too optimistic if technological change accelerates over this period. The chief executive wants the accountant to calculate the impact on the company's accounts if the declining balance method is used. He asked the accountant to 'calculate the impact on annual depreciation if we used a declining balance figure of 12%'.

18 marks, 36 minutes

1. Define the term 'depreciation'. [2]
2. Calculate the annual depreciation for the new lathe using the straight-line method. [3]
3. Calculate the annual depreciation in the second year if the declining balance method is used. [3]
4. Evaluate Hardy Engineering's decision to use the declining balance method of depreciation. [10]

OVER TO YOU

Revision checklist

1. List **four** likely external users of the accounts of a large plc such as Microsoft and explain what they would use these accounts for.
2. Outline why managers need more detailed accounts than external users.
3. What is meant by 'window dressing' the accounts?
4. What are the **three** sections of an income statement and what do they show?
5. What is the difference between gross and net/operating profit?
6. What are the **two** ways in which profit after tax may be appropriated?
7. What does a balance sheet show about a business?
8. Explain the difference between fixed assets and current assets.
9. What is meant by the term 'capital employed' on a balance sheet?
10. What is meant by goodwill and why should it be written off the accounts of a business buying another firm as quickly as possible?
11. Explain why it might be difficult for a music publishing business such as EMI to include intangible assets on its accounts.
12. Explain, using numerical examples, why the reducing balance method of depreciation is often considered to be more accurate than the straight-line method.

Exam practice question

CARLOS CHAVES'S ACCOUNTS

Carlos Chaves is a sole trader who has recently opened a small, specialist food shop. His main competitors are the large supermarket chains. Carlos prides himself on the quality of his products and the personal service he offers. For each month in 2010:

- the shop's sales averaged $80 000
- the cost of goods sold was 75% of sales revenue
- the indirect costs were constant at $20 000.

Carlos has just bought a new van for $40 000 to provide customers with a delivery service. The van has a useful life of four years and he expects to sell the van for $8000 at the end of its life.

20 marks, 40 minutes

1. List **two** advantages that the large supermarket chains will have over Carlos's shop. [2]
2. **a.** Prepare a trading and profit and loss account for the year ending 31 December 2010. Show all workings. [4]
   b. Calculate the annual depreciation expense of the van. [4]
   c. Discuss the usefulness of Carlos's profit and loss account to different stakeholders. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, discuss the importance of ethics in producing a set of final accounts. [20]

3.5

Profitability and liquidity ratio analysis

On completing this chapter you should be able to:

Analyse and apply:

- Gross profit margin
- Net profit margin
- Return on capital employed (ROCE)
- Current ratio
- Acid test ratio (All AO2)

Evaluate:

- Strategies to improve these ratios (AO3)

Calculate:

- Gross profit margin
- Net profit margin
- Return on capital employed (ROCE)
- Current ratio
- Acid test ratio (All AO4)

Setting the scene

COMPARING THE ACCOUNTS OF THE COLA GIANTS

How can stakeholders in PepsiCo and Coca-Cola, the world's two best-known soft drink businesses, compare their performances? One way is to analyse their accounting results. Ratio analysis is widely used by shareholders, banks and creditors – as well as the management of the business – to assess and compare companies performances.

Here are extracts from both companies' 2012 (end of December, in $ million) published accounts:

	Sales revenue	Cost of goods sold	Net profit	Current assets	Current liabilities	Inventories	Trade accounts receivable	Capital employed
PepsiCo	65 492	31 291	9112	18 720	17 089	3581	7041	57 549
Coca-Cola	48 017	19 053	10 779	30 328	27 821	3264	4759	58 353

The liquidity of both companies can be assessed by using the current ratio and acid test ratio. These would indicate how able the companies were to pay off short-term debts. The gross and net profit margin ratios can be calculated from using the data above. These results would be a good starting point in comparing the performances of these two businesses. But these ratios do not give us the complete picture. Which company is making more profitable use of the capital invested in it? Which one seems to handle inventories more effectively? Does Coca-Cola or PepsiCo manage its trade receivables more efficiently? These and other questions can be answered by detailed ratio analysis of published accounts.

3.5 Finance and accounts

Points to consider

- Would it be useful to compare these two companies' accounts with those of a construction company? Explain your answer.
- Do you think a high gross profit margin but a low net profit margin is an indicator of poor performance? Explain your answer.
- Why would it be useful for stakeholders to make a comparison between profit and capital invested into a business?

Key concept link

Strategic decisions should be based on a detailed analysis of 'where the business is now'. One feature of the 'situational analysis' is to assess the profitability and liquidity of the business. For most business organisations, future strategies should be focused on improving long-term profitability. Strategic decisions often involve considerable expenditure so measuring the current liquidity of the business will be essential.

Introduction

When studying a company's accounts it is easy to compare one year's profit figure 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. Look at the company results of two printing firms:

	Net profit 2014 ($000)
Nairobi Press Ltd	50
Port Louis Press Ltd	500

Is Port Louis Press more successful than Nairobi Press? Are the managers of Nairobi Press less effective? Are the companies becoming more profitable? Would they make good investments for future shareholders? Are the strategies adopted by Port Louis Press much more successful than those of Nairobi Press?

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 (Port Louis Press) made a net profit ten times greater than that of the other company.

Now look at additional information about these two businesses:

	Revenue 2014 ($000)
Nairobi Press Ltd	250
Port Louis Press Ltd	3200

The additional data give us a more detailed picture of the performance of these two businesses in 2014, especially if we compare the data above with the earlier profit results. Which management team has been more effective at converting sales revenue into profit? Accountants make this assessment by relating two accounting results to each other in the form of a ratio.

Accounting ratios

There are three main groups of ratios to be studied on the IB syllabus:

- profitability ratios
- **liquidity** ratios
- financial efficiency ratios (HL only).

liquidity: the ability of a firm to pay its short-term debts

Profitability ratios

Profit margin ratios

Gross profit margin and **net profit margin** ratios are used to assess how successful the management of a business has been at converting sales revenue into both gross profit and net profit. They are used to measure the performance of a company and its management team.

gross profit margin (%):

$$= \frac{\text{gross profit}}{\text{sales revenue}} \times 100$$

net profit margin (%):

$$= \frac{\text{net profit}}{\text{sales revenue}} \times 100$$

Using the two businesses referred to above (all figures for 2014), the gross profit margin may be calculated as follows:

	Gross profit ($000)	Revenue ($000)	Gross profit margin
Nairobi Press Ltd	125	250	$\frac{125}{250} \times 100 = 50\%$
Port Louis Press Ltd	800	3200	$\frac{800}{3200} \times 100 = 25\%$

Points to note:

- Nairobi Press is making 50 cents gross profit on each $1 of sales and Port Louis Press is making just 25 cents.
- Port Louis Press's gross profit margin could be lower because it is adopting a low-price strategy to increase sales or because it has higher cost of sales. The company might have higher material costs or higher direct labour costs compared with Nairobi Press.
- Port Louis Press's gross profit margin could increase its ratio by reducing the cost of sales, while maintaining revenue – say, by using a cheaper supplier – or by increasing revenue without increasing cost of sales – say, by raising prices but offering a better service.
- The gross profit margin is a good indicator of how effectively managers have 'added value' to the cost of sales.
- It is misleading to compare the ratios of firms in different industries because the level of risk and gross profit margin will differ greatly.

The net profit margin of the two companies may be calculated as follows:

	Net profit ($000)	Revenue ($000)	Net profit margin
Nairobi Press Ltd	50	250	$\frac{50}{250} \times 100 = 20\%$
Port Louis Press Ltd	500	3200	$\frac{500}{3200} \times 100 = 15.6\%$

Exam tip:
Many candidates state that 'to increase profit margins the business should increase sales'. This is a poor answer *unless* sales revenue can be increased at a greater rate than the costs of the business.

Points to note:

- Nairobi Press is making 20 cents net profit on each $1 of sales and Port Louis Press is making 15.6 cents on each $1 of sales.
- The profitability gap between these two businesses has narrowed. Whereas the difference in gross profit margins is substantial, the net profit margins are much more alike. This suggests that Nairobi has relatively high overheads compared to sales, when contrasted with Port Louis – because the difference between net profit and gross profit is the cost of overheads.
- Port Louis could narrow the gap further by reducing overhead expenses while maintaining sales or by increasing sales without increasing overhead expenses.
- As with all ratios, a comparison of results with those of previous years would indicate whether the performance and profitability of a company were improving or worsening. The net profit margin – and the trend in this ratio over time – is a good indicator of management effectiveness at converting revenue into net profits.

Strategies to improve the profit margin ratios

All businesses will aim to 'improve margins' but this is not easy and there are often limitations to the strategies that can be adopted (see Table 3.5.1).

Strategy to increase profit margins	Examples	Evaluation
Increase gross and net profit margin by reducing direct costs – cutting the cost of goods sold	1. Use cheaper materials, e.g. rubber not leather soles on shoes. 2. Cut labour costs by relocating production to low labour-cost countries, e.g. Dyson relocating the manufacture of vacuum cleaners to Malaysia. 3. Cut labour costs by increasing productivity through automation in production, e.g. the Hyundai production line uses some of the most advanced labour-saving robots in the world. 4. Cut wage costs by reducing workers' pay.	1. Consumers' perception of quality may be damaged and this could hit the product's reputation. Consumers may also expect lower prices, which may cut the gross profit margin. 2. Quality may be at risk – communication problems with distant factories. 3. Purchasing machinery will increase overhead costs (gross profit could rise but net profit fall); remaining staff will need retraining – short-term profits may be cut due to these costs. 4. Motivation levels might fall, which could reduce productivity and quality.
Increase gross and net profit margin by increasing price	1. Raise the price of the product with no significant increase in variable costs, e.g. BT (formerly British Telecom) raising the price of its broadband connections. 2. Petrol companies increase prices by more than the price of oil has risen.	1. Total profit could fall if too many consumers switch to competitors. 2. Consumers may consider this to be a 'profiteering' decision and the long-term image of the business may be damaged.
Increase net profit margin by reducing overhead costs	Cut overhead costs, such as rent, promotion costs or management costs, but maintain sales levels, for example by: 1. moving to a cheaper head office location 2. reducing promotion costs 3. delayering the organisation.	1. Lower rental costs could mean moving to a cheaper area, which could damage image, e.g. of a restaurant. 2. Cutting promotion costs could lead to sales falling by more than fixed costs. 3. Fewer managers – or lower salaries – could reduce the efficient operation of the business.

Table 3.5.1 Evaluation of ways to increase profit margins

LEARNER PROFILE

Balanced, caring

As the CEO of a building materials business you look at the financial data of your business with anxiety. Whichever way you look at the ratios your accountant has prepared for you, the situation does not look good. Profit margins are slim and key liquidity ratios are trending downwards. The outlook is particularly bleak when key ratios are compared with other firms in the market.

The question you must ask yourself is: Who is responsible and should they lose their jobs?

As a balanced, caring CEO how do you respond to the situation? Discuss how you would deal with the managers who are responsible for the business's current situation.

Exam tip:
Many examination questions will ask for methods of increasing 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.

Return on capital employed (ROCE)

Return on capital employed is the most commonly used means of assessing the profitability of a business; it is often referred to as the primary efficiency ratio.

From the results below it is clear that the management of Nairobi Press is more effective at making the capital invested in the business generate profit (all figures for 2014).

	Net profit ($m)	Capital employed ($m)	ROCE
Nairobi Press Ltd	50	400	$\frac{50}{400}\times 100 = 12.5\%$
Port Louis Press Ltd	500	5000	$\frac{500}{5000}\times 100 = 10\%$

return on capital employed (%):

$$= \frac{\text{net profit}}{\text{capital employed}} \times 100$$

capital employed:
= (non-current assets + current assets) – current liabilities or non-current liabilities + shareholders' equity. The total capital invested in the business.

Points to note:

- The higher the value of this ratio, the greater the return on each dollar of capital invested in the business.
- The return can be compared both with other companies and the ROCE of the previous year's performance. Comparisons over time enable 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 should be compared with the interest cost of borrowing finance – if it is less than this interest rate, then any increase in borrowings will reduce returns to shareholders.
- The ROCE can only be raised by increasing the profitable, efficient use of the assets owned by the business, which were purchased by the capital employed.
- The method used for the calculation of capital employed is not universally agreed and this causes problems for comparisons between companies.

Strategies for increasing ROCE

These are similar to those that can be used for increasing the net profit margin. An evaluation of these is contained in Table 3.5.2.

Strategies to increase ROCE	Potential limitations
Increase net profit without increasing capital employed, e.g.	
1. raise prices of existing products	1. demand could be price elastic
2. develop innovative products and set prices high	2. this can only be a long-term strategy
3. reduce variable costs per unit	3. cheaper materials could reduce quality
4. reduce overheads, such as delayering or reducing promotion costs	4. may not be effective in increasing profit in the short run and may have drawbacks, e.g. less promotion could reduce sales
5. increase capital invested in new technology which could lead to an increase in net profits higher than the increase in capital employed	5. finance will be needed and increase in net profits may be relatively less than increase in capital employed
Reduce capital employed, e.g.	
• sell assets that contribute nothing or little to sales/profit – use the capital raised to reduce debts	• assets may be needed in the future, e.g. for expansion of business

Table 3.5.2 Evaluating strategies for increasing ROCE

ACTIVITY 3.5.1

SAMSUNG'S PROFITABILITY

The following data was obtained from Samsung's published accounts (all figures are in billions South Korean wons).

	2012	2013
Revenue	201 104	228 693
Cost of sales	126 652	137 696
Net profit	29 915	38 364
Current assets	87 270	110 760
Inventories	17 747	19 135
Current liabilities	46 933	51 315
Capital employed	134 139	162 760

In April 2014 Samsung Electronics, the world's biggest maker of TVs and mobile phones, reported a drop in net profit for the second quarter in a row. This is 4% down on the same period in 2013. The fall in profit is largely a result of increased competition, forcing prices down and shrinking profit margins. Samsung has warned that it expects competition in the market to intensify further. Samsung's chip-making business only makes a net profit margin of 20% but its main competitor, SK hynix, has recorded a 28.2% margin.

Business analysts are suggesting that Samsung may need to cut costs in order to increase profits again. 'What Samsung needs to do this year are things like cost reduction and reduce marketing costs,' said Greg Roth, an analyst with HMC Securities. 'Samsung has no way to prevent a decline in profits without improving internal efficiencies.'

36 marks, 72 minutes

1. Define the following terms:

  a. capital employed [2]

  b. net profit margin. [2]

2. Calculate Samsung's gross profit for both years. [2]

3. Calculate the following ratios from Samsung's accounts for both years:
   - gross profit margin
   - net profit margin
   - ROCE
   - current ratio
   - acid test ratio. [10]
4. Using the ratios you have calculated, comment on Samsung's performance over the two years. [10]
5. Evaluate **two** strategies that Samsung could adopt in an attempt to improve its profitability ratios. [10]

Liquidity ratios

These ratios assess the ability of the firm to pay its short-term debts. They are not concerned with profits but 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. If it has too much money tied up in working capital, then this could be used more effectively and profitably by investing in other assets.

Current ratio

The result can be expressed either as a ratio (2:1, for example) or just as a number (for example, 2). 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 1.5–2, 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.

current ratio:

$$= \frac{\text{current assets}}{\text{current liabilities}}$$

The current ratios for the printing companies may be calculated as follows (all figures as at 31 December 2014):

	Current assets ($000)	Current liabilities ($000)	Current ratio
Nairobi Press Ltd	60	30	$\frac{60}{30} = 2$
Port Louis Press Ltd	240	240	$\frac{240}{240} = 1$

Points to note:

- Nairobi Press is in a more liquid position than Port Louis Press. Nairobi Press has twice as many current assets as current liabilities. For every $1 of short-term debt it has $2 of current assets to pay for them. This is a relatively 'safe' position – indeed, many accountants advise firms to aim for current ratios between 1.5 and 2.0.
- The current ratio of Port Louis Press is more worrying. It only has $1 of current assets to pay for each $1 of short-term debt. It could be in trouble in the (unlikely) event that all of its short-term creditors demanded repayment at the same time, especially if some of its current assets could not be converted into cash quickly. For this reason, the next ratio, the acid test, is often more widely used.
- Very low current ratios might not be unusual for businesses, such as food retailers, that have regular inflows of cash, such as cash sales, that they can rely on to pay short-term debts.

- Current ratio results over 2 might suggest that too many funds are tied up in unprofitable inventories, debtors and cash and would be better placed in more profitable assets, such as equipment to increase efficiency.
- A low current ratio might lead to corrective management action to increase cash held by the business. Such measures might include: sale of redundant assets, cancelling capital spending plans, share issue, or taking out long-term loans.

acid test ratio:

$$= \frac{\text{liquid assets}}{\text{current liabilities}}$$

Acid test ratio

Also known as the quick ratio, the **acid test ratio** is a stricter test of a firm's liquidity. It ignores the least liquid of the firm's current assets – stocks, which have not yet been sold and there is no certainty that they will be sold in the short term. By eliminating the value of stocks from the acid test ratio, the users of accounts are given a clearer picture of the firm's ability to pay short-term debts.

The acid test ratios for the printing companies may be calculated as follows (all figures as at 31 December 2014):

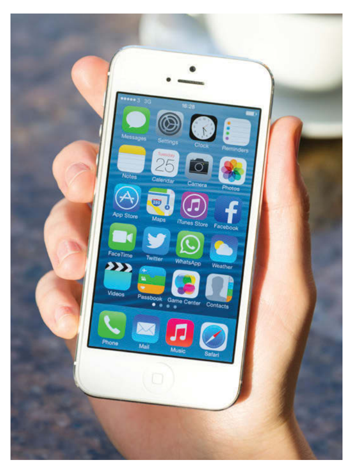
	Liquid assets ($000)	Current liabilities ($000)	Acid test ratio
Nairobi Press Ltd	30	30	1
Port Louis Press Ltd	180	240	0.75

Points to note:

liquid assets: = current assets – inventories

- Results below 1 are often viewed with caution by accountants as they mean that the business has less than $1 of **liquid assets** to pay each $1 of short-term debt. Therefore, Port Louis Press may well have a liquidity problem.
- The full picture needs to be gained by looking at previous years' results. For example, if last year Port Louis Press had an acid test of 0.5, this means that over the past 12 months its liquidity has actually improved and this is more favourable than if its results last year had been 1, showing a decline in liquidity in the current year.
- Firms with very high inventory levels will record very different current and acid test ratios. This is not a problem if inventories are always high for this type of business, such as furniture retailers. It would be a problem for other types of businesses, such as computer manufacturers, where stocks lose value rapidly due to technical changes.
- Whereas selling inventories for cash will not improve the current ratio – both items are included in current assets – this policy will improve the acid test ratio as cash is a liquid asset but inventories are not.

THEORY OF KNOWLEDGE



These may be troubled times for Apple. Its share price has fallen by 40% since its record high earlier in the year. Investors are worried by the sluggish sales growth of the iPad and pressure on profit margins. Add to this Samung's Android devices as a genuine threat to Apple's market share. Apple's latest iPhone is helping though with sales up 58 percent on this time last year. This is an interesting time for the US tech giant's shareholders because they are so used to stellar performance from the company. The death of Steve Jobs last year also raises some questions about where Apple goes next.

In your class discuss the importance of mathematics in making an assessment of Apple's performance in 2012.

Strategies for improving liquidity ratios

See Table 3.5.3 for an evaluation of ways to improve liquidity.

Strategies to increase liquidity	Examples	Evaluation
Sell off fixed assets for cash – could lease these 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 raise their true value. • If assets are still needed by the business, then leasing charges will add to overheads and reduce net profit margin.
Sell off inventories for cash – *note:* 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. • Just-in-time (JIT) inventory management will achieve this objective (see Chapter 5.3).	• This will reduce the gross profit margin if inventories are sold at a discount. • Consumers may doubt the image of the brand if inventories are sold off cheaply. • 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	• Long-term loans could be taken out if the bank is confident of the company's prospects.	• These will increase the gearing ratio (see Chapter 3.6). • These will increase interest costs.

Table 3.5.3 Evaluation of ways to improve liquidity

ACTIVITY 3.5.2

IS THE LIQUIDITY OF AIR MAURITIUS SUFFICIENT?

The following information is taken from Air Mauritius Limited accounts for the year ending 30 September 2013 (all figures are in €000).

Current assets: inventories 15 468; trade and other receivables 65 793; cash and cash equivalents 17 214.

Current liabilities: trade payables 135 921; short-term loans 40 523.

18 marks, 36 minutes

1. Using the financial data, calculate Air Mauritius':
   a. current ratio
   b. acid test ratio. [4]

2. Describe Air Mauritius' liquidity position. [4]

3. Evaluate the usefulness of previous years' data to Mauritius stakeholders when making an assessment of its current liquidity position. [10]

ACTIVITY 3.5.3

HOW IS MY BUSINESS DOING?

Mohammed Ahmed is the chief executive of Ahmed Builders plc. The company specialises in the quality fitting out of shops for internationally famous retailers. These customers demand that work is finished to very tight time limits, so it is important for Ahmed Builders to keep stocks of important materials. Ahmed is keen to compare the performance and liquidity of his company with those of another building company which does similar work. He obtained a set of published accounts for Flash Builders plc and used ratios to help him in the comparison. These were the figures he used from both companies:

	Ahmed ($000)	Flash ($000)
Gross profit (2014)	100	150
Net profit (2014)	20	60
Revenue (2014)	350	600
Current assets (as at 31 December 2014)	100	150
Inventories (as at 31 December 2014)	50	60
Current liabilities (as at 31 December 2014)	45	120

40 marks, 80 minutes

1. Using the data for Ahmed Builders plc and Flash Builders plc, calculate their:
   a. gross profit margin **b.** net profit margin. [6]
2. Using the ratios you have calculated, comment on the profitability of both businesses. [4]
3. Evaluate **two** ways in which Ahmed might attempt to increase the net profit margin ratio for his business. [10]
4. Using the data for Ahmed Builders plc and Flash Builders plc, calculate each company's:
   a. current ratio **b.** acid test ratio. [6]
5. Using the ratios you have calculated, comment on the liquidity of both businesses. [4]
6. Evaluate **two** ways in which Flash Builders plc might be able to improve its liquidity position. [10]

Exam tip: When commenting on ratio results, it is often advisable to question the accuracy of the data used and the limitations of just using a limited number of ratio results in your analysis.

OVER TO YOU

Revision checklist

1. How is the return on capital employed (ROCE) ratio calculated and what does the result indicate about a business?
2. Explain **two** ways in which directors of a carpet-manufacturing business could attempt to increase its ROCE ratio.
3. A soft drink manufacturer operates in a very competitive market. The business currently has low liquidity levels. Would you advise the business to offer longer credit periods to retail store owners who buy large quantities of its drinks? Explain your answer.
4. Explain **two** ways in which a sports shoe manufacturer might increase its net profit margin.
5. Explain why it is useful to measure a company's liquidity with ratio analysis.
6. Explain how it might be possible for a supermarket's gross profit margin to fall, yet its net profit margin to increase.
7. Why is the acid test ratio always lower than the current ratio?
8. Why is net profit margin always lower than gross profit margin?

Exam practice question

KARACHI PAPER PRODUCTS PLC

Look at the extracts from the published accounts for Karachi Paper Products plc and then answer the questions that follow.

	Year ending 31 December 2014 ($m)	Year ending 31 December 2013 ($m)
Revenue	400	330
Cost of goods sold	120	100
Net profit	35	33
Inventories (stock)	58	36
Accounts receivable (debtors)	80	70
Current assets	140	120
Current liabilities	140	120
Long-term (non-current) liabilities	150	120
Capital employed	300	260

24 marks, 48 minutes

1. Define the following terms:
   a. current assets
   b. capital employed. [4]
2. Explain **one** ratio you would use to measure Karachi Paper Products' liquidity. [4]
3. Calculate the following ratios for 2013 and 2014:
   a. return on capital employed
   b. gross profit margin
   c. net profit margin. [6]
4. On the basis of the ratios you have calculated, evaluate the change in performance of Karachi Paper Products over the two years. [10]

Key concept question

20 marks, 40 minutes

With reference to one or two organisation(s) that you have studied, discuss the importance of financial analysis in developing business strategy. [20]

3.6

H

Efficiency ratio analysis

On completing this chapter you should be able to:

Analyse and apply:

- Efficiency ratios:
  - Inventory/stock turnover
  - Debtor days
  - Creditor days
  - Gearing ratio (All AO2)

Evaluate:

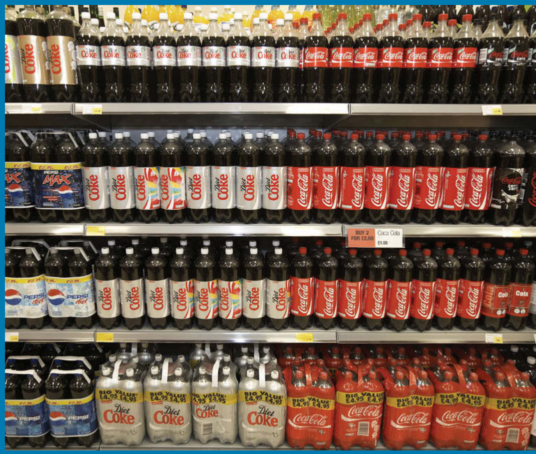
- Possible strategies to improve these ratios (AO3)

Calculate:

- Efficiency ratios:
  - Inventory/stock turnover
  - Debtor days
  - Creditor days
  - Gearing ratio (All AO4)

Setting the scene

COMPARING THE EFFICIENCY OF THE COLA GIANTS



Stakeholders in PepsiCo and Coca-Cola, the world's two best-known soft drink businesses, can compare the profitability and liquidity of these companies by using profit margin ratios, ROCE, current ratio and acid test ratio. Other questions might need to be asked by stakeholders, however. How efficient is the management at managing working capital and paying creditors? Are debtors allowed too long to pay the companies? Do the companies depend greatly on external loan finance to fund their assets? These questions can be answered by further ratio analysis. Here are extracts from the 2013 (end of December, in $ million) published accounts for both companies:

	Revenue	Cost of sales	Inventories	Creditors	Debtors	Credit purchases	Capital employed
PepsiCo	66 415	31 243	3409	12 533	6954	22 485	59 639
Coca-Cola	46 854	18 421	3277	9577	4873	18 410	62 244

Points to consider

- Which stakeholders would be interested in the level of borrowing compared to capital employed in these businesses?
- Should management of either business be worried about the level of inventories being held?
- How could the values of creditors and debtors be compared to make meaningful ratios?

Key concept link

Business managers need to pursue strategies that increase business efficiency in a globalised and competitive marketplace. One aspect of efficiency is how the business manages its working capital and whether this could be more effectively managed.

Introduction

The previous chapter introduced the concept of ratios used to analyse business accounts. There are many other ratios that can be used by stakeholders to assess and monitor business performance and efficiency. This chapter focuses on ratios used to measure financial efficiency.

Efficiency ratios

There are several efficiency ratios that can be used to assess how efficiently the working capital of a business is being managed and how significant borrowed capital is to the financing of the business.

1. Inventory (stock) turnover ratio

In principle, the lower the amount of capital used in holding inventories, the better. Modern inventory-control theory focuses on minimising investment in inventories. This ratio records the number of times the inventory of a business is bought in and resold in a period of time. In general terms, the higher the **inventory turnover ratio**, the lower the capital tied up in inventories. If a business bought inventory once each year, enough to see it through the whole year, the inventory turnover would be 1 and investment in inventories would be high. This capital could have been used – perhaps more profitably – in other parts of the business.

inventory (stock) turnover ratio: $= \dfrac{\text{cost of goods sold}}{\text{inventory level}}$

The following examples use this ratio to compare the inventory turnover between two companies.

	Cost of goods sold $m (2013)	Inventory level $m (31 December 2013)	Inventory turnover ratio
Nairobi Press Ltd	125	25	$\frac{125}{5} = 5$
Port Louis Press Ltd	2400	600	$\frac{2400}{600} = 4$

These results mean that Nairobi Press 'turned over' its inventories five times in 2013 and this indicates better efficiency in inventory management than that recorded by Port Louis Press. According to the 2013 stock turnover ratio, Nairobi Press has a lower level of inventories compared to costs of goods sold than Port Louis Press. If Port Louis Press introduced a system of just-in-time (JIT) stock management, then inventory deliveries would be more frequent but smaller in size and this would increase its inventory turnover ratio.

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 – such as the use of the JIT system – will give a high inventory turnover ratio.
- 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 inventory turnover ratio than a car dealer.

- For service-sector firms, such as insurance companies, this ratio has little relevance, as they are not selling 'products' held in inventories.

The inventory turnover ratio can be calculated in three other ways:

- Using average inventory holding – that is, the average value of inventories at the start of the year and at the end.
- Using revenue, not cost of sales – this would give a very different result, but could be used if cost of sales data were not available.
- Using an alternative formula that measures the average number of days that money is tied up in inventories:

$$\text{Inventory turnover ratio (days)} = \frac{\text{value of inventories}}{\dfrac{\text{cost of sales}}{365}}$$

Improving inventory turnover

Table 3.6.1 outlines some strategies that a business could adopt to attempt to improve its inventory turnover ratio.

Strategies to improve this ratio result	Evaluation
Reduce inventories of finished goods, e.g. in retail outlets	Offering consumers less choice might reduce sales. If revenue falls, then even with lower inventories, the ratio will not improve.
Reduce inventories of raw materials/ components	Unless this reduction is well managed it could lead to production hold-ups and delays – customers may not wait for products to be produced.
Introduce an effective just-in-time inventory management system that should allow lower inventory levels throughout the chain of production	This requires investment in IT, very reliable suppliers, flexible production machinery, adaptable workforce and excellent infrastructure – to allow for frequent, small inventory deliveries.

Table 3.6.1 Strategies to improve inventory (stock) turnover

2. Debtor days (days' sales in trade receivables) ratio

This ratio measures the average length of time it takes the business to recover payment from customers who have bought goods on credit – the debtors. The shorter this time period is, the better the management is at managing debtors and controlling its working capital.

debtor days (days' sales in receivables) ratio:
= debtors (accounts receivable) × 365 / revenue

The **debtor days ratio** can also be calculated by using total sales on credit, thus excluding sales for cash from the calculation – which could be more accurate because cash sales will never lead to debtors. A similar ratio – known as the debtors (accounts receivable) turnover ratio – is calculated by:

$$\frac{\text{revenue}}{\text{debtors (accounts receivable)}}$$

	Debtors (trade accounts receivable) \$m (31 December 2014)	Revenue \$m Year ending 31 December 2014	Debtor days (days' sales in trade receivables)
Nairobi Press Ltd	75	250	$\frac{75 \times 365}{250} = 109.5$ days
Port Louis Press Ltd	600	3200	$\frac{600 \times 365}{3200} = 68.4$ days

The debtor days result shows that both companies give their customers a very long time to pay debts. Perhaps the printing market is very competitive in these cities and to gain business, long credit periods have to be offered. However, days' sales in trade receivables results as high as these put a great strain on 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 selling almost exclusively for cash will have a very low ratio result.
- A debtor days ratio 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 average for most businesses and could result from poor control of debtors and repayment periods.

The value of this ratio could be reduced by giving shorter credit terms – say, 30 days instead of 60 days – or by improving credit control. This could involve refusing to offer credit terms to frequent late payers. The impact on sales revenue of such policies must always be borne in mind – 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.

Strategies to improve this ratio result	Evaluation
Sell only to customers paying in cash – there would then be no debtors (accounts receivable)	This would reduce sales to customers who expect credit terms and who are likely to receive them from other supplying businesses.
Ask debtors to pay more quickly – limit the credit terms offered	This would reduce sales to customers who expect *long* credit terms and who are likely to receive them from other supplying businesses.
Use debt factoring by selling debtors' invoices to factoring company for cash	The factoring business will purchase the invoices at a discount so profit margins will fall for the business selling them.

Table 3.6.2 Strategies to improve (lower) the debtor (accounts receivable) days ratio

3. Creditor days (days in trade payables) ratio

This measures how quickly a business pays its suppliers during the year. The higher this result, the longer the business is taking to pay its suppliers.

The printing companies' **creditor days ratios** are as follows:

creditor days (accounts payable) ratio:

$$= \frac{\text{trade creditors}}{\text{credit purchases}} \times 365$$

	Trade creditors (accounts payable) 31 December 2014 ($m)	Credit purchases Year ending 31 December 2014 ($m)	Creditor days
Nairobi Press Ltd	25	100	$\frac{25}{100} \times 365 = 91$ days
Port Louis Press Ltd	250	1125	$\frac{250}{1125} \times 365 = 81$ days

Points to note:

- A high result for this ratio means the business is slow to pay its suppliers. This reduces the firm's cash outflow to pay suppliers in the short term and results in lower cash requirements.
- New start-up businesses might not be offered any credit by suppliers – all deliveries could be on a 'cash only' basis, so this ratio could not be calculated in these cases.

Exam tip: If you are asked to compare the results of these ratios with those of another business, you could suggest that comparisons only have real significance when the businesses are operating in the same industry.

Strategies to improve this ratio result	Evaluation
Delay payment to suppliers	Suppliers may object to not being paid promptly and may offer less discount and support the business less when it needs rapid deliveries.
Ask all suppliers for extended credit terms	Some may be unwilling to do this and could insist on strict credit terms.
Only purchase from suppliers with extended credit terms	This might limit choice of suppliers and it is unlikely to help build a long-term relationship with suppliers which could benefit both businesses.

Table 3.6.3 Strategies to improve (raise) the creditor days ratio

4. Gearing ratio

This measures the degree to which the capital of the business is financed from long-term loans. The greater the reliance of a business on loan capital, the more 'highly geared' it is said to be. There are several different ways of measuring gearing, but this is one of the most widely used ratios.

$$\text{Gearing ratio} = \frac{\text{long-term loans}}{\text{capital employed}} \times 100$$

The same result will be obtained by using the latest terminology:

$$\frac{\text{non-current liabilities}}{\text{shareholders' equity} + \text{non-current liabilities}} \times 100$$

	Long-term loans (non-current liabilities) ($m)	Capital employed (shareholders' equity + non-current liabilities) ($m)	Gearing ratio
Nairobi Press Ltd	40	400	$\frac{40}{400} \times 100 = 10\%$
Port Louis Press Ltd	2000	5000	$\frac{2000}{5000} \times 100 = 40\%$

Nairobi Press is, clearly, less dependent on long-term loans to finance its assets than is Port Louis Press. This is a safer business strategy – but could the directors of Nairobi Press be missing some potentially profitable investment opportunities by their reluctance to increase debts? On the other hand, if interest rates and company profits fell as a result of a recession, then the directors of Port Louis Press might start to regret their decision to raise finance from debts to this extent. This is the riskier strategy of the two businesses.

Points to note:

- The ratio shows the extent to which the company's assets are 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. The higher the borrowings of the business, the more interest must be paid and this will affect the ability of the company to pay dividends and earn retained profits. This is particularly the case when interest rates are high and company profits are low – such as during an economic downturn. Interest will still have to be paid – but from declining profits.

- Debts have to be repaid eventually and the strain of paying back high debts compared to capital could leave a business with low liquidity.
- A low gearing ratio is an indication of a 'safe' business strategy. It also suggests, however, that management are not borrowing to invest in, or to expand, the business. This could be a problem for shareholders if they want rapid and increasing returns on their investment. The returns to shareholders may not increase by as great a proportion as they could for a highly geared business with a vigorous growth strategy. Shareholders in a company following a successful growth strategy financed by high debt will find their returns increasing much faster than in a slower-growth company not prepared to take risks through high borrowings.
- The gearing ratio of a business could be reduced by using non-loan sources of finance to increase capital employed, such as issuing more shares or retaining profits. These increase shareholders' funds and capital employed and lower the gearing ratio.

Alternative gearing ratios

$$\frac{\text{long-term debt}}{\text{shareholders' equity}} \times 100$$

A result of more than 100% with this ratio would indicate high gearing. Another gearing ratio is:

$$\frac{\text{total debt}}{\text{total assets}} \times 100$$

Table 3.6.4 outlines strategies a business could pursue to reduce the gearing ratio.

Strategies to improve this ratio result	Evaluation
Sell assets and use proceeds to repay loans	These assets might be profitable – now or in the future.
Sell shares (if a company) and use proceeds to repay loans or purchase additional capital (increasing capital employed but not loans)	Permanent capital in the form of share capital might dilute the ownership of existing shareholders. Loans will eventually be repaid but shares are unlikely to be bought back by the company.
Keep retained profit level as high as possible (perhaps by reducing dividends) to increase capital employed but not loans	This strategy could take some time to reduce gearing and cutting dividends might have a negative impact on share prices.

Table 3.6.4 Strategies to improve (lower) the gearing ratio

ACTIVITY 3.6.1

TOTAL OIL

Oil executives frequently compare the performance and efficiency of their company with those of other major oil companies. The following data is taken from Total Oil's 2013 accounts.

Credit sales ($m)	Creditors (accounts payable) ($m)	Debtors (accounts receivable) ($m)	Long-term loans ($m)	Inventories ($m)	Cost of sales ($m)	Capital employed ($m)	Credit purchases (author's estimate) ($m)
227 969	30 282	23 422	34 574	22 097	160 849	177 555	160 000

26 marks, 52 minutes (plus research time)

1. Using the data in the table, calculate the following ratios for Total Oil in 2013:
   - **a.** debtor days
   - **b.** creditor days
   - **c.** inventory/stock turnover
   - **d.** gearing. [8]

2. Using the ratios you have calculated for Total Oil, comment on its efficiency and gearing. [8]
3. Evaluate a strategy Total Oil might use to improve its efficiency and gearing. [10]

Research task Use the internet to research the efficiency and gearing ratios of another oil company for 2013 – perhaps one that operates in your country.

Compare these ratio results with those for Total. Compare and contrast the efficiency and gearing of these two businesses.

ACTIVITY 3.6.2

FINANCIAL EFFICIENCY AND GEARING RATIOS

Union Market Wholesale Ltd and RFL Wholesale are two major wholesale organisations that supply small and medium-sized retail businesses. Financial data for the businesses are set out in the table below.

	Debtors ($m)	Inventories 31 December 2014 ($m)	Cost of sales 2014 ($m)	Revenue 2014 ($m)	Capital employed ($m)	Long-term loans 31 December 2014 ($m)	Creditors (accounts payable) 31 December 2014 ($m)	Credit purchases 2014 ($m)
Union Market Wholesale Ltd	300	73	580	1120	1575	500	58	300
RFL Wholesale	330	150	750	1460	2050	1025	105	550

30 marks, 60 minutes

1. Using the data in the table, calculate the following ratios for Union Market Wholesale Ltd and RFL Wholesale:
   a. debtor days ratio
   b. creditor days ratio
   c. inventory turnover ratio
   d. gearing ratio. [12]
2. Using the ratios you have calculated for Union Market Wholesale Ltd and RFL Wholesale, comment on their efficiency and gearing. [8]
3. RFL Wholesale is planning to invest in a new expansion project costing $75 million. It is considering raising finance either by selling inventories or by taking a bank loan. Discuss the advantages and disadvantages of these two options. [10]

THEORY OF KNOWLEDGE

'You just needed to look at the figures: sales were rising, profit margin was good and return on capital was the best in the industry. So it was a bit of a shock when ARL Leisure went into administration. Accounting irregularities, directors making figures look good to drive up the share price and good old-fashioned fraud were at the heart of ARL's problems.'

a. Examine the role of evidence in making judgements about an organisation's performance.

b. To what extent does financial gain lead to unethical practices in organisations?

Limitations of ratio analysis

1. One ratio result is not very helpful – to allow meaningful analysis to be made, a comparison needs to be made between this one result and either:
   - other businesses, called inter-firm comparisons or
   - other time periods, called trend analysis.
2. Inter-firm comparisons need to be used with caution and are most effective when companies in the same industry are being compared. Financial years end at different times for businesses and a rapid change in the economic environment could have an adverse impact on a company publishing its accounts in June compared to a January publication for another company.
3. Trend analysis needs to take into account changing circumstances over time which could have affected the ratio results. These factors may be outside the companies' control, such as an economic recession.
4. As noted above, some ratios can be calculated using slightly different formulae, and care must be taken only to make comparisons with results calculated using the same ratio formula.
5. Companies can value their assets in different ways, and different depreciation methods can lead to different capital employed totals, which will affect certain ratio results. Deliberate window dressing of accounts would obviously make a company's key ratios look more favourable – at least in the short term.
6. Ratios are only concerned with accounting items to which a numerical value can be given. Increasingly, observers of company performance and strategy are becoming more concerned with non-numerical aspects of business performance, such as environmental audits and human rights abuses in developing countries that the firms may operate in. Indicators other than ratios must be used for these assessments.
7. Ratios are useful analytical tools, but they do not solve business problems. Ratio analysis can highlight issues that need to be tackled – such as falling profitability or liquidity – and these problems can be tracked back over time and compared with other businesses. On their own, ratios do not necessarily indicate the true cause of business problems and it is up to good managers to locate these and form effective strategies to overcome them.

LEARNER PROFILE

Open-minded

Google has been named 'Best Company to Work For' by *Fortune* magazine. A majority of its employees don't just like working for the company, they love it. Expanding on its success, Google has put into place a strategic management approach to its employees based on focusing on its employees' well-being and happiness.

Google's headquarters famously offers its employees peculiar and spectacular perks such as a roller hockey rink, free massages and on-site dance classes. The company went public in 2004 at $100 per share and now trades at more than $600. It started out with just a couple of employees and now has more than 37 000. In addition, last year, after just a decade and a half in existence, Google booked more than $50 billion in revenues and nearly $11 billion in net income.

Source: www.vault.com

Google is a very successful organisation in part due to the efficiency of its staff. You are the owner of a small IT business. As an 'open-minded' manager you are considering the adoption of Google's approach to the way you run your business.

In your class discuss whether this approach really would lead to greater efficiency.

OVER TO YOU

Revision checklist

1. Explain to a manager what the efficiency ratios could tell her about the business.
2. Analyse why, with examples, it is difficult to make a realistic comparison between the inventory turnover ratios of companies in different industries.
3. Why would introducing just-in-time inventory control be likely to reduce the inventory turnover ratio for a car manufacturer?
4. Explain why a manager, even though the business has limited working capital, might decide not to restrict credit terms offered to customers.
5. Explain how a high gearing ratio might lead to high shareholder returns in the future.
6. Would you advise a business to attempt to raise or lower its gearing ratio during a period of economic uncertainty with rising interest rates? Explain your answer.
7. Explain **two** drawbacks of using accounting ratios to assess the performance of one business compared to another.
8. A soft drink manufacturer operates in a very competitive market. The business currently has low liquidity levels. Would you advise the business to offer longer credit periods to retail store owners who buy large quantities of its drinks? Explain your answer.

Exam practice question

KARACHI PAPER PRODUCTS PLC

This business owns forests and paper mills. It is one of the main producers of paper used in industry in the region. The market for paper products is becoming more competitive. Interest rates have started to rise after a long period of low rates because the government is becoming worried about inflation.

	Year ending 31 December 2014 ($m)	Year ending 31 December 2013 ($m)
Revenue	400	330
Cost of goods sold	120	100
Credit purchases	100	80
Creditors	45	30
Inventories (stock)	58	36
Debtors	80	70
Long-term (non-current) liabilities	150	120
Capital employed	300	260

26 marks, 52 minutes

1. Define the following terms:
   a. revenue
   b. inventories. [4]
2. Explain **one** efficiency ratio that the business could use. [4]
3. Calculate the following ratios for 2013 and 2014:
   a. inventory turnover
   b. creditor days
   c. gearing
   d. debtor days. [8]
4. On the basis of the ratios you have calculated, evaluate whether the management of Karachi Paper Products should introduce strategies to improve these results. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, examine how change and culture might affect the way you measure business efficiency. [20]

3.7 Cash flow

On completing this chapter you should be able to:

Analyse and apply:

- The difference between profit and cash flow (AO2)
- The working capital cycle (AO2)
- Cash flow forecasts (AO2) and make calculations to amend them (AO4)
- The relationship between investment, profit and cash flow (AO2)

Evaluate:

Strategies for dealing with cash flow problems:

- Reducing cash outflows
- Improving cash inflows
- Additional finance (AO3)

Setting the scene

ASIAN GLASSES RUNS OUT OF CASH

Asian Glasses had been making spectacles for years but had reached a critical point with no sales growth and low profits. A new managing director, Jerry Xue, did not take long to make changes. He aimed to raise the annual sales revenue from $1 million to $4 million in two years by specialising in fashion sunglasses. New designs were developed. Jerry received big orders from some of the leading retailers. The sunglasses sold for high prices. These large orders were profitable, but there was a major problem. The biggest retailers were the slowest payers as they expected several months of credit. They also demanded such high standards that some production had to be scrapped.

Jerry started to worry about the firm's cash position. Suppliers were demanding payment. The bank overdraft had reached record levels. Overtime working by staff to complete orders on time took cash out of the business. Then Jerry discovered that his bookkeeper had not included transport costs in the monthly cash flow forecast – the business had even less money than they thought.

On the day that Jerry had appointments with a department store buyer in the morning and the bank manager in the afternoon, the glass lens machine broke down and a major supplier refused to supply materials. Within weeks, the assets of the business had been sold off and the creditors owed money by Asian Glasses received a fraction of what they were owed.

Points to consider

- As the business is profitable, how could Asian Glasses run out of cash?
- How useful would an accurate forecast of cash flows have been to Jerry?
- What could Jerry have done to improve the cash position of Asian Glasses?
- Why did this business need day-to-day finance?

Key concept link

All business activities eventually cease if there is inadequate cash flow. The primary objective of any business organisation is likely to be survival, and inadequate cash leads to business failure. Managing change in business – such as growth, introducing strategies for developing new products or markets or responding to significant external shocks – requires sufficient cash flow to make essential payments.

Introduction – the importance of cash flow

The Asian Glasses case study allows us to see the importance of cash flow to all businesses – even those that claim to be making a profit! Profit does not pay the bills and expenses of running a business – but cash does. Of course, profit is important, especially in the long term when investors expect rewards and the business needs additional finance for investment. Cash is always important – in both the short and long term. Cash flow relates to the timing of payments to workers and suppliers and receipts from customers. If a business does not plan the timing of these payments and receipts carefully, it may run out of cash even though it is operating profitably. If suppliers and creditors are not paid in time, they can force the business into **liquidation** of its assets if it appears to be **insolvent**. Monitoring the weekly or monthly **net cash flow** is a key responsibility for finance managers.

liquidation: when a firm ceases trading and its assets are sold for cash

insolvent: when a business cannot meet its short-term debts

net cash flow: the sum of cash payments to a business (inflows) less the sum of cash payments made by it (outflows)

So, cash flow is certainly important, especially to small business start-ups. Cash flow planning is vital for entrepreneurs for several reasons:

- Business start-ups are often offered much less time to pay suppliers than larger, well-established firms – they are given shorter credit periods.
- Banks and other lenders may not believe the promises of new business owners as they have no trading record. They will expect payment at the agreed time.
- Finance is often very tight at start-up, so not planning accurately is of even more significance for new businesses.

ACTIVITY 3.7.1

Sheila and her friend Alison have decided to run their own mobile hairdressing business using the training they have received at college and the experience they both gained working for three years for a local hairdresser. Investigate, locally, the equipment and working stock they will need. From this, estimate the capital they will need to set up the business and survive in the first year. Write a brief report on your findings.

Cash and profit

Cash and profit – what's the difference? To many failed business owners there was none – which is why their businesses collapsed. It is very common for profitable businesses to run short of cash. However, loss-making businesses can have high cash inflows in the short term. The essential difference between cash and profit can be explained with a simple example.

Example

Shula owns Fine Foods, a specialist delicatessen. Last month she bought $500 of fresh goods from a supplier who offers 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.

- What was Shula's profit or loss (ignoring all other costs)? A loss of $200 – because even though she has not yet paid for the goods they are still recorded as a cost.

cash outflows: payments in cash made by a business, such as those to suppliers and workers

cash inflows: payments in cash received by a business, such as those from customers (debtors) or from the bank, e.g. receiving a loan

- What was the difference between her **cash outflow** and **inflow**? A positive inflow of $300 – because she has not paid the supplier yet. So Shula has a positive cash flow from these goods this month even though she made a loss on them.
- Cash was not the same as profit for this business.

ACTIVITY 3.7.2

PAPER PROFITS HIDE NEGATIVE CASH FLOW

Dun and Bradstreet have reported that nearly half of all Australian businesses operated with a negative cash flow over recent financial years. This figure is worrying as 80% of business failures are related to cash flow pressures rather than poor sales. Many firms with large profits fail to manage their cash payments or collect enough cash in a timely manner – resulting in negative net cash flow. This situation occurs despite businesses making sales and recording profits. If credit and other forms of finance were to 'become scarce' then it becomes more likely that businesses will fail. Slow customer payments to suppliers – a persistent culture in Australian businesses – means that payment terms have risen to 54 days on average – making cash flow even worse for some firms.

10 marks, 20 minutes

1. Suggest **two** reasons why many Australian businesses have been operating with a negative cash flow despite being profitable. [4]
2. Explain how the following might affect Australian businesses:
   a. credit and other forms of finance 'becoming scarce' [3]
   b. further delays by customers in paying suppliers. [3]

Working capital

Working capital is often described as the 'lifeblood' of a business. All businesses need finance to pay for everyday expenses such as wages and the purchase of stock.

Without sufficient working capital a business will lack liquidity – be illiquid – unable to pay its immediate or short-term debts. Either the business raises finance quickly – such as through a bank loan – or it may be forced into liquidation by its creditors, the firms it owes money to.

Where does working capital come from?

current liabilities: debts of the business that will usually have to be paid within one year

debtors: customers who have bought products on credit and will pay cash at an agreed date in the future

The simple calculation for working capital is: current assets − **current liabilities**. Current assets are stocks, **debtors** and cash. Virtually no business could survive without these three assets, although some business owners refuse to sell any products on credit so there will be no debtors. This is very rare for businesses beyond a certain size.

Where does the capital come from to purchase and hold these current assets? Most businesses will obtain some of this finance in the form of current liabilities – overdrafts and creditors are the main forms. However, it would be unwise to obtain all the funds needed from these sources. First, they may have to be repaid at very short notice, meaning the firm is again left with a liquidity problem. Second, it will leave no working capital for buying additional stocks or extending further credit to customers when required.

How much is needed?

Sufficient working capital is essential to prevent a business from becoming illiquid and unable to pay its debts. Too high a level of working capital is a disadvantage; the opportunity cost of too much capital tied up in stocks, debtors and idle cash is the return that money could earn elsewhere in the business – invested in fixed assets perhaps.

The working capital requirement for any business will depend upon the 'length' of this '**working capital cycle**'.

working capital cycle: the period of time between spending cash on the production process and receiving cash payments from customers

The longer this time period from buying materials to receiving payment from customers, the greater will be the working capital needs of the business. Figure 3.7.1 shows the simple cycle of a business that produces goods but neither asks for nor offers credit. Credit given to customers by the business will lengthen the time before a sale is turned into cash – extending the working capital cycle. Credit received by the business from suppliers will reduce the length of this cycle. To give more credit than is received is to increase the need for working capital. To receive more credit than is given is to reduce the need for working capital.

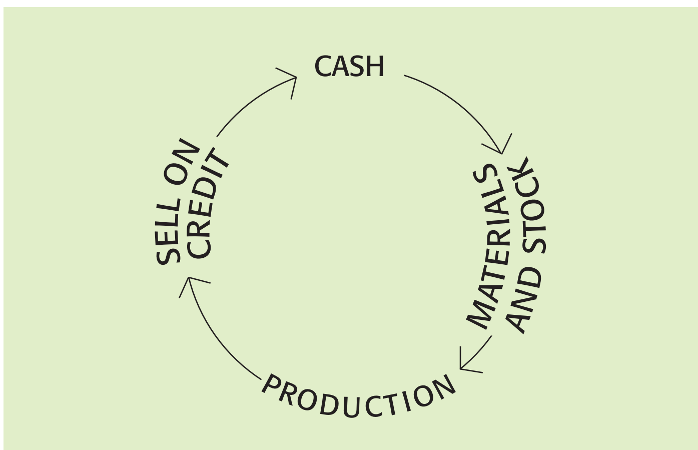


Figure 3.7.1 The simple working capital cycle – the longer this cycle takes to complete, the more working capital a business will need

Cash flow forecasts

Forecasting cash flow is estimating future cash inflows and cash outflows, usually on a month-by-month basis. Let's take the case of Keon, an entrepreneur planning to open a car-valeting service offering car cleaning to individual customers and owners of car fleets, such as taxi firms.

Forecasting cash inflows

The business owner will probably start by attempting to forecast cash inflows first. Some will be easier to forecast than others. Here are some examples of cash inflows and how they might be forecast:

- Owners' own capital injection – easy to forecast as this is under Keon's direct control.
- Bank loan payments – easy to forecast if they have been agreed with the bank in advance, both in terms of amount and timing.

- Customers' cash purchases – difficult to forecast as they depend on sales, so a sales forecast will be necessary – but how accurate might this be?
- Debtors' payments – difficult to forecast as these depend on two unknowns. First, what is the likely level of sales on credit and, second, when will debtors actually pay? One month's credit may have been agreed with them, but payment after this period can never be guaranteed.

Forecasting cash outflows

Exam tip: Never fall into the trap of referring to forecasts as *actual* accounts – they are financial estimates that are dealing with the future.

Again, some cash outflows will be much easier to forecast than others. Here are some examples:

- Lease payment for premises – easy to forecast as this will be in the estate agent's details of the property.
- Annual rent payment – easy to forecast as this will be fixed and agreed for a certain time period. The landlord may increase the rent after this period, however.
- Electricity, gas, water and telephone bills – difficult to forecast as these will vary with so many factors such as the number of customers, seasonal weather conditions and energy prices.
- Labour cost 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.
- Variable cost payments such as cleaning materials – the cost of these should vary consistently with demand, so revenue forecasts could be used to assess variable costs too. How much credit will be offered by suppliers? The longer the period of credit offered, the lower will be the start-up cash needs of the business.

Structure of cash flow forecasts

cash flow forecast: estimate of a firm's future cash inflows and outflows

net monthly cash flow: estimated difference between monthly cash inflows and outflows

opening cash balance: cash held by the business at the start of the month

closing cash balance: cash held at the end of the month becomes next month's opening balance

Due to the crucial importance of cash as the lifeblood of any successful business, all firms should engage in **cash flow forecasting** to help identify cash flow problems before it is too late.

A simplified cash flow forecast is shown in Table 3.7.1. It is based on Keon's car-valeting service. Although there are different styles of presenting this information, all cash flow forecasts have three basic sections:

- **Section 1 Cash inflows** This section records the cash payments to the business, including cash sales, payments for credit sales and capital inflows.
- **Section 2 Cash outflows** This section records the cash payments made by the business, including wages, materials, rent and other costs.
- **Section 3 Net monthly cash flow and opening and closing balance** This shows the net cash flow for the period and the cash balances at the start and end of the period – the opening cash balance and the closing cash 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.

	All figures in $000	Jan.	Feb.	Mar.	Apr.
Cash inflows					
	Owner's capital injection	6	0	0	0
	Cash sales	3	4	6	6
	Payments by debtors	0	2	2	3
	Total cash in	9	6	8	9

Table 3.7.1 Keon's cash flow forecast for the first four months (figures in brackets are negative)
[*table continues over*]

	All figures in $000	Jan.	Feb.	Mar.	Apr.
Cash outflows					
	Lease	8	0	0	0
	Rent	1	1	1	1
	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
Opening balance		0	(2)	(1)	(0.5)
Net cash flow	Net monthly cash flow	(2)	1	0.5	1.5
Closing balance		(2)	(1)	(0.5)	1

Table 3.7.1 *Continued*

What does the forecast in Table 3.7.1 tell Keon about the prospects for his business? In cash terms, the business appears to be in a good position at the end of four months. This is because:

- in April the closing cash balance is positive, so the bank overdraft is fully repaid
- there is only one month – the first month of operation – in which the monthly net cash flow is negative
- the monthly net cash flow improves substantially over this period.

Remember, these are only forecasts – the accuracy of the cash flow forecast will depend greatly on how accurate Keon was in his demand, revenue and material cost forecasts.

ACTIVITY 3.7.3

Suggest **one** more likely cash payment that could be received by a business and **one** more cash payment made by a business.

ACTIVITY 3.7.4

APRIL CASH FLOW

Using Table 3.7.1, draw up a revised cash flow forecast for April assuming:

- cash sales are forecast to be $1000 higher
- cost of materials is forecast to be $500 higher
- other costs are forecast to be $1000 higher.

Benefits of cash flow forecasts

Cash flow forecasting has a number of benefits, especially for start-up businesses:

- By showing periods of negative cash flow, plans can be put in place to provide additional finance – for example, arranging a bank overdraft or preparing to inject more owner's capital.
- If negative cash flows appear to be too great, then plans can be made for reducing these – for example, by cutting down on purchase of materials or machinery or by not making sales on credit, only for cash.

- A new business proposal will never progress beyond the initial planning stage unless investors and bankers have access to a cash flow forecast – and the assumptions that lie behind it.

Limitations of cash flow forecasts

Although an entrepreneur should take every reasonable step to improve the accuracy of cash flow forecasts, it would be unwise to assume that they will always be accurate. So many factors, either internal to the business or in the external environment, can change to blow a cash flow forecast off course. This does not make them useless – but they must be used with caution. Here are the most common limitations of cash flow 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 can lead to major inaccuracies in forecasts. For example, fluctuations in oil prices can cause the cash flow forecasts of even major airlines to be misleading.
- Incorrect assumptions can be made in estimating the sales of the business, perhaps based on poor market research, and this will make the cash inflow forecasts inaccurate.

ACTIVITY 3.7.5

FASHION-SHOP BUSINESS PLAN NEEDS CASH FLOW FORECAST

Sayuri and Korede were putting the finishing touches to the cash flow forecast section of the business plan for an exclusive 'top brands' fashion store in the city. Sales forecasts were based on Sayuri's observation of consumers in other fashion shops and some desk research on the internet. This had revealed the rapid growth of high-income consumers spending increasing amounts on expensive clothing.

Cash outflow forecasts were based on estimates of electricity and telephone usage. Korede had found what he thought was a suitable shop, so they knew how much the rent would be. They would pay themselves a salary of $2000 a month each initially. Some decisions still needed to be taken. Should they employ full-time salaried staff or part-time hourly wage employees? The cost of buying the clothes was also uncertain. There would be no problem if they sold all the suits and dresses that they bought in – but how likely was that? What would happen to cash flow forecasts if stock was left unsold and huge price reductions had to be advertised? The almost-completed forecast is shown below.

	All figures in $000	April	May	June	July
Cash inflows					
	Owner's capital injection	28	0	0	0
	Cash sales	6	8	12	9
	Payments by debtors (e.g. credit card companies)	0	2	2	3
	Total cash in	34	10	14	12
Cash outflows					
	Lease	18	0	0	0
	Rent	2	2	2	2
	Clothes purchases	6	4	3	4
	Labour	3	3	4	3

	Other costs	6.5	2	2.5	1.5
	Total cash out	35.5	11	11.5	*y*
Opening balance		0	(1.5)	(2.5)	0
Net cash flow	Net monthly cash flow	*x*	(1)	2.5	*z*
Closing balance		(1.5)	(2.5)	0	1.5

24 marks, 48 minutes

1. Complete the cash flow forecast by inserting values for *x*, *y* and *z*. [3]
2. Analyse **one** problem that Sayuri and Korede might have experienced when drawing up their cash flow forecast. [4]
3. The first three months' actual trading was poor and cash sales were 20% below forecast. Draw up a new cash flow forecast for July assuming 20% lower cash sales, 20% lower clothes purchases, an opening cash balance of zero; all other factors remain unchanged. [7]
4. Discuss the view that a cash flow forecast increases the chances of this business being successful. [10]

Causes of cash flow problems

Lack of planning

Cash flow forecasts help greatly in predicting future cash problems for a business. This form of 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.

Exam tip: Remember, cash flow forecasts do not solve cash flow problems by themselves – but they are an essential part of financial planning and can help prevent cash flow problems from developing.

Poor credit control

The **credit control** department of a business keeps a check on all customers' accounts – who has paid, who is keeping to agreed credit terms and which customers are not paying on time. If this credit control is inefficient and badly managed, then debtors will not be 'chased up' for payment and potential **bad debts** will not be identified.

credit control: monitoring of debts to ensure that credit periods are not exceeded

bad debt: unpaid customers' bills that are now very unlikely ever to be paid

Allowing customers too much credit

In many trading situations, businesses will have to offer trade credit to customers in order to be competitive. Assume a customer has 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 customers will go for credit terms because it improves their cash flow. Allowing customers too long to pay means reducing short-term cash inflows, which could lead to cash flow problems.

LEARNER PROFILE

Knowledgeable

So I get a phone call from the finance director of Simpatico Marketing to ask for a 30-day credit on a major brochure order we have just done for them. This was a new order for us and was worth $80 000 which was big for us and a breakthrough for our business. If we did well with Simpatico other orders would follow and this could lift our entire business to another level.

As the CEO of Rapido Printing Ltd the final call on this credit decision for Simpatico was with me but our finance director was nervous: an $80 000 exposure would leave our cash flow position vulnerable. I remember our finance director's words well, 'Listen boss, I know how important this contract is to you but I've heard the odd rumour about Simpatico that makes me uneasy. They are very profitable but they carry lots of debt'.

I said yes to the credit period for Simpatico and ten days later they went into administration and we lost $80 000 which, for a time, almost made us bankrupt.

You are the CEO of Rapido. How would you have improved your knowledge of Simpatico's cash position to help you make a more informed decision about giving them trade credit?

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 growing.

Overtrading: expanding a business rapidly without obtaining all the necessary finance so that a cash flow shortage develops

Unexpected events

Unforeseen increases in costs – a breakdown of a delivery van that needs to be replaced, a dip in predicted sales income, or a competitor lowering prices unexpectedly – could lead to negative net monthly cash flows.

ACTIVITY 3.7.6

TAXI FIRM'S CASH FLOW

How would the following events be likely to affect the cash flow of a taxi-operating company?

- An increase in oil prices
- An increase in unemployment
- Lower train fares

The relationship between investment, profit and cash flow

To business managers the term 'investment' does not have the same meaning as when it is used in general speech. Many people consider their savings to be 'good investments'. However, business investment means capital expenditure – spending on projects, usually long term, requiring equipment, materials and resources of all kinds. These investments might include:

- building a new factory/offices/shop
- opening a new quarry or mine
- researching and developing a new product
- entering a new market by setting up offices and sales force there
- taking over another business.

Private sector business-investment decisions are nearly always undertaken because management believes that, in time, profits will be earned as a consequence.

Investment spending leads to a cash outflow, often in the first year of the project. However, the cost of the project is not recorded at the time of the cash expenditure. Capital spending is recorded as a cost over a period of years as the benefit from it is also likely to be received over several years. To match the cost of the project to the expected revenue from it, the actual expense is recorded as annual depreciation (loss of value) over the useful life of the assets purchased.

Table 3.7.2 shows this process and the relationship between investment, profit and cash flow. The project lasts for two years and the assets purchased fall in value each year and are sold at the end of their useful life – end of year two.

Year	Investment	Impact on cash flow	Impact on profit
0	£6m	£6m outflow	No impact
1	No further spending	Cash from sales – cash payments for operating expenses	Revenue – (operating expenses + annual depreciation)
2	No further spending; assets at end of useful life are sold	(Cash from sales + cash from sale of assets) – cash payments for operating expenses	(Revenue + income from sale of assets) – (operating expenses + annual depreciation)

Table 3.7.2 Investment, profit and cash flow

ACTIVITY 3.7.7

GOLD MINING: RISING COSTS AND LIMITED CASH FLOW

Gold mining requires businesses to take a long-term view. Gold is becoming increasingly difficult to find and mine as the best reserves are exhausted. The capital expenditure required for opening a new mine or extending an existing one is very substantial – and it can take years before net cash flows turn positive. Operating costs of mines are difficult to forecast due to unforeseen geological problems. Revenue is even more uncertain owing to the fluctuations in world gold prices. The impact of rising costs and uncertainty is shown by the following graph:

Joachim Berlenbach (fund manager at Earth Resource Investment Group): 'This graph includes all the costs that make up a company's cash outflow: operating cash costs, capital expenditure on existing mines, capital expenditure on expanding mines, exploration and finance costs, plus general and administration expenses.

Total costs are at $1600/oz for the 13 biggest companies. At a gold price of $1600/oz, the industry does not produce a single dollar of positive cash flow. If we take cost inflation of only 10% per year, we will need a gold price over $2000/oz to maintain production.'

This rather negative picture does not mean that gold mining is unprofitable. The capital expenditure on new mine capacity will be recorded on income statements over a number of years – not in one annual figure, as it will on a cash flow account.

Source: Adapted from goldnews.bullionvault.com

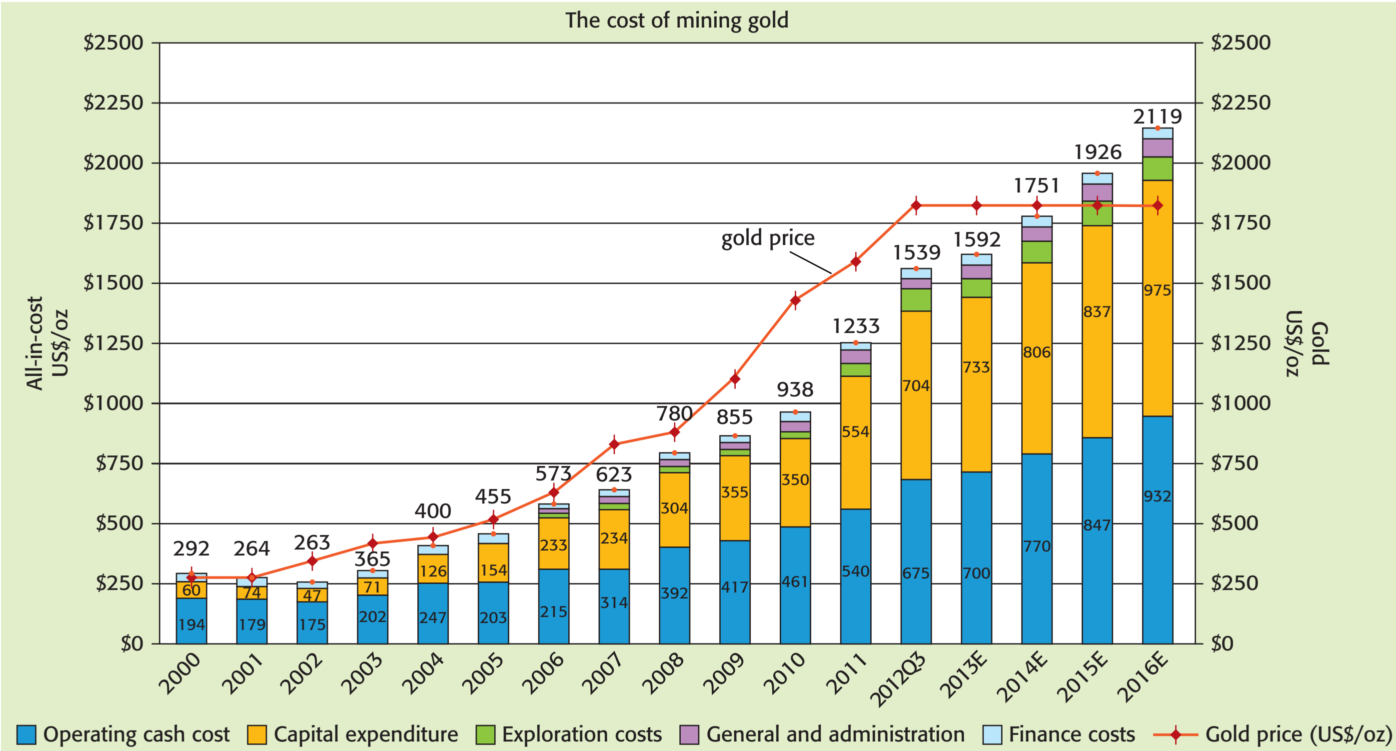


Figure 3.7.2 Costs and cash outflows for major gold mining businesses - compared with the price of gold. E = estimated

16 marks, 32 minutes

1. Explain **two** reasons why it might be difficult to forecast net cash flows for a gold mining business. [4]
2. Explain **two** reasons why the annual net cash flows of a gold mining business will not be the same as annual profit. [4]
3. Discuss whether the best way for a gold mining business to improve annual cash flow is to cut back on capital expenditure. [8]

Strategies for dealing with cash flow problems

There are three main strategies that businesses can adopt to deal with cash flow problems:

- reducing cash outflows
- improving cash inflows
- sourcing additional finance.

Care needs to be taken here – the aim is to improve the cash position of the business, not just revenue or profits. These are different concepts. For example, a decision to advertise more in order to increase sales on credit, which will eventually lead to increased cash flows, may make the short-term cash position worse as the advertising has to be paid for. Only an increase in revenue that also leads to a simultaneous increase in net cash flow will improve the cash flow of the business.

Tables 3.7.3 and 3.7.4 outline the methods used to increase cash inflows – including finance options – and reduce cash outflows.

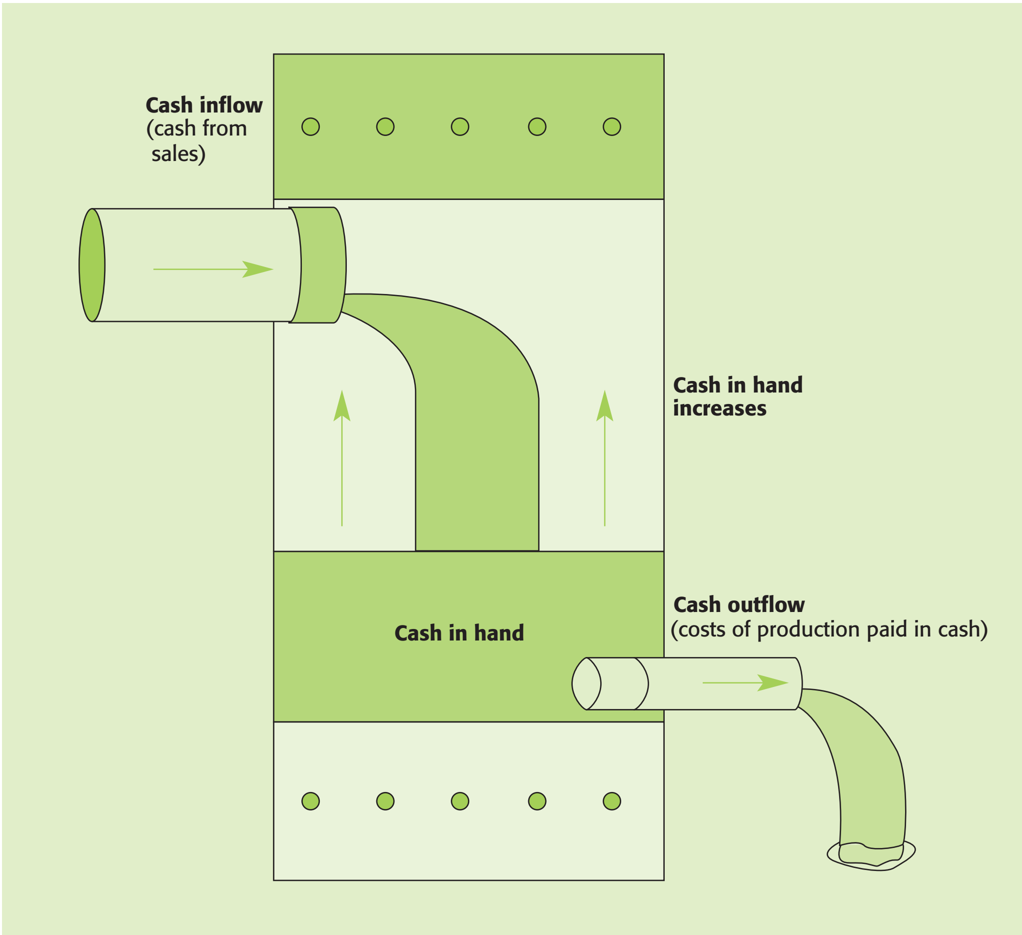


Figure 3.7.3 Symbolic drawing of cash-flow 'tank' with leakages and injections of cash

Exam tip: When answering an examination question about improving cash flow, just writing 'the firm should increase sales' will not demonstrate a true understanding of the difference between revenue and cash flow.

Method to increase cash inflow	How it works	Evaluation
Reduce credit terms to customers	Cash flow can be brought forward by reducing credit terms from, say, two months to one month.	• Customers may purchase products from firms that offer extended credit terms.
Increase cash sales (with no increase in promotion costs)	Sale of inventories at lower than normal price; obtaining free publicity, e.g. for community work.	• Sale of inventories at lower than normal price may improve cash flow but it will worsen profit margins.
Overdraft	Flexible loans can be arranged on which the business can draw as necessary up to an agreed limit.	• Interest rates can be high and there may be an overdraft arrangement fee. • Overdrafts can be withdrawn by the bank and this 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.

Table 3.7.3 Ways to increase cash inflows, including additional sources of finance, and their possible drawbacks [*table continues over*]

Method to increase cash inflow	How it works	Evaluation
Sale of assets	Cash receipts can be obtained from selling off redundant assets, which will boost cash inflow.	• Selling assets quickly can result in 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, e.g. to a finance company, but they can then be leased back from the new owner.	• The leasing costs add to annual overheads. • There could be loss of potential profit if the asset rises in price. • The assets could have been used as collateral for future loans.
Debt factoring	Debt-factoring companies can buy the customers' bills from a business and offer immediate cash – this reduces the risk of bad debts too.	• Only about 90–95% of the debt will now be paid by the debt-factoring company – this reduces profit. • The customer has the debt collected by the finance company – this could suggest that the business is in trouble.

Table 3.7.3 *Continued*

Method to reduce cash outflow	How it works	Evaluation
Delay payments to suppliers (creditors)	Cash outflows will fall in the short term if bills are paid after, say, three months instead of two months.	• Suppliers may reduce any discount offered with the purchase. • Suppliers can either demand cash on delivery or refuse to supply at all if they believe the risk of not being paid is too great.
Delay spending on capital equipment	By not buying equipment, vehicles and so on, cash will not have to be paid to suppliers.	• The business may become less efficient if outdated and 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 spending that does not directly affect output, e.g. promotion costs	These costs will not reduce production capacity and cash payments will be reduced.	• Future demand may be reduced by failing to promote the products effectively.

Table 3.7.4 Ways to reduce cash outflows and their possible drawbacks

Exam tip: In your class consider the reasons why you think HMV has gone into administration.

THEORY OF KNOWLEDGE

HMV calls in administrators

Many feel the 91-year-old music chain deserves a place on the high street after it fell victim to the online shopping trend. Large suppliers to HMV, such as Universal, have fought to keep HMV trading over the past 12 months, striking a confidential deal with the retailer which saw them take a stake in the business in exchange for favourable supply terms.

HMV has had a miserable year with sales down 10.2% for the half year to 27 October. But the deterioration in its cash flow position has pushed the retail chain over the edge into administration.

HMV is the latest casualty of the shift to online shopping, putting 4500 jobs at risk.

Discuss the role emotion might play in a decision to try and save a business like HMV.

ACTIVITY 3.7.8

CASH FLOW DRYING UP FOR INDIAN SMALL FIRMS

Madhu Gupta has a problem. His company, Mojj Engineering Systems, makes large-scale equipment for food and chemical plants. His customers keep ringing up and saying: 'We don't need the equipment yet – hold it in stock,' 'Can we have an extra discount?' or even 'We will only buy it if you give us credit.'

'Until recently, we had no idea things could happen as quickly as this,' said Mr Gupta. 'It was too sudden to prepare for it.' He was, of course, complaining about the global recession and the speed with which it hit many businesses.

Mr Gupta has already paid cash for all his raw materials. Completed machines are filling up the yard in his factory. He will not get the money back for materials bought, or for labour costs, until he delivers these machines and is paid for them. The finance the business was planning to use for expansion to a new factory is now being used to pay for the increase in working capital.

16 marks, 32 minutes

1. Define the term 'working capital'. [2]
2. Explain why Mr Gupta is finding it so difficult to control his working capital. [4]
3. Evaluate **three** ways in which Mr Gupta could try to improve the cash flow position of the business. [10]

Exam tip: If you suggest 'cutting staff and cheaper materials', this may reduce cash outflows, but what will be the negative impact on output, sales and future cash inflows? This suggestion will nearly always be inappropriate for an examination question on improving cash flow.

OVER TO YOU

Revision checklist

1. Explain the working capital cycle for:
   a. a shipbuilding business
   b. a sweet shop.
2. Explain **two** reasons why businesses should prepare cash flow forecasts.
3. Explain why a bank manager would be particularly keen to see a cash flow forecast in the business plan of a new business when applying for a loan.
4. What is meant by 'monthly net cash flow'?
5. What is meant by 'closing cash balance'?
6. Explain how sale and leaseback of fixed assets improves business cash flow.
7. Is there any purpose in cash flow forecasts if they can be made inaccurate by external events?
8. How could a business vary its debtor/creditor policy to improve its cash flow position?
9. How does a cash flow forecast assist a business in planning its finance requirements?
10. Explain **two** problems a new business would have in establishing a cash flow forecast.
11. Discuss **two** ways in which a clothing retailer could improve its cash flow position.
12. Explain the relationship between spending on an investment and the returns from it and cash flow.
13. Explain **two** reasons why a profitable business might 'run out of cash'.

Exam practice question

'COFFEE CALL' SEEKS FUNDS FOR EXPANSION

Coffee Call is a small, independent coffee shop. It is run by two brothers, Erin and Carl Shutter. They are keen to increase sales by using the shop space more effectively and installing three new tables. This will, however, require a significant investment and the brothers have approached the bank with a business plan for the expansion with the aim of securing loan finance. The brothers have also been approached by a venture capitalist who is willing to fund the expansion in return for a 20% stake in Coffee Call. The brothers are concerned to keep the liquidity of the business secure during the expansion.

The following cash flow data have been produced by Coffee Call's accountant for the period January to June:

- Sales for the first three months of the year will be $20 000, rising to $40 000 in the following three months once Coffee Call has installed the extra seating.
- Material costs are 50% of sales and are paid each month.
- Electricity and gas cost $4000, with half paid in February and the remainder in September.
- Staff wages of $2000 are paid each month, but these will rise to $3000 after three months once Coffee Call has expanded.
- Erin and Carl draw $10 000 each out of the business in March and December.
- Marketing costs of $500 are paid each month.
- A loan of $20 000 is taken out in February to fund the expansion.
- The $20 000 cost of fitting the new tables is paid in March.
- The brothers believe the tables can be fitted in three days without any disruption to sales.
- The opening cash balance is $7000.

20 marks, 40 minutes

1. Define the term 'liquidity'. [2]
2. Draw up a cash flow forecast for Coffee Call for the first six months of the year. [8]
3. Discuss the advantages and disadvantages of Coffee Call using the venture capitalist as a source of finance. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, compare and contrast the importance of change and ethics in the management of cash flow. [20]

3.8

H

Investment appraisal

On completing this chapter you should be able to:

Analyse, apply and calculate:

- Investment opportunities using payback and average rate of return (ARR) (AO3 and AO4)
- Investment opportunities using net present value (NPV) (AO3 and AO4)

Setting the scene

GLASGOW NHS INVESTS IN RFID TO REDUCE COSTS

NHS Greater Glasgow and Clyde has invested in a wireless networking project in one of its hospitals. It tracks medical equipment with RFID (radio frequency identification) tags. The scheme will cost £70 000 and 1500 items of medical equipment will eventually be tagged. According to the NHS clinical scientist Jason Britton, the hospital loses between £20 000 and £40 000 a year in wasted time looking for misplaced equipment such as defibrillators, infusion pumps and blood pressure monitors. 'Devices can get lost in the system for years before they are discovered,' he said. With RFID, a central office will know exactly where each of the tagged items is in the hospital. Doctors will be able to locate the equipment quickly, thereby improving the level of patient care. The investment should pay back within two to three years.

NIGERIAN WATER PRIVATISATION APPEARS TO BE A GOOD INVESTMENT

The privatisation scheme selected by the Nigerian government for water supply involved private firms buying 20-year contracts to build and operate water-supply services to different regions of the country. These were risky investments for private sector businesses as it was unclear how much consumers would be prepared to pay for clean water supplies. An analysis of the likely profitability of these projects concluded that:

- profit in today's values might be around $67 million
- the average rate of return should be close to 28%
- the payback period would be approximately 3.8 years.

Source: http://wedc.lboro.ac.uk

Points to consider

- Both of these investment projects were expected to earn returns greater than the original cost. Why might it be difficult to forecast future returns from an investment?
- Both articles refer to the time to 'pay back' the investment cost. Why do you think this might be important?

Key concept link

Most businesses will assess qualitative factors involved in investment decisions as well as analysing 'is it likely to be profitable?' One of these qualitative factors is likely to be the ethical issues that might be raised by the investment.

Introduction

Investment means purchasing capital goods – such as equipment, vehicles and new buildings – and improving existing fixed assets. Many investment decisions involve significant strategic issues – such as relocation of premises or the adoption of computer-assisted engineering methods. Other investment plans are less important to the overall performance of the business – such as replacing worn-out photocopiers. Relatively minor investment decisions will not be analysed to the same degree of detail as more substantial decisions on capital expenditure.

What is investment appraisal?

investment appraisal: evaluating the profitability or desirability of an investment project

Investment appraisal is undertaken by using quantitative techniques that assess the financial feasibility of the project. Non-financial issues can also be significant and therefore qualitative appraisal of a project might also be very important. In some businesses, especially those dominated by the founding entrepreneur, formal investment appraisal may not be applied. Instead, the owner may develop a 'feel' for what is likely to be most successful and go ahead with that project even though no formal analysis has been undertaken. The use of such 'intuitive' or 'hunch' methods of taking investment decisions cannot be easily explained or justified – unless they turn out to be very successful.

Quantitative investment appraisal

Quantitative investment appraisal requires the following information:

- the initial capital cost of the investment, including any installation costs
- the estimated life expectancy – for how many years can returns be expected from the investment?
- the residual value of the investment – at the end of their useful lives will the assets be sold, earning additional net returns?
- the forecasted net returns or net cash flows from the project – these are the expected returns from the investment minus the annual running cost.

Methods of quantitative investment appraisal include:

- payback period
- average rate of return
- net present value using discounted cash flows.

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 **net cash flows**.

annual forecasted net cash flow: forecasted cash inflow minus forecasted cash outflows

We assume for the IB examinations, rather simplistically, that the cash inflows are the same as the annual revenues earned from the project and the cash outflows are the annual operating costs.

These net cash flow figures can then be compared with those of other projects and with the initial cost of the investment. Forecasting cash flows is not easy and is rarely likely to be 100% accurate. With long-term investments, forecasts several years ahead have to be made and there will be increased chances of external factors reducing the accuracy of the figures. For instance, when appraising the construction of a new airport, forecasts of cash flows many years ahead are likely to be required. Revenue forecasts may be affected by external factors such as:

- an economic recession that could reduce both business and tourist traffic through the airport
- increases in oil prices that could make air travel more expensive than expected, again reducing revenue totals
- the construction of a new high-speed rail link within the country, which might encourage some travellers to switch to this form of transport.

These 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 borne in mind by managers. All investment decisions involve some risk due to this uncertainty.

ACTIVITY 3.8.1

CASH FLOW UNCERTAINTIES

For each of the following investment projects explain **one** reason why there is likely to be some uncertainty about the future net cash flow forecasts earned by them:

a. a project to construct a factory to make large and expensive luxury cars

b. an investment in a new computerised banking system offering customers new services using state-of-the-art equipment that has not yet been thoroughly tested

c. cash flow forecasts for a new sports centre that are based on a small market research sample of the local population

d. the building of a new toll motorway between two cities

e. the construction of an oil-fired power station.

Quantitative techniques of investment appraisal

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 at this time is therefore negative – shown by a bracketed amount (see Table 3.8.1) for further example. This shows the forecasted annual net cash flows and cumulative cash flows. This latter figure shows the 'running total' of cash flows and 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 year. But

payback period: length of time it takes for the net cash inflows to pay back the original capital cost of the investment 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 a 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:

$$\frac{\text{additional cash inflow needed}}{\text{annual cash flow in year 3}} \times 12 \text{ months}$$

$$= \frac{\$50\,000}{\$150\,000} \times 12 \text{ months} = 4 \text{ months}$$

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 3.8.1 Cash flows of an investment

Importance of payback of a project

Managers can compare the payback period of a particular project with other alternative projects so as to put them in rank order. Alternatively, the payback period can be compared with a 'cut-off' time period that the business may have decided on – for example, it may not accept any project proposal that does not pay back within five years. The uses and benefits of the payback period technique include the following:

- 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 more quickly the capital is made available for other projects.
- The longer into the future before a project pays back the capital invested in it, 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 to an investing company, the higher its real value will be.

Virgin Atlantic invested £200 000 in a new technology communication system which provides direct contact with potential customers, giving details about special fare offers. The system earned extra cash flow of £200 000 in three months – a very rapid payback.

Evaluation of 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 3.8.2).

Advantages	Disadvantages
• 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 'screen out' 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 of the cash flows after the payback period. It may be possible for an investment to give a really 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 other two appraisal methods (average rate of return and net present value).

Table 3.8.2 Payback method – advantages and disadvantages

Average rate of return (ARR)

$$\text{ARR (\%)} = \frac{\text{annual profit (net cash flow)}}{\text{initial capital cost}} \times 100$$

average rate of return (ARR): measures the annual profitability of an investment as a percentage of the initial investment

Average rate of return may also be referred to as the accounting 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. For simplicity, we will assume that the net cash flows equal the annual profitability.

Table 3.8.3 shows the expected cash flows from a business investment into a fleet of new fuel-efficient vehicles. The inflows for years 1 to 3 are the annual cost savings made. In year 4, the expected proceeds from selling the vehicles are included.

Year	Net cash flow
0	($5 million)
1	$2 million
2	$2 million
3	$2 million
4	$3 million (including residual value)

Table 3.8.3 Net cash flows for fleet investment

The four stages in calculating ARR are as follows:

1. Add up all positive cash flows = $9 million
2. Subtract cost of investment = $9 million – $5 million
   = $4 million (this is total profit)
3. Divide by lifespan = $4 million/4 = $1 million (this is annual profit)
4. Calculate the annual profit as a percentage of the initial cost; this is the ARR = $1 million/$5 million × 100 = 20%

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:

criterion rate or level: the minimum level (maximum for payback period) set by management for investment appraisal results for a project to be accepted

- the ARR on other projects
- the minimum expected return set by the business – known as the **criterion rate**; in the example above, if the business refused to accept any project with a return of less than 15%, 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 3.8.4).

Advantages	Disadvantages
• 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 – this concept is considered in the section on net present value.

Table 3.8.4 Average rate of return – advantages and disadvantages

ACTIVITY 3.8.2

ASHTON TEXTILES LTD PLANS AN INVESTMENT

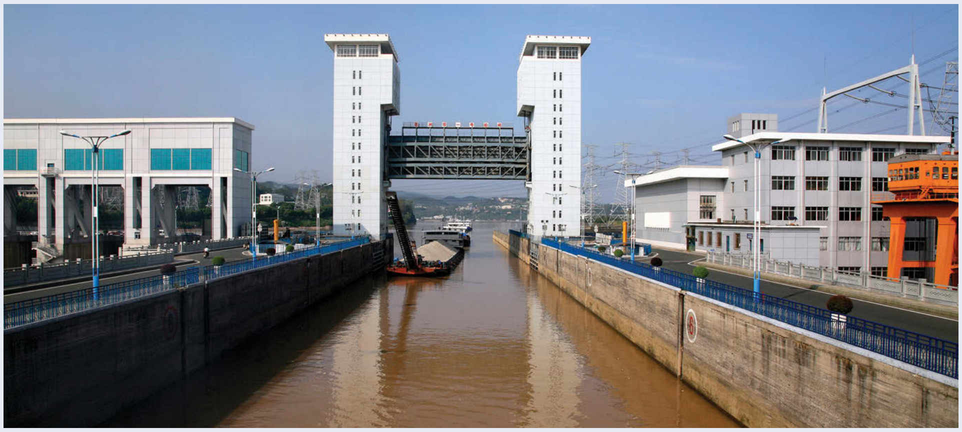
Ashton Textiles Ltd is planning an investment programme to overcome a problem of demand exceeding capacity. It is considering two alternative projects involving new machinery. The initial outlays and future cash outflows are given below. Ashton has a good relationship with the supplier of the machine for Project Y, but has not dealt with the supplier of Project X before although this supplier has a good reputation. The machine for Project X is imported and there are some concerns about changes in the exchange rate and how this might affect the final cost of Project X. The machine for Project Y is supplied by a local firm. One of Ashton's competitors uses the machine for Project X and raises some concerns about the reliability of the machine, although the salespeople from the machine's supplier say it has the best reliability of any similar machine on the market.

Year	Project X	Project Y
0	($50 000)	($80 000)
1	$25 000	$45 000
2	$20 000	$35 000
3	$20 000	$17 000
4	$15 000	$15 000
5	$10 000	–

Net cash flows for Project X and Project Y

20 marks, 40 minutes

1. Define the term 'investment appraisal'. [2]
2. Calculate the payback periods for Project X and Project Y. [4]
3. Calculate the ARR for Project X and Project Y. [4]
4. On the basis of financial and non-financial factors evaluate whether Ashton Textiles Ltd should choose Project X or Project Y. [10]



Gezhouba Dam, China – most major projects are evaluated using investment appraisal

LEARNER PROFILE

Risk-takers

You left your lucrative job as chef last year with one of Paris's top hotels and you are going it alone. Your project is your dream of opening a bistro in one of Paris's most fashionable areas on the 'Left Bank' of the Seine. You are backed by two investors in the business who have a 50% shareholding. These investors are very good business people and they have been meticulous in the way they have forecasted costs and revenues and have applied various investment appraisal techniques.

There is a risk though. You have a young family and you have remortgaged your house to fund the project. If things go wrong you could lose everything.

Discuss in your class the risk-taking issues faced by new businesses like this one.

Higher Level

Discounting future cash flows

If you have worked through Activity 3.8.2 you will realise that managers may be uncertain which project to invest in if the two methods of investment appraisal used give conflicting results: if a project is estimated to pay back at the end of year 3 at an ARR of 15%, should this be preferred to an alternative project B with a payback of four years but an ARR of 17%?

Managers need another investment appraisal method, which solves this problem of trying to compare projects with different returns and payback periods. This additional method considers both the size of cash flows and the timing of them. It does this by discounting cash flows. If the effects of inflation are ignored, most people would rather accept a payment of $1000 today instead of a payment of $1000 in a year's time. Which would you 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 $1000 could be saved at the current rate of interest. The total of cash plus interest will be greater than the offer of $1000 in one year's time.
- The cash today is certain, but the future cash offer is always open to uncertainty.

This is called 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 $1000 received today can be saved at 10% interest, then it will grow to $1100 in one year's time. Therefore, $1100 in one year's time has the same value as $1000 today at 10% interest. This value of $1000 is called the present value of $1100 received in one year's time. Discounting calculates the present 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 value of a future sum of money depends on two factors:

1. The higher the interest rate, the less value future cash has in today's money.
2. 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. You do not have to calculate these – they are available in discount tables and an extract of one is given in Table 3.8.5. To use the discount factors to obtain present values of future cash flows, multiply the appropriate discount factor by the cash flow. For example, $3000 is expected in three years' time. The current rate of interest is 10%. The discount factor to be used is 0.75 – this means that $1 received in three years' time is worth the same as 75 cents today. This discount factor is multiplied by $3000 and the present value is $2250.

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	0.80	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 3.8.5 Extract from discounted cash flow table

Net present value (NPV)

This method once again 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:

net present value (NPV): today's value of the estimated cash flows resulting from an investment

1. Multiply discount factors by the cash flows. Cash flows in year 0 are never discounted as they are today's values already.

2. Add the discounted cash flows.
3. Subtract the capital cost to give the NPV.

The working is clearly displayed in Table 3.8.6. The initial cost of the investment is a current cost paid out in year 0. Current cash flows are not discounted.

Year	Cash flow	Discount factors @ 8%	Discounted cash flows (DCF)
0	($10 000)	1	($10 000)
1	$5000	0.93	$4650
2	$4000	0.86	$3440
3	$3000	0.79	$2370
4	$2000	0.74	$1480

Table 3.8.6 Discounted cash flows

Net present value is now calculated.

total discounted cash flows = $11 940

original investment = ($10 000)

NPV = $1940

This result means that the project earns $1940 in today's money values. So, if the finance needed can be borrowed at an interest rate of 8% or less, the investment will be profitable. What would happen to NPV if the discount rate was raised, perhaps because interest rates have increased? This will reduce NPV as future cash flows are worth even less when they are discounted at a higher rate. The choice of discount rate is, therefore, 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 the finance is raised internally, the rate of interest should still be used to discount future returns. This is because of the opportunity cost of internal finance – it could be left on deposit in a bank to earn interest. An alternative approach to selecting the discount rate to be used 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 net present value is positive, the investment could go ahead.

Evaluation of net present value

Net present value is a widely used technique of investment appraisal in industry, but, as it does not give an actual percentage rate of return, it is often considered together with the internal rate of return percentage, which is not an IB specification topic (see Table 3.8.7).

Advantages	Disadvantages
• It considers both the timing of cash flows and their size in arriving at an appraisal. • The rate of discount can be varied to allow for different economic circumstances. For instance, it 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 greatly on the rate of discount used, and expectations about interest rates may be inaccurate. • Net present values 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 (internal rate of return).

Table 3.8.7 Net present value – advantages and disadvantages

Exam tip: When calculating investment appraisal methods, set out your working carefully, using the same type of tables used in this chapter.

ACTIVITY 3.8.3

SEN SPORTS INC.'s NEW GYM PROJECT

Sen Sports Inc. owns and manages gyms. It is a business with an excellent reputation in the market and it is growing strongly. It is planning to open a new gym as part of its growth strategy. The net cash flows for the new gym project are set out in the table below. One concern Sen Sports has is the relatively high rate of interest being charged by banks in the market and the threat that interest rates could increase even higher. For this reason, the finance director of Sen Sports has set a discount rate of 14% although she has also considered a higher discount rate if interest rates move upwards. The CEO of Sen Sports considers an ARR above 10% and a payback period of 3 years as an acceptable starting point to take a new gym project forwards. This particular gym project is attractive because it is set in a high-profile city location which will really help to promote the Sen Sports brand image.

Year	Net cash flows ($)
0	(850 000)
1	240 000
2	300 000
3	350 000
4	350 000

Net cash flows for Sen Sports Inc.

Year	1	2	3	4
Discount factors @ 14%	0.88	0.76	0.67	0.59

20 marks, 40 minutes

1. Define the term 'net present value'. [2]
2. Calculate the net present value of the new gym. [4]
3. Explain the impact a rise in the discount rate would have on the net present value of the project. [4]
4. On the basis of financial and non-financial factors examine whether Sen Sports should open the new gym. [10]

Qualitative investment appraisal

Investment appraisal techniques provide numerical data, which are important in taking decisions. However, no manager can afford to ignore other factors which cannot be expressed in a numerical form but may have a crucial bearing on a decision. These are referred to as qualitative factors and include the following:

- The impact on the environment and the local community – bad publicity stemming from the announcement of some proposed investment plans may dissuade managers from going ahead with a project because of the long-term impact on image and sales. An example is the dispute over the building of a third runway at London's Heathrow airport.

- Planning permission – certain projects may not receive planning permission if they are against the interests of local communities. Local planners weigh up the social costs and benefits of a planned project. Community members will often have a direct role through a public enquiry or may set up a pressure group to make their views known and try to achieve a particular outcome.
- 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 there is concern that the aim of giving excellent and personal customer service is being threatened. Similarly, the decision to replace large numbers of workers with labour-saving machinery may be reversed if the negative impact on human relations within the business appears to be too great.
- 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.

ACTIVITY 3.8.4

LOCATION INVESTMENT DECISION

A shoe-shop owner is planning to open another branch and has to decide between two new locations that involve large capital investment – the business cannot afford both of them. He has forecasted the following annual net cash flows for these two locations. These forecasts are based on market research and cost estimates. The cash flows are as follows:

Year	Location A	Location B
0	($12 000)	($12 000)
1	$3000	$6000
2	$4000	$5000
3	$5000	$3000
4	$6000	$2000
5	$5000	$5000

Year	1	2	3	4
Discount factors @ 10%	0.91	0.83	0.75	0.68

22 marks, 44 minutes

1. Define the term 'payback'. [2]
2. Calculate the payback period and ARR for location A and location B. [6]
3. On the basis of your calculations, explain why the shoe-shop owner might find it difficult to choose between the two locations. [4]
4. Using a 10% discount rate calculate the net present value of location A and location B. [4]
5. On the basis of your calculations, state whether you would choose location A or B. [2]
6. Analyse **two** problems of using the net present value method as a way of deciding between different investment projects. [4]

Exam tip: Unless the question asks only for an analysis of numerical or quantitative factors, your answers to investment appraisal questions should include an assessment of qualitative factors too.

THEORY OF KNOWLEDGE

HS2 fast train project plan

The HS2 project is a UK government plan for a new railway line between London and major cities in the West Midlands and beyond carrying 400-metre-long (1300ft) trains with up to 1100 seats per train. The trains would operate at speeds up to 250 miles per hour (400kph) – faster than any current operating speed in Europe and would travel up to 14 times per hour more in each direction. The HS2 project is seen as a key infrastructure investment project that will improve transport communication in the UK, improving the way goods and people can be moved around the country. In June 2013 the government forecasted that the project would cost £42.6 billion at present values.

What are the knowledge issues associated with investment appraisal on such a large-scale project?

OVER TO YOU

Revision checklist

1. Give **three** examples of new projects that a supermarket could invest in.
2. List **four** types of information usually required to undertake quantitative investment appraisal.
3. What is meant by the 'annual net cash flow' from an investment project?
4. Examine **two** reasons why the forecasted annual net cash flows for an investment in a new clothes shop could prove to be inaccurate.
5. Explain what a 'payback of two years and six months' means for an investment project.
6. State **three** reasons why a manager might select an investment project with a short payback period.
7. Explain any **one** of the reasons you identified in question 6.
8. Write down the formula for calculating the 'average rate of return' for an investment project.
9. Explain why a manager would prefer, other things being equal, to select an investment project with an ARR of 12% rather than one with an ARR of 8%.
10. What does a 'criterion rate of return' mean?

11. Explain why qualitative factors might be significant to an investment decision to replace bank branches with an internet banking service.
12. Explain how environmental considerations could affect an investment decision.
13. Explain why a business's objectives could influence an investment decision to open a factory in a low-income developing country.
14. Why is discounting of future net cash flows often used in investment appraisal?
15. Explain what a 'net present value of $4500' means.
16. Explain what happens to the net present value of a project when the discount rate is increased – and why.

Exam practice question

INVESTING TO STAY COMPETITIVE

Asia Print plc is a large printing firm offering a range of services to industry, such as printed catalogues, leaflets and brochures. It operates in a very competitive market as it is relatively easy for new firms to join using the latest computer software 'page-making' packages. In an effort to maintain market share, the directors of Asia Print plc are considering several new investment projects. The two most promising schemes are:

Project Y – a newly designed, highly automated printing press with fast changeover facilities and full-colour ability. Direct internet links with customers would allow for rapid input of new material to be printed. Two highly trained operatives will be required and this would mean six redundancies from existing staff.

Project Z – a semi-automated machine with a more limited range of facilities but with proven reliability. Existing staff could operate this machine but there would be three redundancies. It is very noisy and local residents might complain.

The finance director was asked to undertake an investment appraisal of these two machines. He had gathered the following data. Each additional unit produced would be sold for an average of $1.25, and variable costs would be $0.5 per unit. In addition, the annual operational cost of the two machines is expected to be $1 million for Y and $0.5 million for Z. The introduction of either machine would involve considerable disruption to existing production. Staff would have to be selected and trained for Project Y and the trade union is very worried about potential job cuts. The residual value of Y is expected to be $1 million and of Z, $0.5 million.

	Project Y	Project Z
Purchase price ($m)	20	12
Expected life expectancy (years)	5	4
Forecast annual sales (million units)	8	6

20 marks, 40 minutes

1. Explain **two** difficulties Asia Print might have forecasting future sales. [4]
2. Calculate the ARR and payback period for Project Y and Project Z. [6]
3. On the basis of financial and non-financial factors examine which project Asia Print should choose. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, examine the role investment appraisal plays in business strategy and innovation. [20]

3.9 Budgeting

H

On completing this chapter you should be able to:

Know and understand:

- The difference between cost centres and profit centres (AO1)

Analyse and apply:

- The importance of budgets for organisations (AO2)
- The roles of cost centres and profit centres (AO2)
- Variances (AO2)
- The role of budgets and variances in strategic planning (AO2)

Calculate:

- Variances from budgets (AO4)

Setting the scene

BILLIONS OVER BUDGET, ANGLO AMERICAN KEEPS GOING IN BRAZIL

Anglo American plc – the mining giant – is spending US$8.8 billion on a massive iron ore mine in Conceição do Mato Dentro, Brazil. This sum is over three times the originally budgeted – or planned – figure. The project is also three years behind schedule. The senior management of Anglo American did not foresee the planning problems with the Brazilian government which have added to costs and slowed down the opening of the new mine. Neither did they accurately budget for the construction costs of the mine in very difficult terrain with poor transport connections.

The former CEO, Cynthia Carroll, is convinced the mine will still be profitable when it finally opens, despite the price of iron ore falling from US$159 per tonne to US$111 per tonne in recent months. The slowdown in the Chinese economy has hit demand for iron ore so prices have fallen below the level that Anglo American used in their original financial plans for the mine. However, once the purchase price of US$4.6 billion and the construction costs of US$8.8 billion have been paid for, the mine is expected to yield strong cash flows for the next 45 years.

Source: Adapted from online.wsj.com

Points to consider

- Why was it important for Anglo American to have a financial plan or budget for a project this size?
- Why did the budgeted costs and revenues for this site prove to be so unrealistic? Give as many reasons as you can.
- What are the problems in trying to set financial plans for a project such as this mine which could last for 45 years?

Key concept link

Budgeting is an important element of financial planning. All new business strategies and innovative developments will need careful budgeting – capital is not limitless and it needs to be carefully allocated and accounted for.

Introduction

The financial planning process is known as budgeting. A budget is a detailed financial plan for a future time period. If no financial plans are made, an organisation drifts without real direction and purpose. Managers will not be able to allocate the scarce resources of the business effectively without a plan to work towards. Employees working in an organisation without plans for future action are likely to feel demotivated, as they have no targets to work towards – and no objective to be praised for achieving. If no targets are set, then an organisation cannot review its progress because it has no set objective against which actual performance can be compared.

Benefits of setting budgets

Strategic planning for the future must consider 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 will have many benefits.

Budgets are set for both sales revenue and costs and it is usual for each cost and profit centre to have budgets set for the next 12 months, broken down on a month-by-month basis. Setting budgets and establishing financial plans for the future have seven main purposes:

budget: a detailed financial plan for the future

1. Planning – the budgetary process makes managers consider future plans carefully so that realistic targets can be set.
2. Effective allocation of resources – budgets can be an effective way of making sure that the business does not spend more resources than it has access to. There will be priorities to discuss and to agree on since what can be done is always likely to be greater than resources will permit.
3. Setting targets to be achieved – most people work better if they have a realisable target at which to aim. This motivation will be greater if the **budget holder** or the cost- and profit-centre manager has been given some delegated accountability for setting and reaching budget levels. These then become delegated budgets.
4. Coordination – discussion about the allocation of resources to different departments and divisions requires coordination between these departments. Once budgets have been agreed, people will have to work effectively together if targets set are to be achieved.
5. Monitoring and controlling – plans cannot be ignored once in place. There is a need to check regularly that the objective is still within reach. All kinds of conditions may change and businesses cannot afford to assume that everything is fine.
6. Modifying – if there is evidence to suggest that the objective cannot be reached and that the budget is unrealistic, then either the plan or the way of working towards it must be changed.
7. Assessing performance – once the budgeted period has ended, variance analysis will be used to compare actual performance with the original budgets.

budget holder: individual responsible for the initial setting and achievement of a budget

Key features of budgeting

A budget is not a forecast, although much of the data on which it is based will come from forecasts, since we are looking into the future. Budgets are plans that organisations aim to fulfil. A forecast is a prediction of what could occur in the future.

Budgets may be established for any part of an organisation as long as the outcome of its operation is quantifiable. There may be sales budgets, capital expenditure budgets, labour cost budgets and so on.

delegated budgets: control over budgets is given to less senior management

Coordination between departments when establishing budgets is essential. This should avoid departments making conflicting plans. For example, the marketing department may be planning to increase sales by lowering prices, yet the production department may be planning to reduce output and the direct-labour cost budget. These targets will conflict and need to be reconciled.

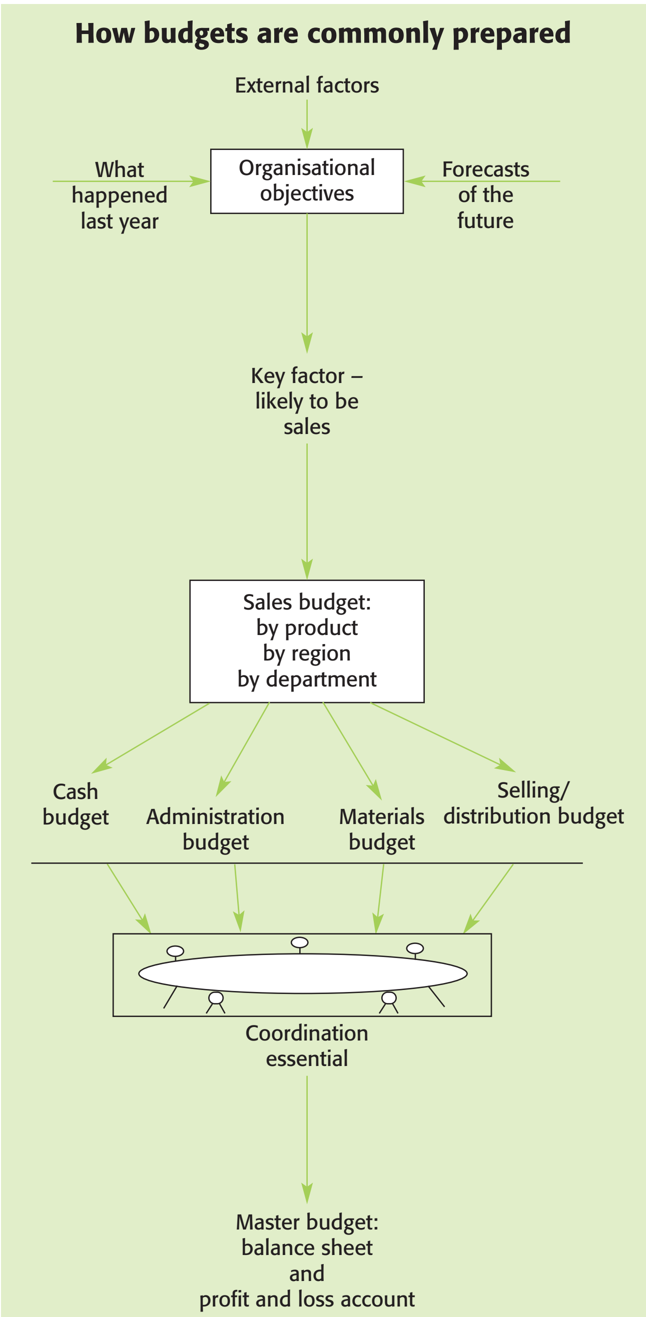


Figure 3.9.1 How budgets are commonly prepared

Decisions regarding budgets should be made with the subordinate managers who will be involved in putting them into effect. Those who are to be held 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 budgets**'.

The budget will be used to review the performance of a department and the managers of that department will be appraised on their effectiveness in reaching targets. Successful and unsuccessful managers can therefore be identified.

These stages of involvement in constructing the budget, taking responsibility for its operation and being appraised in terms of success are the human aspects of the process. They have a very important role to play in the motivation of staff.

Preparation of budgets

Stages in setting budgets

Figure 3.9.1 shows how budgets are commonly prepared. This involves seven stages:

Stage 1 The most important organisational objectives for the coming year are established – these will be based on:

- the previous performance of the business
- external changes likely to affect the organisation
- sales forecasts based on research and past sales data.

Stage 2 The key or limiting factor that is most likely to influence the growth or success of the organisation must be identified – usually sales. The sales budget will be the first to be prepared. Accuracy is essential at this stage, because an error in the key-factor budget will distort all other budgets as well. For example, if the sales budget proves to be inaccurate, e.g. set at a level that proves to be too high, then cash, production, labour budgets and so on will become inaccurate too.

Stage 3 The sales budget is prepared after discussion with sales managers in all branches and divisions of the business.

Stage 4 Subsidiary budgets are prepared, which will now be based on the plans contained in the sales budget. These will include cash budget, administration budget, labour cost budget, materials cost budget, and selling and distribution budget. The budget holders, e.g. cost- and profit-centre managers, should be involved in this process if the aim of delegated responsibility for budgets is to be achieved.

Stage 5 These budgets are coordinated to ensure consistency. This may be undertaken by a budgetary committee with special responsibility for ensuring that budgets do not conflict with each other and that the spending level planned does not exceed the resources of the business.

Stage 6 A master budget is prepared that contains the main details of all other budgets and concludes with a budgeted profit and loss account and balance sheet.

Stage 7 The master budget is then presented to the board of directors for its approval.

Once approved, the budgets will become the basis of the operational plans of each department and cost centre within the organisation. However, the overall plan is usually over too long a time period to be a motivating target and will be broken down into short periods like a month or even a week.

Exam tip: When discussing delegated budgeting try to link this in your answer with the motivational approach of Herzberg – making work more challenging and rewarding.

Setting budget levels

Incremental budgeting and zero budgeting are the two methods most widely used to set budget levels.

Incremental budgeting

In many businesses that operate in highly competitive markets there may be plans to lower the cost budget for departments each year, but to raise the sales budgets. This puts increased pressure on many staff to achieve higher productivity. **Incremental budgeting** does not allow for unforeseen events. Using last year's figures as a basis means that each department does not have to justify its whole budget for the coming year – only the change or 'increment'.

incremental budgeting: uses last year's budget as a basis and an adjustment is made for the coming year

Zero budgeting

This approach to setting budgets requires all departments and budget holders to justify their whole budget each year. **Zero budgeting** 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 can be reflected in very different budget levels each year.

zero budgeting: setting budgets to zero each year and budget holders have to argue their case to receive any finance

THEORY OF KNOWLEDGE

'Everyone wants to be thin, but nobody wants to diet. Everyone wants to live long, but few will exercise. Everybody wants money, yet seldom will anyone budget or control their spending.'

– An anonymous quote

Budgetary control is often challenging for organisations because people will always want to spend more than they have. To what extent is budgeting going against human nature?

Potential limitations of budgets

There are various drawbacks and problems associated with budgets including the following limitations:

- They lack 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 – see the 'Setting the scene' case study on page 326. These external changes include unplanned increases in materials and energy-cost inflation.
- They are focused 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, a decision to reduce the size of the workforce to stay within the labour budget may limit the firm's ability to increase output if sales were to rise more quickly than forecast in the future.
- They result in unnecessary spending. When the end of the budgeting period approaches and managers realise that they have underspent their budgets, unnecessary spending decisions might be made 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 needs must be met. Setting and keeping to budgets is not easy and all managers with delegated responsibility for budgets will need extensive training in this role.
- Revised budgets may need to be set for new projects. When a major new project is being undertaken, perhaps a one-off building scheme such as a large bridge or tunnel, setting realistic budgets may be difficult and frequent revisions in the budgets might be necessary.

Cost and profit centres

An important element of understanding budgets and the purposes of budgets is to be able to explain what cost centres and profit centres are. Budgets are allocated to these sections of a business.

Cost centres

cost centre: a section of a business, such as a department, to which costs can be allocated or charged

Examples of **cost centres** are:

- in a manufacturing business – products, departments, factories, particular processes or stages in the production, such as assembly
- in a hotel – the restaurant, reception, bar, room letting and conference sections.

Different businesses will use different cost centres that are appropriate to their own needs.

Profit centres

profit centre: a section of a business to which both costs and revenues can be allocated

Examples of **profit centres** are:

- 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.

Why do businesses divide operations into cost and profit centres?

If an organisation is divided into these centres, certain benefits are likely to be gained:

- Managers and staff will 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 performing well and those 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?

However, the following problems might arise when using these centres:

- Managers and workers may consider their part of the business to be more important than the whole organisation. There could be damaging competition between profit centres to gain new orders.
- Some costs – indirect costs – can be impossible to allocate to cost and profit centres accurately and this can result in arbitrary and inaccurate overhead cost allocations.
- Reasons for the good or bad performance of one particular profit centre may be due to external factors not under its control.

Exam tip: You may be asked to explain the roles of cost centres or profit centres.

Budgetary control – variance analysis

During the period covered by the budget and at the end of it the actual performance of the organisation needs to be compared with the original targets, and reasons for differences must be investigated. This process is known as **variance analysis**. A variance is the difference between budgeted and actual figures. Variance analysis is an essential part of budgeting for a number of reasons:

variance analysis: the process of investigating any differences between budgeted figures and actual figures

- It measures differences from the planned performance of each department both month by month and at the end of the year.
- It assists in analysing the causes of deviations from budget. For example, if actual profit is below budget, was this due to lower sales revenue or higher costs?
- An understanding of the reasons for the deviations from the original planned levels can be used to change future budgets in order to make them more accurate. For example, if sales revenue is lower than planned as a result of market resistance to higher prices, then this knowledge could be used to help prepare future budgets.
- The performance of each individual budget-holding section may be appraised in an accurate and objective way.

If the variance has had the effect of increasing profit, for example sales revenue higher than budgeted for, then it is termed a **favourable variance**. If the variance has had the effect of reducing profit, for example direct material costs are higher than budgeted, then it is termed an unfavourable or **adverse variance**. See the West Indian Carpets worked example on page 333.

favourable variance: exists when the difference between the budgeted and actual figures leads to a higher than expected profit

adverse variance: exists when the difference between the budgeted and actual figures leads to a lower than expected profit

Responding to variance analysis results

Managers may need to respond quickly to both adverse and favourable variances. Clearly, adverse variances will need to be looked at in some detail to see if cheaper supplies or working methods could be adopted. However, an adverse variance caused by an increase in output leading to higher raw material costs is of much less concern.

Favourable variances cannot be ignored either. 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 very promising – why were sales and output lower than planned for?

LEARNER PROFILE

Principled/caring

At the swimming pool manufacturer Planet Waves plc things have got really tough. Sales and profits are down massively and action is needed. The board has brought in a new CEO, Steve Lynn, who has pushed through a new set of budgets that have made even the most hardened senior managers' eyes water.

Budgets for direct and indirect costs have been slashed and this means redundancies. It also means driving much harder buying prices with suppliers who will struggle to survive on even smaller margins. One shareholder was heard saying, 'Steve Lynn is going to drive this budget through whatever it takes because if he doesn't, Planet Waves is not going to survive.'

Discuss in your class whether you can be a principled and caring manager in Steve Lynn's situation.

Budgetary control and strategic planning

Setting, agreeing and controlling budgets is time-consuming. Budgets can fail to reflect changing circumstances and become inflexible. Budget holders can look upon a budget as a limit up to which they can spend, whether their department needs all of the resources or not. Therefore, is the budgetary process worthwhile?

Try to think of the alternatives:

- Without a detailed and coordinated set of plans for allocating money and resources of the business, who would decide 'who gets what'?
- Without a clear sales budget as the cornerstone of the budgetary process, how would departments know how much to produce or to spend on sales promotion or how many people to employ?
- Would it be possible to assess how the business had done or how well individual departments had performed without a clear series of targets with which to compare performance?
- Without figures to monitor progress during the budgetary period, how would it be possible to know where the business is or to suggest changes that might be made?
- Budgets have to be agreed and controlled. This gives responsibility and a sense of direction to those delegated to work with them. These human advantages are difficult to ensure without planned money values to work with.

Based on these arguments in favour of budget setting and budgetary control, all businesses are likely to undertake some form of financial planning.

Variance analysis – worked example for West Indian Carpets Ltd

Financial variable	Budget ($)	Actual result ($)	Variance ($)	Favourable or adverse
Sales revenue	15 000	12 000	3000	Adverse – this reduces profit
Direct costs	5000	4000	1000	Favourable – this increases profit
Overhead costs	3000	3500	500	Adverse – this reduces profit
Net profit	7000	4500	2500	Adverse – profit is below forecast

Table 3.9.1 West Indian Carpets Ltd

The variance calculations for West Indian Carpets Ltd, shown in Table 3.9.1, can be verified by checking the net profit variance ($2500 adverse) against the net sum of the other variances ($3500 adverse – $1000 favourable = $2500 adverse). The benefits to be gained from regular variance analysis include:

1. Identifying potential problems early so that remedial action can be taken. Perhaps, in this case, a new competing carpet retailer has opened up and West Indian Carpets will have to quickly introduce strategies to combat this competition.
2. Allowing managers to concentrate their time and efforts on the major, or exceptional, problem areas – this is known as management by exception. In this case, it seems that managers should urgently investigate the likely causes of the lower than expected sales figures.

Table 3.9.2 identifies the possible causes of adverse and favourable variances.

Adverse variances	Favourable variances
1. Sales revenue is below budget *either* because units sold were fewer than planned for *or* the selling price had to be lowered due to competition. 2. Actual raw material costs are higher than planned for *either* because output was higher than budgeted *or* the cost per unit of materials increased. 3. Labour costs are above budget *either* because wage rates had to be raised due to shortages of workers *or* the labour time taken to complete the work was longer than expected. 4. Overhead costs are higher than budgeted, perhaps because the annual rent rise was above the level forecasted.	1. Sales revenue is above budget *either* due to higher than expected economic growth *or* problems with one of the competitors' products. 2. Raw material costs are lower *either* because output was less than planned *or* the cost per unit of materials was lower than budgeted. 3. Labour costs are lower than planned for *either* because of lower wage rates *or* quicker completion of the work. 4. Overhead costs are lower than budgeted, perhaps because advertising rates from TV companies were reduced.

Table 3.9.2 Possible causes of adverse and favourable variances

ACTIVITY 3.9.1

The finance director of Kinibali Timber Ltd is concerned about the performance of the business. Sales are increasing but profits are not. He is reviewing the business's budgets and looking to identify where problems exist.

	Budgeted figures	Actual figures	Variances
Sales revenue	660	700	–
Direct labour	150	180	–
Direct materials	120	170	–
Fixed costs	60	50	–
Profit	–	–	–

Budgeted and actual figures for the year ending 31 December 2013 ($000)

20 marks, 40 minutes

1. Define the term 'budget'. [2]
2. Outline **two** reasons why budgeting is important to Kinibali Timber Ltd. [4]
3. Calculate the sales, cost and profit variances for Kinibali Timber Ltd. [6]
4. Analyse **two** reasons why variances are useful to managers. [4]
5. Based on the variance figures you have calculated, explain where Kinibali Timber Ltd's problems seem to be. [4]

OVER TO YOU

Revision checklist

1. What is the difference between a forecast and a budget?
2. Explain **three** advantages to a new business of operating an extensive budgeting system.
3. What is meant by 'master budget'?
4. Outline why a fashion clothing business might face problems when setting its sales revenue budget.
5. A food retailing business with many branches is planning to introduce delegated budgeting for the first time.
   a. Explain **two** possible benefits of this to the business.
   b. Outline **two** possible limitations of doing this.
6. Explain why a firm might decide to use zero budgeting.
7. Examine **two** advantages to a business of using variance analysis.
8. Distinguish, with the aid of numerical examples, between 'favourable variances' and 'adverse variances'.
9. Discuss **two** ways that a sports shoe retailing business might use to correct an adverse sales revenue variance.

Exam practice question

VARIANCE ANALYSIS AT OASIS COOKERS LTD

Oasis Cookers Ltd makes gas and electric ovens. The business has a good reputation for quality products. These are sold through a number of selected retailers who have agreed to display and market the ovens in ways that differentiate them from cheaper models. The national economy is experiencing a downturn with no economic growth. The government has been forced to increase interest rates to control cost-push inflation and this has contributed to an appreciation of the currency's exchange rate. Foreign oven imports are falling in price because of this. The management of Oasis Cookers Ltd are studying the latest variance analysis results:

	Budgeted figures ($000)	Actual figures ($000)	Variances
Sales revenue	165	150	
Cost of materials	80	70	
Labour costs	22	23	
Gross profit	63	57	
Overheads	40	43	
Net profit	23	14	

20 marks, 40 minutes

1. Define the term 'variance'. [2]
2. Explain how a manufacturing business sets budgets for sales and costs. [4]
3. Explain **two** problems of trying to budget for the cost of raw materials. [4]
4. Complete the table by calculating the variances, indicating whether they are adverse or favourable. [6]
5. Using the variance results, comment on the performance of Oasis Cookers during the year. [4]

Key concept question

20 marks, 40 minutes

With reference to one or two organisation(s) that you have studied, discuss how budgeting can be used to support business strategy. [20]

MARKETING

Unit

4

4.1

The role of marketing

On completing this chapter you should be able to:

Know and understand:

- Marketing and its relationship with other business functions (AO1)
- Characteristics of the market in which an organisation operates (AO1)

Analyse and apply:

- The difference between marketing of goods and marketing of services (AO2)
- Market orientation against product orientation (AO2)
- The difference between commercial marketing and social marketing (AO2)

Evaluate:

- The importance of market share and market leadership (AO3)
- Marketing objectives of for-profit and not-for-profit organisations (AO3)
- How marketing strategies evolve in response to changes in consumer preferences (AO3)
- How innovation, ethical considerations and cultural differences may influence marketing practices and strategies (AO3)

Calculate:

- Market share (AO4)

Setting the scene

McDONALD'S – MARKETING DOES NOT STAND STILL

What food do you think of when you hear 'McDonald's'? Most people would still say 'burger and chips'! But the multinational fast-food business is working hard to change its brand image. There are several reasons for this but three stand out:

- The recent global economic downturn has created market opportunities for 'premium products' aimed at consumers who are short of cash and cannot afford a meal in a three-star restaurant.
- Increasing concern about the bad health effects of fast food – especially the youth obesity problem of today – means that healthier menu options are becoming much more popular.
- Different consumer tastes prevail in some of the markets in which McDonald's is now expanding.

McDonald's claims: 'We are constantly researching consumer wants, and as many people cannot now afford full restaurant meals, we are revising our menu to appeal to them with luxury beef and chicken products in specialist ciabatta bread. The company is also committed to increasing its range of salads and other healthy options.' McDonald's is also aware of the cash limits of its traditional customers and is targeting them with a new 'dollar-saver' menu. In India, it has opened its first 'vegetarian only' restaurant.

No business can afford to stand still – not only do consumer preferences change but there are always competitors to worry about. Burger King is also trying new ingredients, such as Spanish sausages and tiger prawns. It promoted its new upmarket menu with a world-record-breaking $95 burger with the most expensive beef in the world! It captured the newspaper headlines, but it will not become a regular product.

Points to consider

- What do you think marketing managers do? Make a list of as many marketing tasks as you can from this case study.
- Explain why McDonald's is changing its food menus.
- Why are 'researching consumer wants' and promotion important to firms such as McDonald's and Burger King?

Key concept link

Marketing is a business function that is responsible for some of the most important strategic business decisions – such as whether to enter new markets. Marketing decisions often have to reflect the globalised nature of many markets and ethical considerations can influence marketing and promotional campaigns.

Introduction

Most people think of **marketing** as just being about advertising and selling of products. However, this is a very limited view – marketing embraces 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 is the management process responsible for identifying, anticipating and satisfying consumers' requirements profitably.

Another definition comes from *Contemporary Marketing Wired*, by Boone and Kurtz (9th edition, 1998):

> Marketing is the process of planning and undertaking the conception, pricing, promotion and distribution of goods and services to create and maintain relationships that will satisfy individual and organisational objectives.

It seems from this definition that marketing involves a number of related management functions. These include:

- market research
- product design
- pricing
- advertising
- distribution
- customer service
- packaging.

So, marketing is a very important business activity! Marketing activities are all those associated with identifying the particular wants and needs of target-market customers and then trying to satisfy those customer needs better than your competitors do. This means that market research is needed to identify and analyse customer needs. With this knowledge, strategic decisions must then be taken about product design, pricing, promotion and distribution.

marketing: the management task that links the business to the customer by identifying and meeting the needs of customers profitably – it does this by getting the right product at the right price to the right place at the right time

Marketing and its relationship with other business functions

Important strategic marketing decisions are unlikely to succeed unless they are integrated and coordinated with the other main business functions. Consider this decision by 'Under Armour':

Under Armour increases its Marketing Budget

Company forecasts sales could increase substantially this year

The sportswear company, Under Armour, has announced that it is increasing its marketing budget, in line with a sharp increase in sales.

Sales in 2013 reached $2.33 billion, with sales forecasts predicting a 25% increase to £2.91 billion in 2014. On the back of this, the 2014 advertising budget is ballooning by 34%. CEO Kevin Plank stated the company intends to apportion 11% of revenues to marketing, which equates to $330 million. Just two years ago, the budget was $205 million, and in 2013, it stood at $246.5 million. Some marketing is handled in-house, but Under Armour also works with the marketing agency Droga5.

Why did this marketing decision need to be coordinated with other business functions?

1. **Finance** – this department needs to fund the increased promotion budget. Without the assurance from the company's accountants that adequate finance is available, the marketing department could not make this decision to substantially increase spending on marketing.
2. **Human resources** – additional employees are likely to be required if the additional marketing and promotion activity for Under Armour products is successful. These employees will be required in operations, administration, finance – and marketing itself, as additional sales and support staff will be needed as well as advertising and promotions specialists as Under Armour 'handles some marketing in-house'. These employees have to be recruited in good time and they must have appropriate skills – so constant liaison between the marketing and human resources departments is essential.
3. **Operations** – the links between marketing and operations are vital. Market research data will be used by operations to determine the preferences of consumers for the future product mix. The additional marketing budget of Under Armour is expected to lead to a 25% increase in sales in 12 months – additional output, inventories, supplies and despatches will need to be organised by the operations function.

This example helps to illustrate the key importance of the marketing department establishing close relationships with other functions within the organisation so that marketing decisions have a greater chance of achieving their objectives.

Market characteristics

Markets can be differentiated by assessing the following characteristics:

- market size
- market growth
- competitors and ease of entry
- differentiated or homogeneous products
- segmentation.

We will now look at each of these characteristics in detail.

Market size

Market size can be measured in two ways: volume of sales (units sold) or value of goods sold (revenue).

market size: the total level of sales of all producers within a market

The size of a market is important for three reasons:

- A marketing manager can assess whether a market is worth entering or not.
- Businesses can calculate their own market share.
- Growth or decline of the market can be identified.

It is not always easy to measure market growth 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 can be measured in two ways:

- by volume – the market has risen from 24 to 26 million units, an increase of 8.33%
- by value – the revenue has risen from $768 million to $936 million, an increase of 21.87%.

Which of these two figures – value or volume – should be used for measuring the changing market share for any one jeans manufacturer? The manufacturer could use the measure that reflects better on its own position. It may, therefore, also be difficult to compare firms' changing market shares. A cosmetic 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.

Market growth

market growth: the percentage change in the total size of a market (volume or value) over a period of time

Some markets are obviously growing faster than others; some, such as 3G mobile phones, are declining rapidly. The pace of growth will depend on several factors including economic growth, changes in consumer incomes, development of new markets, changes in consumer tastes and technological change, which can boost market sales through innovative products. The rate of growth will also depend on whether the market is 'saturated' or not. In most Western countries, the sales of washing machines are not rising each year as most households already have one – most purchases are, therefore, replacement models. Sales of these products are still rising in India and China as most potential consumers have yet to purchase one.

Competitors and ease of entry

ease of entry: the lack of barriers for the establishment of new competitors in a market

All businesses need to be aware of the number and size of their direct competitors – and the ease with which new rivals could join the market. Generally, the greater the number of competitors and the easier it is for new ones to join a market, the more price competition there will be. The scope for product or service differentiation is important though. If products can truly be 'made different' from rivals' products, it might still be possible for a business to charge relatively high prices even though the number of competitors is substantial.

Differentiated or homogeneous products

Milk, maize (corn), bottled water and petrol are four products which are difficult to differentiate. A business selling in any of these markets will be less able to stand out from rivals in terms of product quality than, for example, a business operating in the car or TV markets. **Homogeneous products** are those that cannot be distinguished between even though they may come from different suppliers. It will be difficult for a business to charge prices different from the 'going rate' for these products.

homogeneous products: goods that are physically identical or viewed as identical by consumers

Segmentation

This term refers to the dividing of prospective consumers into groups (segments) that have common needs and will respond similarly to marketing activities. Market **segmentation** enables companies to target different groups of consumers who perceive the value of certain products and services differently from each other. **Target marketing** – as opposed to **mass marketing** – recognises the diversity of customers and does not try to satisfy them all with the same good or service. The first step in target marketing is to identify these different market segments and their needs.

segmentation: dividing a market into distinct groups of consumers who share common tastes and requirements

target marketing: focusing marketing activity on particular segments of the market

mass marketing: selling to the whole market using a standardised product and the same marketing activities

consumer good: tangible physical product marketed to end users (consumers)

consumer service: intangible provision of an activity to end users (consumers)

Differences between marketing goods and marketing services

Tangible, physical **consumer goods** are often marketed in different ways to intangible **consumer services**. Managers responsible for selling services – such as banking or hotel services, hairdressing and beauty treatments – have to recognise several key differences between goods and services:

- Services are *consumed immediately* – they cannot be stored – so empty hotel bedrooms during the off-peak season may have to be filled by charging much lower prices.
- Services cannot be taken back to be repaired or replaced – so the *service quality must be right first time* or the consumer will not return.
- Consumers find it much *more difficult to compare service quality* than for manufactured goods – so promotion of services must be informative and detailed about the precise nature of the range and quality of services offered.
- *People* (trained, approachable and helpful employees) *are very important to the successful marketing of services*. By contrast, products such as Nintendo's Wii often 'sell themselves' due to their innovative features.

Marketing goods and services can have many similarities as well as differences. The marketing of both goods and services benefits from creating trust and building brand recognition into the marketing activities, but goods can be impulse purchases whereas services need time to be delivered to consumers. There are several differences between marketing goods and services, most of which focus on relationship building.

Building trust

For newly formed and other small businesses, 'the business entrepreneur is the product'. In other words, the entrepreneur has to sell confidence and trust in themselves, and their ability to perform the services as described. The promises made about services must be delivered every time – there is rarely an opportunity to correct a poor service delivery as there might be with a faulty good.

Time for delivering the service

Services by their very nature are time-intensive activities because there is no way to continue providing a service without continuing to spend time with the customer. Time is an important part of marketing a service because if a promise is made to provide a service within a given time frame, the business must be certain it is able to deliver while still managing and providing services for others. Accurate time estimates and effective time management when delivering services to clients will allow more customers to be seen and provided with services to an appropriate standard.

Deliverability

A major challenge with marketing services is being able to convince customers that quality results can be delivered within a given period of time. Usually service marketing materials such as websites have testimonials and case studies from other satisfied clients that are designed to prove that the business is able to deliver on the promises contained in the promotional materials.

Relationships

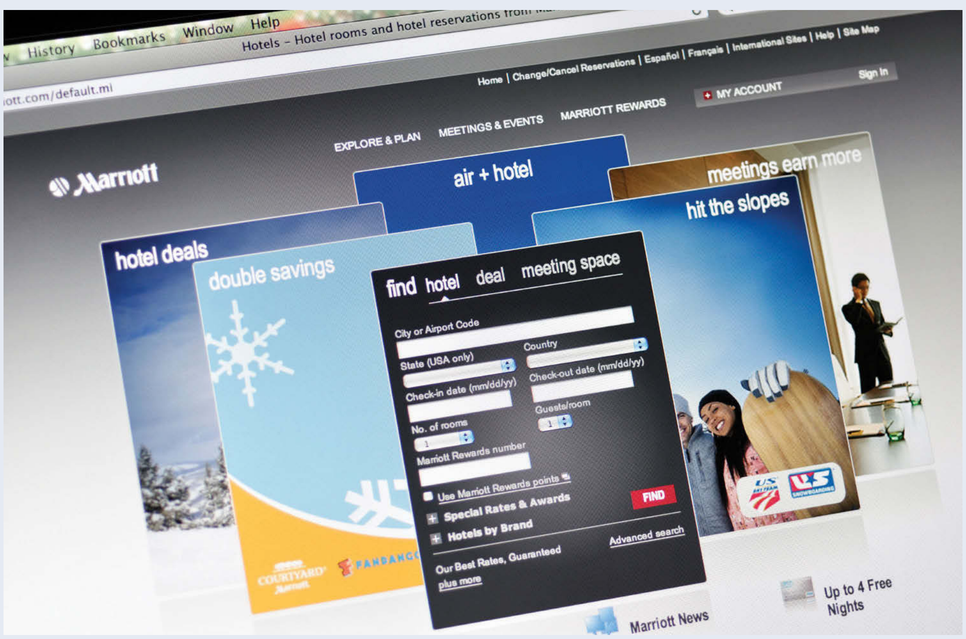
Marketing a service-based business relies more on building long-term relationships with consumers than marketing goods does. When service businesses build up trust and a long record of reliably supplying high-level service consistently, they establish relationships that can help to provide long-term sources of revenue as well as providing a greater chance of positive feedback via social media.

Perceived value

Many service companies focus their marketing efforts on the goal of instilling a high perceived value of the service in the minds of the customer. If the customer is made to feel easier, better or richer in some way from using the service, then the marketing has been successful! Since the customer will not walk away from the business with a tangible product in-hand, this emotional connection is a key element in service marketing. One aspect of this emotional attachment is setting the right price level. Marketing of goods is often focused on the price level. Most high-end service providers do not compete on price – largely because they know that it is a losing proposition. Price cutting can lead to devaluation of the service being provided and also lead to a decline in the quality of services being offered as a result of lesser-qualified firms entering the market to compete on the basis of price alone.

ACTIVITY 4.1.1

MARKETING SMALL HOTELS



Unlike the large multinational hotel companies, many independent hotels have limited marketing budgets. So how can they compete? Business consultants suggest that effective marketing of small hotels on a low budget is possible by following this advice:

1. Focus on consumer service and cater for special needs.

The advantage of a small business it that it can offer customers a personalised service. Small hotels needs to identify their unique selling point, whether this is location, specialised tour packages, or even rooms that cater for people with pets. A customer's experience on a trip or of a region can be impacted enormously by their experience of the small hotel business.

2. Use social media effectively.
A Facebook page and a twitter account containing the name and brand logo are essential. Market research has found that consumers who are engaged with brands on Twitter are subsequently 67% more likely to buy from those brands. For Facebook, the figure is 51%. Small hotels are competing with well-recognised brands of hotels, so they need to increase their credibility wherever possible.

3. Make booking online easy.
Customer's decisions are influenced by many factors, including their experience of a website. It is therefore vital that customers experience an efficient website in order to convert website visits into sales.

20 marks, 40 minutes

1. Define the term 'consumer service'. [2]
2. Explain why small hotels need to 'make booking seamless' to make the standard of consumer service as high as possible. [4]
3. Analyse the importance of social media in promoting small hotels. [4]
4. Compare and contrast the marketing of consumer services like hotels with the marketing of consumer goods. [10]

Marketing approaches

Market orientation and product orientation

market orientation: an outward-looking approach basing product decisions on consumer demand, as established by market research

This is an important distinction. Most businesses would today describe themselves as being '**market-oriented**' or 'market-led'. This approach requires market research and market analysis to indicate present and future consumer demand. The consumer is put first – the business attempts to produce what consumers want rather than try to sell them a product they may not really want to buy. It has advantages, especially in fast-changing, volatile consumer markets. In these cases, increasing consumer awareness of competitors' products, prices and image can result in significant fluctuations in popularity of goods and services. The benefits of market orientation are threefold:

- The chances of newly developed products failing in the market are much reduced – but not eliminated – if effective market research has been undertaken first. With the huge cost of developing new products, such as cars or computers, this is a convincing argument for most businesses to use the market-oriented approach.
- If consumer needs are being met with appropriate products, then they are likely to survive longer and make higher profits than those that are being sold following a product-led approach.
- Constant feedback from consumers – market research never actually ends – will allow the product and how it is marketed to be adapted to changing tastes before it is too late and before competitors 'get there first'.

The days of 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 an extent and the following instances help to explain why:

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

1. Product-oriented businesses invent and develop products in the belief that they will find consumers to purchase them. The development of the WAP mobile phone was driven more by technical innovation than by consumer needs – consumers were not aware that such versatile products were likely to be made available until the basic concept had been invented and developed into an innovative new product. Pure research in this form is rare but still exists, for example in pharmaceutical and electronic industries. Here there is still the belief that if they produce an innovative product of a good enough quality, then it will be purchased.
2. 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 still do exist, especially in product areas where quality or safety is of great importance, such as bottled-water plants or the manufacture of crash helmets.

Evaluation of these two approaches

The trend then is towards market orientation, but there are limitations. If a business attempts to respond to every passing consumer trend or market fashion, then it may well overstretch its resources and end up not doing anything particularly well. Trying to offer choice and range so that every consumer need is met can be expensive. In contrast, researching and developing an innovative product can be successful, even if there has been no formal market research – consider Dyson's hugely profitable cyclone vacuum cleaner, for example.

ACTIVITY 4.1.2

THE CLASSIC WATCH COMPANY

Men's and women's taste in watches has changed as incomes have risen

The Classic Watch Company was in trouble. Sales had fallen for each of the last three years. The founder of the company, Harry Brainch, could not understand the reasons for this. His business had been making the Classic Ladies' wristwatch for the last 20 years. The current model had been updated but was still essentially the same design as the original watch. Consumers had been attracted to its simple, robust design and good value. These were very important qualities during the economic crisis that the country had suffered from for much of the last few years.

More recently, consumer incomes had started to rise. Old manufacturing industry had been replaced by service sector businesses that offered many supervisory and managerial jobs. Youth unemployment, in particular, had fallen and young consumers had much more money to spend than previously. Both men and women were becoming much more fashion conscious as their consumer tastes changed with higher incomes. Harry knew his business had to change and become more market-oriented in its approach. His problem was not knowing which new styles of watches to introduce. He almost wished a return to the good old days when shoppers were happy to buy a recognised design at a reasonable price.

14 marks, 28 minutes

1. Define the term 'market-oriented'. [2]
2. Outline why the Classic Watch Company seems to have a product-oriented approach to marketing. [4]
3. Explain **two** problems the Classic Watch Company faces by using a product-oriented approach to marketing. [4]
4. Analyse **two** changes the Classic Watch Company would need to make to become a market-oriented business. [4]

Social marketing

This approach to marketing adopts a wider perspective than the previous forms of orientation. It focuses on other stakeholders as well as the business and its consumers. Social responsibility is becoming increasingly popular among organisations and can be regarded as an important strategic marketing tool. This raises the question of what the central purpose of marketing should be. Is it 'a management tool to help maximise profits' or should it be 'a means of satisfying consumer needs profitably, but with minimum damage and costs to society'? Managers who believe in 'social marketing' claim the latter concept of marketing is the correct one to adopt. The term **'social (or societal) marketing'** was first coined by Kotler in 1972.

social (societal) marketing: this approach considers not only the demands of consumers but also the effects on all members of the public ('society') involved in some way when firms meet these demands

These other members of the public or stakeholders include employees, shareholders, suppliers, competitors, government, the community and the natural environment. Examples of societal marketing include The Body Shop, which promises not to support animal testing of its products and purchases its supplies from sustainable sources produced in non-environmentally damaging ways. These products are not the cheapest – but they do meet society's long-term interests. Another example is the sale of dolphin-safe tuna fish, which has been caught by rod and line rather than nets that can entrap dolphins. This tuna is more expensive – but it is more appealing to society's concerns.

The social marketing concept has the following implications:

- It is an attempt to balance three concerns: company profits, consumer wants, society's interests.
- There may be a difference between short-term consumer wants (low prices) and long-term consumer and society welfare (protecting the environment and paying workers reasonable wages). Social marketing considers long-term welfare.
- Businesses should still aim to identify consumer needs and wants and to satisfy these more efficiently than competitors do – but in a way that enhances consumers' and society's welfare.

- Using this concept could give a business a significant competitive advantage. Many consumers prefer to purchase products from businesses that are seen to be socially responsible.
- A social marketing strategy, if successful, could lead to the firm being able to charge higher prices for its products as benefiting society becomes a unique selling point.

The difference between commercial marketing and social marketing

Most of this chapter has focused on commercial (or business) marketing – satisfying customers' needs for profit. Social marketing also aims to satisfy customer needs – but by achieving specific behavioural goals for the good of society at the same time.

Tins of dolphin-safe tuna – an example of social marketing

'Social good' is the main focus of social marketing. 'Financial return' is the main objective of commercial marketing.

Market share and market leadership

Market share is calculated by the following formula:

$$\text{market share } \% = \frac{\text{firm's sales in time period}}{\text{total market sales in time period}} \times 100$$

'Firm's sales' and 'total market sales' can be measured in either units (volume) or sales value in this market. Market share, and increases in it, is often the most effective way to measure the relative success of one business's marketing strategy against that of its competitors. If a firm's market share is increasing, then the marketing of its products has been relatively more successful than most of its competitors. The product with the highest market share is called the 'brand leader'. Why might it be important for a brand or a manufacturer to have **market leadership** in this way?

market share: the percentage of sales in the total market sold by one business

market leadership: when a business has the highest market share of all firms that operate in that market

ACTIVITY 4.1.3

MARKET SHARE FOR TABLET COMPUTERS

Total sales in market A in 2014 were 54 000 units. The average selling price was $300.

In 2014, Company X sold 15 000 units in market A at $300 each.

Company X was market leader in market A in 2014.

8 marks, 16 minutes

1. Calculate the market share of Company X in 2014. [4]
2. Analyse two benefits to Company X of being the market leader. [4]

Exam tip: You may be asked to do some simple calculations about market growth and market share – remember to take your calculator into the examination with you!

The benefits of being the market leader with highest market share include the following:

- Sales are higher than those of any competing business in the same market and this could lead to higher profits too.
- Retailers will be keen to stock and promote the best-selling brands. They may be given the most prominent position in shops.
- As shops are keen to stock the product, it might be sold to them with a lower discount rate – say 10% instead of 15%, which has to be 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.

The importance of market share and market leadership

Market share is an important measure of business performance – especially relative performance as compared with rival companies. There are many 'internal' measures of marketing success such as customer satisfaction, brand awareness, loyalty and profit margins but market share can be benchmarked against the competition. Other reasons why market share is important are:

- Being 'market leader' with the highest market share can be used in advertising and promotional material. 'This is the most popular product in the market' can be a convincing argument influencing more consumers to buy it.
- Market leaders are in a strong bargaining position with both suppliers and retailers. Suppliers will want to continue with long-term supply contracts with the most successful business in the market, not just because of high sales of their components or services but also because some of the 'glitter' will rub off to benefit their status and good name. Retailers will be very keen to stock the market-leading product as consumers would be disappointed not to find it in their stores. These strong bargaining positions could lead to lower costs and longer credit periods from suppliers and higher selling prices to, and shorter payment periods from, retailers.
- Recruitment of high-class employees is often easier for market-leading businesses as people would rather work for 'winners' than unsuccessful businesses.
- Financing might become easier if investors and banks become convinced that the status of being market leader with the highest market share adds to the stability and profit potential of the business.

However, being market leader puts pressure on a business and key staff to continue to do as well if not better in future. The business media will look for any sign of slippage in position and will gleefully report that a business is losing market share and losing touch with its consumers.

In addition, too much emphasis on market share could take attention away from profitability. Price cuts and lower profit margins are one way of increasing market share – but is this strategy sustainable in the longer term? The reasons why a business is market leader need to be assessed carefully before stakeholders can conclude that the business really does have a winning formula rather than just a 'sell-it-cheap-to-increase-share' strategy.

Exam tip: It is very important to understand that a firm's market share can fall even when its sales are rising. This is because, if the total market sales are increasing at a faster rate than one firm's sales, the market share will fall.

ACTIVITY 4.1.4

TESCO IS MARKET LEADER IN THAILAND

Tesco Lotus – the brand name used by the European supermarket in Thailand – had 15% of the supermarket grocery (food) market in 2013. Total sales in this sector amounted to £25 billion. Two French-owned companies operating in Thailand were second and third on the list of firms' market shares – Big C had 7% and Carrefour 4%. If non-food items are included then Tesco Lotus has 43% market share. Being market leader gives Tesco

Lotus a huge advantage – and it is not standing still. It has plans to both open new stores and enter new markets. Recently, Tesco Lotus entered the fast-growing school-uniform market, worth $140 million a year, with prices 20–30% lower than traditional shops.

This expansion is not without its critics and the new Thai government has taken action to protect locally owned shops and to ensure good consumer choice is maintained. A new law is proposed that would severely restrict the opening of all new foreign-owned stores. Consumer groups are split on the new law – they want to keep the variety offered by local stores, but they enjoy the big stores and low prices too.

10 marks, 20 minutes

1. State the equation used to calculate Tesco Lotus's market share in Thailand. [2]
2. Calculate Tesco Lotus's sales in the Thai supermarket grocery market in 2013. [2]
3. If Tesco Lotus's grocery sales increase by $2 billion in 2014, but the total size of the Thai supermarket grocery market increases by $10 billion, calculate Tesco Lotus's 2014 market share. [2]
4. Explain **two** advantages Tesco Lotus might gain from being 'market leader' in Thailand. [4]

A Tesco Lotus store in Bangkok

Marketing objectives

Marketing objectives are the goals that are set for the marketing function of a business. They should be focused on achieving the overall corporate aims of the business.

1. For-profit organisations

The long-term objectives of a company will have a significant impact on both the **marketing objectives** and marketing strategies adopted. A business with clear short-term profit targets will focus on maximising sales at the highest prices possible. In contrast, a business with longer-term objectives, which may include both profitability as well as the achievement of goals of social responsibility, may adopt a 'societal marketing' approach.

marketing objectives: the goals set for the marketing department to help the business achieve its overall objectives

Examples of for-profit organisations' marketing objectives include an increase in:

- market share – perhaps to gain market leadership
- total sales (value or volume – or both)

- average number of items purchased per customer visit
- frequency that a loyal customer shops
- percentage of customers who are returning customers (customer loyalty)
- number of new customers
- customer satisfaction
- brand identity.

The achievement of any or all of these marketing objectives will help the organisation achieve its primary profit-seeking corporate objective.

To be effective, marketing objectives should:

- *Fit in with the overall aims and mission of the business* – the marketing objectives should reflect the aims of the whole organisation and they should attempt to aid the achievement of these.
- *Be determined by senior management* – the key marketing objectives will determine the markets and products a business trades in for years to come and these issues must be dealt with by managers at a very senior level in the company.
- *Be realistic, motivating, achievable, measurable and clearly communicated to all departments in the organisation*.

Marketing objectives are important for the following reasons:

- They provide a sense of direction for the marketing department.
- Progress can be monitored against these targets.
- They can be broken down into regional and product sales targets to allow for management by objectives.
- They form the basis of marketing strategy. These marketing objectives will have a crucial impact on the marketing strategies adopted, as without a clear vision of *what* the business hopes to achieve for its products, it will be pointless discussing *how* it should market them.

2. Non-profit-making organisations

Not-for-profit organisations are distinguished from profit-maximising organisations by three characteristics. First, most not-for-profit organisations do not have external shareholders providing risk capital for the business. Second, they do not distribute dividends, so any profit (or surplus) that is generated is retained by the business as a further source of capital. Third, their organisational objectives usually include some social, cultural, philanthropic, welfare or environmental dimension.

In some ways, marketing and non-profit-making might appear to be opposing concepts. Yet charities and other not-for-profit organisations have very clear fundraising objectives – to support their cause or help achieve social objectives – and this money needs to be raised in the most cost-effective way. There are, therefore, many similarities between marketing objectives in for-profit organisations and in not-for-profit organisations. The main marketing activities will also be similar:

- Market research – how does the public view our charity and which groups are most likely to donate?
- Identifying the best ways to communicate effectively with donors – many charities have moved away from expensive and ineffective direct-mail shots to internet and viral marketing campaigns. A recent blog-driven campaign helped to raise funds for Water For People (see website: www.waterforpeople.org).
- The need to assess the effectiveness of different promotions and campaigns to increase value for money in the future.

What are the differences in marketing in non-profit-making organisations compared to marketing in profit-seeking ones?

- The importance of maintaining high ethical standards to avoid alienating the public
- Constant feedback on the success of charity campaigns – and future issues to be addressed – to maintain public interest and awareness
- Free publicity, with the aim of capturing the public's imagination, for example for fundraising events and stunts, is much more important for charitable causes than for most consumer products.

Marketing objectives for not-for-profit organisations include:

- Maximise revenue from trading activities
- Increase recognition of the organisation by society
- Promote the work and aims of the organisation to a wide audience.

Marketing strategies

How marketing strategies evolve in response to changes in consumer preferences

Marketing should never stand still – read again the 'Setting the scene' case study. Changes in consumer preferences should be researched, anticipated and acted upon by the marketing department. Examples of recent changes in consumer preferences include:

- fuel-efficient cars – and fewer 'gas guzzlers'
- healthy food – and less fried food
- tablet computers – and fewer PCs
- informal business clothing – and fewer 'business suits'.

Businesses that fail to respond to these and other changes in preference by developing and marketing new products will usually quickly lose sales and market share. However, some businesses make a point of *not* responding to fickle fashion and preferences changes and promote the fact that 'their products and production methods remain largely unchanged'. This approach is similar to the focus on product orientation which was considered above.

ACTIVITY 4.1.5

PEPSICO RESPONDS TO CHANGING PREFERENCES

We are a global food and beverage company operating in highly competitive categories and we rely on continued demand for our products. To generate revenues and profits, we must sell products that appeal to our customers and to consumers. Any significant changes in consumer preferences or any inability on our part to anticipate or react to such changes could result in reduced demand for our products and erosion of our competitive and financial position. Our success depends on: our ability to anticipate and respond to shifts in consumer trends, including increased demand for products that meet the needs of consumers who are concerned with health and wellness; our product quality; our ability to extend our portfolio of convenient foods and beverages in growing markets; our ability to develop or acquire new products that are responsive to certain consumer preferences, including reducing sodium, added sugars and saturated fat; developing a broader portfolio of product choices and increasing non-carbonated beverage offerings; our ability to develop sweetener innovation; our ability to improve the production and packaging of our products; and our ability to respond to competitive product and pricing pressures.

Source: www.pepsico.com

20 marks, 40 minutes

1. Define the term 'consumer product'. [2]
2. Explain how government tax and regulation in response to rising obesity might affect the demand for Pepsico's soft drinks. [4]
3. Analyse how PepsiCo might develop a new product to deal with rising health concerns over its soft drinks. [4]
4. Evaluate the advantages and disadvantages for PepsiCo of changing its marketing strategy in response to changes in consumer preferences. [10]

How innovation, ethical considerations and cultural differences may influence marketing practices and strategies in an organisation

Innovation

The major innovations in recent years that have had impact on marketing activities have been guerrilla marketing (see Chapter 4.5) and internet marketing. In the case of internet marketing, the increasing growth of social media networks is encouraging businesses to switch a higher proportion of their budgets towards these forms of communicating with customers rather than traditional forms of newspaper and TV advertising.

Example 1: Nike switches to digital

Nike has switched its promotional priorities towards digital media such as social networking sites. It has reduced its spending on TV and paper-based media by 40% in three years. Most of its huge US$2.7 billion marketing budget (2013) is being spent on enhancing its communications with customers online. Other major brands are thought to be pursuing similar strategies in the hope of boosting brand loyalty through online chatter and real-time social media engagement.

Ethical considerations

Ethical objectives are covered in detail in Chapter 1.3. Marketing activities can have a major impact on whether a business achieves its ethical objectives. If a single issue is considered – advertising sweets to children – then the arguments for and against taking an ethical stand can be the basis for a discussion on many other marketing issues with an ethical dimension.

Example 2: "Children's impulse control for sweets influenced by computer games"

A study from the Netherlands has found that children playing computer games featuring advertisements for sweets consume more calories than when the game contains adverts for toys. These research findings come at a time when many doctors and dieticians are worried about growing rates of obesity, especially amongst young children.

Children with poor self-control were particularly vulnerable to prompts from a sweet-themed game and ate more sweets even when offered a reward not to eat, the researchers found.

One of the author's of the report, Dr. Frans Folkvord told Reuters

One of the author's of the report said that even children as old as 15 do not realise that 'advergames' are advertisements, and suggests that parents need to help train their children to recognise advertising in order to reduce their undesired effects, such as overeating.

Some child charities suggest that parents should explain to their children why food companies advertise their products and brands, helping them to become more critical and better informed consumers.

Arguments for	Arguments against
• The product is not illegal so advertising it should not be controlled or made illegal. • Advertising sweets to children has been proven to increase sales. • Children like sweets and advertising to them informs them of new types and flavours of sweets. • Advertising can increase consumer information and choice and helps in the making of informed choices. • If sweets advertisements are discussed with adults then it helps children become more aware and critical when exposed to advertisements.	• Sweets are a contributory factor in childhood obesity. • Sweets add to tooth decay problems in children so advertising that increases sales of sweets to children is damaging their health. • It might be legal to advertise sweets to children but it 'might not be the right thing to do' if it is perceived as being unethical by adult consumers. They may react negatively towards the businesses that undertake it.

Table 4.1.1 Arguments for and against advertising sweets to children

THEORY OF KNOWLEDGE

E-cigarette market on fire

An internet survey has found that the market for e-cigarettes is expanding rapidly. A member of the team at the University of California, San Diego, which helped lead research into the impact on public health, stated that the product has 'caught on fire', with ten new brands entering the market every month for the past two years and over 7700 flavours in total.

E-cigarettes contain a battery-powered heating cartridge that vaporises liquid-containing nicotine and/or flavourings. On the whole, they deliver significantly lower levels of nicotine when compared to normal cigarettes, and some studies suggest they help those trying to give up smoking. They will be of benefit to public health, provided they are used to help quit smoking, although there are concerns they could encourage children that it is safe to smoke.

The US is proposing regulations that would mean each individual e-cigarette would require federal approval, which is causing concerns for the companies creating them. This could create an endless stream of paperwork for both the companies and the federal government.

In your class discuss the knowledge issues associated with knowing whether e-cigarettes are a good thing for society. To what extent should we be supporting the successful marketing of e-cigarettes?

Cultural differences

The impact of cultural differences on marketing activities is covered in detail in Chapter 4.7.

Failing to respond to cultural differences can lead to bad feeling and bad publicity whereas responding to local tastes and sensibilities can encourage consumers to accept a new brand as being designed for their needs.

Example 3: Getting the name wrong

While Microsoft's Vista might conjure up images of open windows and scenic views in some countries, the name means 'chicken' or 'frumpy woman' in Latvian. Getting brand names right is particularly tricky in some languages. A study by Auckland University of Technology and Hong Kong Baptist University found that only 22% of major foreign brands had optimised their names for the Chinese market.

One example that worked well was Nike which became *Nai Ke*. Not only does it have a similar sound, but the characters mean 'Endurance Conquer'.

Source: https://econsultancy.com

LEARNER PROFILE

Reflective

Sometimes in marketing like any other area of business you make a mistake:

- You change your product and the customer doesn't like it.
- Your advertising campaign shocks consumers so much it leads to a fall in sales.
- When you market your product in a new country you find it doesn't sell.

- The price you charge for the product is too low so sales are good but profits are not.
- Your products turn out to be dangerous and it leads to lots of bad publicity.

Do some research to find out about some major marketing mistakes made by organisations. As a reflective CEO, examine how you would respond to making the marketing mistakes considered above.

OVER TO YOU

Revision checklist

1. Why is 'marketing' not just 'selling and advertising'?
2. Using examples, differentiate between market orientation and product orientation.
3. Why is it usually better for a business to be market-oriented?
4. Explain **three** examples of problems that might result from failing to link marketing decisions with other departments in the business.
5. State **four** possible examples of marketing objectives that a business might set.
6. Which **one** of these objectives do you think would be most appropriate for Coca-Cola in your country? Explain your answer.
7. Using numerical examples, explain the difference between market share and market size.
8. Why would a business that had the second-largest market share be keen to become market leader?
9. Explain **two** differences between the marketing of products and the marketing of services.
10. Explain **three** characteristics that can be used to differentiate between markets.
11. Outline **three** factors that could lead to a business experiencing declining market share in a growing market.
12. Outline **three** ways in which a manufacturer of jeans might increase market share.
13. Outline **three** possible marketing objectives for a for-profit organisation.
14. Measure Company A's market share and the growth rate of the market it operates in from the following data. Comment on your results.

	2013	2014
Total market sales (units)	36 000	48 000
Total market value ($ in millions)	5.0	6.5
Company A's sales (units)	3600	5000
Company A's sales value ($m)	0.5	0.6

Exam practice question

SAMSUNG RELEASES FOUR NEW AFFORDABLE GALAXY SMARTPHONES

Samsung has added four new Galaxy smartphones to its existing line, designed to deliver an 'exceptional experience at an affordable price'. The new products are targeted at the low-price market segment of the smartphone market where Samsung really wants to grow its market share.

The Galaxy Core II, Galaxy Star 2, Galaxy Ace 4 and Galaxy Young 2 all run Google's Android 4.4 KitKat system and feature smaller displays and less-powerful processors than the flagship model, the Galaxy S5, but they still do a remarkable job and offer the consumer an exceptional experience for the price.

Last week Samsung also announced the specifically fitness-focused Galaxy S5 Sport, which will be both dust- and water-resistant. The product is an innovative response to the way smartphone owners use their phones when they are at the gym, out for a run and even cycling. The phones come with new fitness apps which allow you to do things like measure your performance on a running machine or map your ride when you are cycling.

Source: Adapted from www.telegraph.co.uk

20 marks, 40 minutes

1. Define the term 'market segment'. [2]
2. Outline how Samsung might calculate its market share of the 'low-price' market segment of the smartphone market. [4]
3. Explain **two** reasons why Samsung might have launched the 'fitness-focused Galaxy S5 Sport'. [4]
4. Evaluate Samsung's decision to target the 'low-price' market segment of the smartphone market. [10]

Key concept question

20 marks, 40 minutes

With reference to one or two organisation(s) that you have studied, discuss how ethics and culture influence the way firms target consumers in different markets with their products. [20]

4.2

Marketing planning

On completing this chapter you should be able to:

Know and understand:

- The elements of a marketing plan (AO1)

Analyse and apply:

- The role of marketing planning (AO2)
- The four Ps of the marketing mix (AO2)
- An appropriate marketing mix for a particular product or business (AO2)
- The difference between target markets and market segments (AO2)
- The difference between niche market and mass market (AO2)
- How organisations target and segment their market and create consumer profiles (AO2)
- A product position map (AO2)
- The importance of having a unique selling point (USP) (AO2)

Evaluate:

- The effectiveness of a marketing mix in achieving marketing objectives (AO3)
- How organisations can differentiate themselves and their products from competitors (AO3)

Determine and/or construct:

- An appropriate marketing mix for a particular product or business (AO4)
- Possible target markets and market segments (AO4)
- A product position map (AO4)

Setting the scene

MARKETING PLANNING FOR THE IPHONE PAYS OFF

Apple's mission is to lead the industry in innovative products. Its constant search for USPs paid off with the original iPhone. It was the first mobile device to have a touchscreen. Not only was the product unique at the time but the marketing of the iPhone was well planned and it met all of its marketing objectives.

After assessing market trends and rivals' products in 2007, Apple's senior management told the research department to develop the most advanced mobile phone on the market. Once the iPhone was successfully developed with a range of advanced features, clear marketing objectives were set which included:

- 2% market share in USA and UK in first year after launch (445 000 sales)
- 10% market share in second year after launch
- 50% market share three years after launch.

The overall marketing strategy was to differentiate the iPhone from other mobile phones and aim at the primary target market of the upper-middle-class professional. Pricing was premium penetration for the first few months – and then lowered to establish quick market dominance. Promotion was extensive – the Apple website, Apple shop displays and product demonstrations all concentrated on attracting consumers to the product's key features. A multimillion-dollar advertising budget was used to pay for TV and upmarket printed media. Constant market research was undertaken to make sure the strategy was getting through to the target market.

All marketing objectives were met – Apple had succeeded in establishing itself as the world's leading maker of smartphones.

It did not stop there. Constant product improvements have been announced – in late 2013 the iPhone 5 and 5C were released. The cheaper version – the 5C – was targeted at expanding markets in developing countries and young customers.

Apple revealed that revenue jumped 4% to US$37.5 billion in the three months to September 2013 spurred by sales of almost 34 million iPhone 5s – a new record. Apple's iPad sales in the same period totalled 14.1 million. The company unveiled new tablets in 2013 including the latest version of the iPad mini as it aims to maintain its share of the growing tablet sector amid mounting competition from cheaper alternatives.

Points to consider

- How did careful planning help the original iPhone meet all its marketing objectives?
- How important is it for Apple to develop new products regularly?
- To what extent is the marketing mix for Apple products, such as the iPad and iPhone 5, appropriate?

Key concept link

Market conditions and consumer preferences are constantly changing and marketing strategies cannot remain constant over time. Planning for change within the marketing function is an essential requirement for success. Market research should underpin strategic changes and it also helps to identify when innovative products are needed to satisfy consumer preferences. Product innovation can often result in a unique selling point and this can be an effective element of an appropriate marketing mix.

Introduction – marketing planning

A market plan is often a formal written document which outlines in detail how the business unit intends to achieve the marketing objectives derived from the corporate objectives. Effective **marketing planning** is nearly always based on clear awareness of market trends, competitors' actions and consumer wants, so market research is vital.

marketing planning: the process of formulating appropriate strategies and preparing marketing activities to meet marketing objectives

The main elements of a marketing plan are:

- details of the company's (SMART) marketing objectives
- sales forecasts to allow the progress of the plan to be monitored
- marketing budget – how much finance is planned to be spent and how it is to be allocated
- marketing strategies to be adopted to achieve the marketing objectives
- detailed action plans showing the marketing tactics to be used to implement the strategies.

A marketing plan is an essential component of any successful marketing campaign. Successful marketing does not just 'happen', it has to be planned and prepared for.

Role of marketing planning

Table 4.2.1 shows the roles and limitations of marketing plans.

Roles	Limitations
• Plans provide focus to the work of the marketing department and a 'road map' of the stages to be taken in implementing marketing strategies. • Marketing strategies linked to SMART objectives will increase the likelihood of the marketing campaign's success. • The budget should be planned in advance with the finance department and should be adequate to achieve the campaign's objectives. • Helps achieve integration of different business functions as all departments will need to be involved in the planning process. • Planning ahead helps to ensure that the marketing mix is appropriate and fully integrated.	• Plans that are not revised to meet changing internal or external conditions – such as the arrival of new competitors – will become outdated. • Plans are insufficient on their own – they need to be reviewed constantly and the final outcome must be judged against the original objectives to aid future decision-making. • Marketing plans need to be based on an up-to-date assessment of the market and consumer preferences or it will be inappropriate for current conditions.

Table 4.2.1 Marketing plans – roles and limitations

Marketing mix

marketing mix: the key decisions that must be taken in the effective marketing of a product

The **marketing mix** for a product is a major factor in influencing whether a business can sell it profitably.

The marketing mix is made up of seven interrelated decisions – the seven Ps. The four Ps considered at Standard Level are **product, price, promotion** (including advertising and packaging) and **place** (where and how a product will be sold to consumers). The other three Ps, studied only at higher level, largely relate to the marketing of services – **people, process** and **physical evidence**.

The four Ps are:

- **Product** – consumers require the right good or service. This might be an existing product, an adaptation of an existing product or a newly developed one.
- **Price** is important too. If set too low, then consumers may lose confidence in the product's quality; if too high, then many will be unable to afford it.
- **Promotion** must be effective and targeted at the appropriate market – telling consumers about the product's availability and convincing them that 'your brand' is the one to choose. Packaging is often used to reinforce this image.
- **Place** refers to how the product is distributed to the consumer. If it is not available at the right time in the right place, then even the best product in the world will not be bought in the quantities expected.

Not all of the four Ps have the same degree of significance in every marketing mix. It is vital that these elements fit together into a coherent and integrated plan – targeted at clear marketing objectives. An appropriate marketing mix will ensure that these marketing decisions are interrelated. They must be carefully coordinated to make sure that customers are not confused by conflicting messages being given about the good or service being sold – this is called a **coordinated marketing mix**.

coordinated marketing mix: key marketing decisions complement each other and work together to give customers a consistent message about the product

An appropriate 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 advertisement lead to many sales?

These are all examples of poorly integrated and inappropriate marketing-mix decisions. The marketing decisions – shown in italics – lack integration with the rest of the marketing mix and are therefore inappropriate. If the messages consumers receive about a product are confused or lacking in focus, they may fail to recognise the true identity or 'personality' of the product. Consumers are likely to reject products where the marketing mix has not communicated a clear and unambiguous message, resulting in fewer long-term sales.

If just one part of the marketing is inconsistent or does not integrate with the rest, it may lead to the failure of even the best marketing plan. The most appropriate marketing-mix decisions will therefore be:

- based on marketing objectives that are achievable within the marketing budget
- coordinated and consistent with each other
- targeted at the appropriate consumers.

ACTIVITY 4.2.1

Look at the examples of four marketing-mix decisions and then answer the questions that follow.

WHAT WENT WRONG?

	Product	Price	Place	Promotion
Mix A	Fast sports car	High – based on top-range competitors' prices	Exclusive dealers in impressive city showrooms	Advertised on radio only
Mix B	Range of furniture for families with low incomes	Low – low costs allow prices to be set below competitors'	Sold only over the internet	Advertised on posters and in free local newspapers
Mix C	Ladies' fashion hairdressing salon with cutting by well-known stylists	Low-price offers to large family groups	Salon located in wealthy area of city	Advertised in fashion and beauty magazines
Mix D	Fast-food restaurant	Skimming or high-price strategy	Expensive business district location with many top-class restaurants	Advertised in business magazines, loyalty-card scheme operated together with quality retail department stores

14 marks, 28 minutes

1. For each product in the table, identify the element of its marketing mix that does not fit with the overall marketing mix for the product. [4]
2. Choose **two** products in the table and recommend a change in each product's marketing mix that would make the mix effective. [10]

Exam tip: IB questions may ask you to recommend and evaluate a marketing mix for a product. As with an actual business, the key point here is to suggest a fully coordinated marketing mix which is appropriate for achieving a set marketing objective.

Differences between market segments and target markets

market segment: a sub-group of a market made up of consumers with similar characteristics, tastes and preferences

If a business is using only mass marketing then it is not important to differentiate between **market segments** as the 'whole market' is being targeted. In most cases, businesses attempt to aim their products at particular groups of consumers, believing that these groups demand slightly different products or 'offerings'. The first stage in this process is to research the whole market and identify specific consumer groups within it. These are called market segments. The individuals in a particular segment respond to trends and market forces in similar ways and require similar products.

In the clothing market, children make up one segment; males can be part of another segment while females form another segment. The 'youth clothing segment' could be further segmented into students and those in employment.

target market: the market segment that a particular product is aimed at

Once the market segments have been identified then businesses must decide which of these segments are going to become **target markets**. This is the key difference between the two terms – target markets are the segments of the market that the business is going to aim its product at. A clothing business does not have to target all segments in the clothing industry. It might decide to target only males or females, the youth market segment or more 'mature' consumers. Each target market will now require its own marketing strategy and promotion mix.

Market segmentation and consumer profile

market segmentation: identifying different segments within a market and targeting different products or services to them

Market segmentation is sometimes referred to as differentiated marketing. Instead of trying to sell just one product to the whole market as in mass marketing, different products are targeted at different segments. This is a form of niche marketing. To be effective, firms must research and analyse the total market carefully to identify the specific consumer groups or segments that exist within it.

Below are some examples of market segmentation:

- Computer manufacturers, such as Hewlett Packard, produce PCs for office and home use, including games, but also make laptop models for business people who travel.
- Coca-Cola not only makes the standard cola drink but also Diet Coke for slimmers and flavoured drinks for consumers with particular tastes.
- Renault, the carmaker, produces several versions of its Mégane model, such as a coupé, saloon, convertible and 'people carrier' – all appealing to different groups of consumers.

Sometimes firms only market their goods or services to one segment and deliberately do not aim to satisfy other segments. Gap is a clothing retailer that aims only at the youth market; Nike shoes are only for sports use and Coutts Bank only offers banking services to the seriously rich. These businesses make a virtue out of concentrating on one segment and developing an image and brand that suits that segment.

Identifying different consumer groups

consumer profile: a quantified picture of consumers of a firm's products, showing proportions of age groups, income levels, location, gender and social class

Successful segmentation requires a business to have a very clear picture of the consumers in the target market it is aiming to sell in. This is called the **consumer profile**. The main characteristics of consumers contained in a consumer profile are income levels, age, gender, social class and region. Marketing-mix decisions need to be appropriate for the consumer profile of the target market. A well-targeted product will need less advertising and promotional support than one which does not really meet the needs of the consumers that it is aimed at.

Markets may be segmented in a number of different ways. The three commonly used bases for segmentation are shown below.

1. Geographic differences

Consumer tastes may vary between different geographic areas, for example the need for warmer clothing in Northern Europe compared to South-East Asia, and so it may be appropriate to offer different products and market them in 'location-specific' ways.

THEORY OF KNOWLEDGE

Global knowledge issues in marketing a school

A school in Worcestershire, UK, lends its name and expertise to a private school in Thailand. The Bromsgrove International School teaches the British curriculum and has been operating since September 2005. It is one of a group of UK independent schools, including Harrow, Dulwich and Shrewsbury.

Bromsgrove believes the school that is in the centre of Bangkok promotes and enhances the reputation of the Bromsgrove brand locally in the UK and around the world. The venture was initiated by an approach by a group of educationalists and business people in Bangkok who wanted to start a high-quality British school.

Bromsgrove School describes itself as one of the UK's leading independent schools which has a high level of achievement and a reputation and ethos which make it appropriate for the Bromsgrove name and methods to be used by the school in Thailand.

To what extent does Bromsgrove School's knowledge of its own local market mean that the same approach to its marketing planning can be used in another country in the world?

2. Demographic differences

These are the most commonly used basis for segmentation as age, sex, family size and ethnic background can all be used to separate markets. A house construction firm will use demographic data to help determine which segment of the market a new block of apartments should be aimed at. Should they be retirement flats with a resident caretaker? Should they be small studio flats for young, single people? Should they offer large reception rooms to encourage certain ethnic groups that live in extended families to be attracted to the apartments? The construction firm may not attempt to attract all market segments – but having decided on the most appropriate one, it will be essential to gear the price and promotion strategies towards this segment.

An individual's social class may have a great impact on their expenditure patterns. This will be largely due to income differences between different classes of employment. The wealthy will have very different consumption patterns from the 'working class'. The jobs people do are one of the main factors influencing people's income levels; however, other forces apart from income levels could operate. For instance, top professional groups would be expected to spend more money on, say, power boating and golfing, as these tend to be class-related activities.

Many marketing acronyms exist as abbreviations for different demographic groups of consumers. Here are just three:

- DINKY – double income no kids yet
- NILK – no income lots of kids
- WOOF – well-off older folk.

LEARNER PROFILE

Knowledgeable

Here are four classic translation mistakes that have been made by some of the world's biggest companies:

- The Scandinavian vacuum manufacturer Electrolux used the slogan 'Nothing sucks like an Electrolux' in an American campaign.
- When Parker Pen marketed a ballpoint pen in Mexico, the advertisements were supposed to say: 'It won't leak in your pocket and embarrass you'. However, the company mistakenly thought the Spanish word 'embarazar' meant embarrass. Rather than the meaning they intended to convey, the advertisements actually read 'It won't leak in your pocket and make you pregnant.'
- KFC's famous slogan 'Finger-lickin' good' didn't work well in China when it read: 'We'll eat your fingers off' in Chinese!

In your class discuss the importance of business people's knowledge of language when they are marketing goods in a global business environment.

3. Psychographic factors

These are to do with differences between people's lifestyles, personalities, values and attitudes. Lifestyle is a very broad term which often relates to activities undertaken, interests and opinions rather than personality. The huge increase in TV channels and TV viewing in many countries has contributed to the growth of 'TV dinners', which are pre-prepared meals ready to eat without missing any of your favourite programmes. Table 4.2.2 summarises the advantages and limitations of market segmentation.

Advantages	Limitations
• Businesses can define their target market precisely and design and produce goods that are specifically aimed at these groups leading to increased sales. • It helps to identify gaps in the market – groups of consumers that are not currently being targeted – and these might then be successfully exploited. • Differentiated marketing strategies can be focused on target market groups. 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 unable to compete in the whole market are able to specialise in one or two market segments. • Price discrimination can be used to increase revenue and profits.	• Research and development and production costs might be high as a result of marketing several 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 stock-holding costs might be higher than for the option of just producing and stocking one undifferentiated product. • By focusing on one or two limited market segments there is a danger that excessive specialisation could lead to problems if consumers in those segments change their purchasing habits significantly.

Table 4.2.2 Market segmentation – advantages and limitations

Difference between niche market and mass market

Niche marketing can be targeting products at a very small section of the whole market and may 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 only sell very cheap items, attracting a low-income segment of the market.

Mass marketing is the exact opposite. 'One product for the whole market' is now becoming quite an unusual concept for firms to adopt – yet is still seen in, for example, the toothpaste and fizzy drinks markets. Hoover, the vacuum-cleaner manufacturer, used to sell a very limited range of products as most consumers wanted just a simple and effective cleaner. Now, with increased consumer choice and more competitors operating in the market, Hoover offers a much wider range of models of different sizes, power output and prices to appeal to different segments of the **mass market**. So, although not true niche marketing, the company is recognising the limits of pure mass marketing.

Both types of marketing – niche and mass – have their advantages, as outlined in Table 4.2.3.

niche market: a small and specific part of a larger market

niche marketing: identifying and exploiting a small segment of a larger market by developing products to suit it

mass market: a market for products that are often standardised and sold in large quantities

mass marketing: selling the same products to the whole market with no attempt to target groups within it

Advantages of niche marketing	Advantages of mass marketing
• Small firms may be able to survive and thrive in markets that are dominated by larger firms. • If the market is currently unexploited by competitors, then filling a niche can offer the chance to sell at high prices and high profit margins – until the competitors react by entering too. Consumers will often pay more for an exclusive product. • Niche market products can also be used by large firms to create status and image – their mass-market products may lack these qualities. **Note:** these can also be viewed as the disadvantages of mass marketing.	• Small-market niches do not allow economies of scale to be achieved. Therefore, mass-market businesses are likely to enjoy substantially lower average costs of production. • Mass-market strategies run fewer risks than niche strategies. As niche markets contain relatively small numbers of consumers, any change in consumer buying habits could lead to a rapid decline in sales. This is a particular problem for small firms operating in only one niche market with one product. **Note:** these can also be viewed as the disadvantages of niche marketing.

Table 4.2.3 Advantages of niche marketing and mass marketing

ACTIVITY 4.2.2

TI PEDDLE PREMIUM CYCLES FOR NICHE MARKET

Tube Investments of India is planning to enter the ultra-premium cycle market segment – with price ranges from $300 to $4000. 'Though the market size is small, we cannot afford to be absent from this segment,' TI Cycles' vice president said. Last year TI Cycles sold 2.8 million units and the marketing objective for the current year is 3.1 million units. The company started making electric scooters last year and has already launched BSA Workouts exercise equipment. The ultra-premium bicycles will not add greatly to total sales revenue – but they will help to take the brand upmarket as Indian consumers' incomes increase.

Source: www.thaindian.com

16 marks, 32 minutes

1. Define the terms:
   a. niche market [2]
   b. market segment. [2]

2. Explain how TI would set the price and product elements of the marketing mix to reach the ultra-premium cycle market segment. [4]
3. Analyse **one** problem for TI as it tries to enter the ultra-premium cycle market segment. [4]
4. Explain **one** reason why TI wants to market products in different market segments. [4]

Product positioning

Once a market has been segmented and target markets identified, a business has to 'position' its product. Before deciding on which product to develop and launch, it is common for businesses to analyse how the new brand will relate to the other brands in the market, in the minds of consumers. This is called positioning the product by using a technique such as product positioning.

product position map or **perception map:** a graph that analyses consumer perceptions of each of a group of competing products in respect of two product characteristics

The first stage in preparing the **product position map** or **product perception map** is to identify the features of this type of product considered to be important to consumers – as established by market research. These key features might be price, quality of materials used, perceived image, level of comfort offered (hotels) and so on. They will be different for each product category.

The second stage, based on qualitative market research, is to position each of the competing products on the graph according to consumers' perceptions of them.

Figure 4.2.1 illustrates the main cola products of Coca-Cola Company and PepsiCo and their brand perceptions. The product positioning map uses the two criteria:

- male/female consumers
- high/no calories.

It suggests that there might be a market gap for a soft drink with high calories aimed at female consumers. Neither company is aiming new products at this sector, however. Can you think why not?

PepsiCo's newest soft drink Pepsi NEXT is looking to break into the market for people who want to drink 'real-tasting' cola but prefer mid-calories instead of zero-calories. Coca-Cola's C2 is operating in the similar area with 'half the carbohydrates, sugars and calories' compared to standard Coke. Both Pepsi and Coke introduced mid-calories colas back in 2001; Pepsi Edge was the original brand. However, due to slow sales, the product was taken off the market after five years. According to John Sicher, editor of Beverage Digest, 'Pepsi seems to believe that times are different now and consumers might want to try this kind of beverage.'

Source: www.labbrand.com

This product-positioning analysis could be used in a number of ways:

- It identifies potential gaps in the market. This could be the segment that the business should aim for. Alternatively, the firm could play safe and position the new product in with others – this is likely to be less risky but could be less profitable too.
- Having identified the sector with the greatest 'niche' potential the marketing manager is then made aware of the key feature(s) of the product that should be promoted most heavily.
- Lastly, when this analysis is used to monitor the position of existing brands a firm can easily see if a repositioning of one of them is required. This could involve a new advertising campaign or restyled packaging rather than a newly launched product.

Coca-Cola product line		Pepsi product line	
Coca-Cola		Pepsi	
Coca-Cola C2		Pepsi Max	
Diet Coke		Diet Pepsi	
Coca-Cola Zero		Pepsi One	

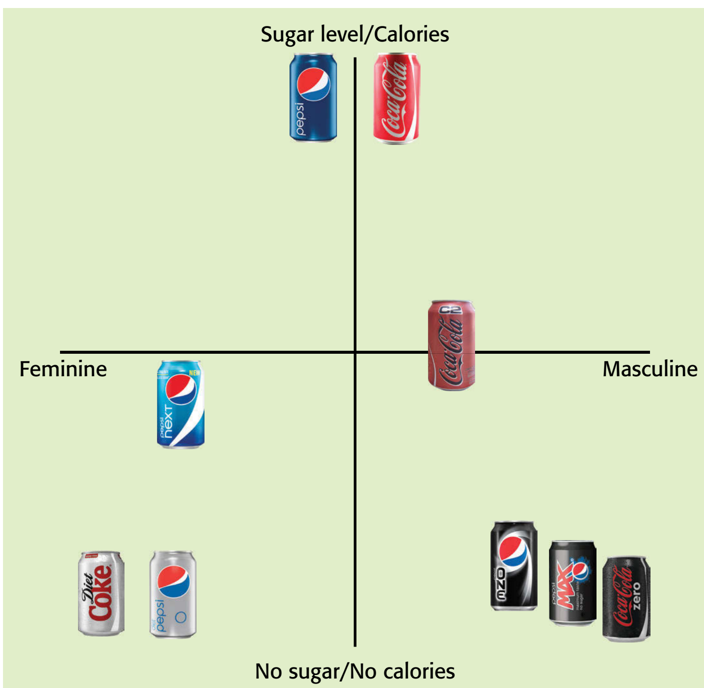


Figure 4.2.1 Product positioning of well-known cola drinks

ACTIVITY 4.2.3

'UNDERSTANDING MARKET SEGMENTATION KEY TO REPEAT VISITS BY TOURISTS'

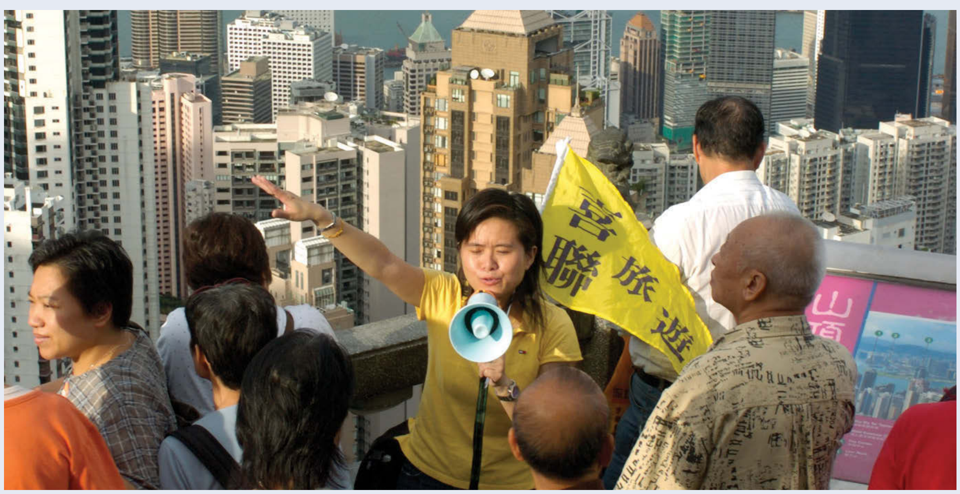
According to a study by Cathy Hsu of the School of Tourism at Hong Kong University, the key to boosting the number of tourists revisiting the region is for companies to understand market segmentation. In a survey of 1300 tourists passing through Hong Kong international airport, Professor Hsu identified six distinct groups of tourists who, she claimed, needed to be treated differently by marketing activities.

The six groups were:

1. leisure travellers 55 years or younger
2. first-time mature travellers 55 years +
3. repeat mature travellers
4. business travellers with incomes over $50 000 per year
5. business travellers with incomes under $50 000 per year
6. travellers visiting friends or family in Hong Kong.

These groups needed a different marketing focus to encourage repeat visits. Young, single leisure travellers might be attracted by 'bring a friend' promotions. High-income business travellers could be more influenced by promotions about the wide range of leisure and shopping facilities in the region. Mature repeat travellers made up just 4.5% of the total sample, suggesting that this was a market segment that needed to be more fully developed. The segment that needed little additional marketing focus was made up of those visiting family and friends – they would be likely to visit Hong Kong again anyway.

Source: www.eturbonews.com



The tourist market can be segmented in many ways to allow for differentiated marketing

22 marks, 44 minutes

1. Explain the process of market segmentation. [4]
2. Explain **two** of the ways in which market research has allowed the total tourist market to Hong Kong to be segmented. [6]
3. Evaluate the possible benefits and limitations to a Hong Kong travel company of targeting different segments of the tourist market with different marketing activities. [12]

Unique selling point/proposition (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 – the best form of product differentiation is one that creates a **USP**.

unique selling point/proposition (USP): a factor that differentiates a product from its competitors, such as the lowest cost, the highest quality or the first-ever product of its kind; a USP could be thought of as 'what you have that competitors don't'

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. Against all odds, the Dyson became the biggest-selling vacuum cleaner in Europe within four years, despite being an unknown name and costing more than competing products.
- Mast Brothers Chocolate – every bar of chocolate is handmade from purchasing the cacao beans directly from growers. The brothers transport the beans in wooden sailing ships to the final processing plant to reduce environmental impact.

The benefits of an effective USP include:

- effective promotion which focuses on the differentiating feature of the product or service
- opportunities to charge higher prices due to exclusive design/ service
- free publicity from business media reporting on the USP
- higher sales than undifferentiated products
- customers more willing to be identified with the brand because 'it's different'.

Dyson vacuum cleaners – James Dyson spent 15 years developing the world's first bagless vacuum cleaner. His product was launched in 1993 with the USP: 'The only vacuum cleaner in the world to maintain 100% suction, 100% of the time'

USPs can be based on any aspect of the marketing mix. For example:

- **Product.** The TESLA electric car is now widely recognised as the best electrically driven car in the world. It incorporates a number of key patented innovations that make it faster and give it a longer range than other electric vehicles.
- **Price.** 'Never knowingly undersold' is the classic advertising slogan for the John Lewis Partnership's department stores in the UK. The retailer checks and matches its high-street competitors' prices regularly, both at national and local level. The company achieved 10% sales growth in the UK in 2014 despite other high-street retailers reporting a fall in sales.
- **Place.** Dell became the first computer manufacturer to focus almost exclusively on internet sales. Keeping its costs down allowed it to offer competitive prices.
- **Promotion.** 'When it absolutely, positively has to be there overnight' (FedEx courier service) is one of the most famous promotional slogans of recent years. It helped to establish in customers' minds the unique quality of service that this company claimed to offer.

How organisations can differentiate themselves and their products from competitors

In globalised markets with increasing competition, it is becoming increasingly important for businesses and their products to offer something substantially different to most of their competitors. This differentiation can take a number of different forms. The possible benefits and limitations of these are analysed in Table 4.2.4.

Form of differentiation	Benefits	Limitations
Low/lowest prices	Consumers have limited spending power and low prices will always attract a high proportion of them towards the product.	Will total profit fall if the profit margin is reduced to very low levels? Do low prices integrate with the rest of the marketing mix? Could consumers perceive the product/brand to be of low quality too?
Trust	Customers are careful to spend their limited incomes wisely and will study each purchase to make sure they're making a 'safe' decision. They want to buy from companies they trust and believe in.	Trust is difficult for a newly formed business to establish so other forms of differentiation might be necessary. Trust – and with it, company image – can be damaged greatly by issues such as environmental disasters or a series of poor feedback on social media. It is always very difficult to re-establish trust.
Ethical stance	In some communities, consumers are very keen to support companies that adopt an ethical stance by purchasing their products. This ethical approach might lead to higher costs and prices but some customers will 'pay the difference' because they share the company's values.	In some markets low prices are more important than ethical positions. A lack of genuine ethical position – rather than just an ethical promotion campaign, for example – could lead to a loss of trust if consumers discover that the business was really only adopting a 'window dressing' show of ethical behaviour.
Convenience	Consumers' lack of time or dislike of the shopping experience means that more convenient ways to browse and purchase could create effective differentiation. Free delivery, click and collect, and streamlined online shopping processes are examples of convenient ways to shop.	These methods of 'convenient shopping' are now so widespread that it is difficult to gain true, long-lasting differentiation.
Product features	If these are the result of research and development (R&D) that leads to patented products or processes, then it can be difficult for competitors to copy this form of differentiation. As with USPs (see above) it can lead to a reputation for innovative, cutting-edge products that can command premium prices.	R&D is an expensive and time-consuming process and does not always lead to successful innovative products. Constant development might be needed to stay ahead of competitors so a business needs to continue to commit resources into developing innovative products that differentiate the business and its brands effectively.

Table 4.2.4 Forms of differentiation

ACTIVITY 4.2.4

LE SPORTIF HEALTH AND SPORTS CLUB

Le Sportif is a health and sports club located in Paris. The club has performed well over the last two years but now faces competition from two clubs, Wellness and Glides, which have just opened. Wellness, which targets high-income professional clients, has been particularly successful and has attracted a number of customers from Le Sportif.

The management of Le Sportif conducted some extensive market research to find out more information about their customers. They used a series of focus groups to find out about customers' views on Le Sportif and a questionnaire to provide them with more precise data about the way customers used the club.

Le Sportif has responded positively to its market research by adopting the following strategies:

- introducing a family membership scheme
- introducing a range of family-based classes to encourage health and fitness
- opening a coffee shop.

The management of Le Sportif believe that this new customer-oriented approach, which targets a niche market of health and fitness for the whole family, will give the club a USP and will enable it to stand out from the competition.

28 marks, 56 minutes

1. Define the following terms:
   a. target market
   b. niche market. [4]
2. Explain how the management of Le Sportif could use product positioning. [6]
3. Analyse the benefits of market segmentation to a business such as Le Sportif. [8]
4. Evaluate the advantages and disadvantages of Le Sportif's method of differentiating itself from competitors. [10]

OVER TO YOU

Revision checklist

1. Explain **two** of the main elements of a marketing plan.
2. Explain the problems a business might experience when developing and launching a new product without a marketing plan.
3. Give **two** examples of a four Ps marketing mix which could be considered to be inappropriate.
4. Explain why marketing objectives should be considered when devising a marketing mix.
5. Explain the difference between target markets and market segments.
6. Outline the key features of a marketing mix of a product that you have recently purchased.
7. Explain the difference between niche markets and mass markets.
8. Explain **two** ways in which the market for sport shoes could be segmented.
9. Suggest **two** criteria that could be used for constructing a product position map for cafes.
10. Explain **one** possible benefit to a business of developing a USP.
11. Explain the USP of any company of your choice.
12. Explain **two** ways in which a business can differentiate its products from those of competitors.
13. What would the benefits be of using a targeted marketing strategy for a clothing retailer?

Exam practice question

Many top market global brands have been struggling to increase sales or market share in recent years. The news of Burberry's continuing success leaves some wondering how the company is delivering such a strong performance, with a revenue increase of 35%, 105 new stores added and a productivity boost of 11% in the last 12 months. 'While the luxury industry faces global challenges in the year ahead, we remain confident in our team's ability to outperform, underpinned by the consistent execution of our key strategies,' said Burberry's chief executive. The sales figures show that the company's plan to survive the financial crisis by targeting flagship markets has so far been successful. Burberry's USP of being an 'iconic British luxury brand' has been enhanced in the last few years to attract a new, younger market segment while keeping current customers satisfied. Now the company is targeting young, digitally aware consumers in the world's wealthiest markets. As rising internet penetration and increasing familiarity with online shopping is a burgeoning trend, the company's focus is mainly on digital integration. The company's targets are 25 of the world's wealthier cities (including London, New York and Beijing); according to Burberry these account for more than half of the global luxury fashion trade. These target markets also benefit from high levels of tourism and very wealthy residents. The company is investing in underpenetrated markets such as Asia Pacific, Latin America and the Middle East, as these are forecast to see continued growth in consumption of luxury goods as tourism, salaries and store openings increase. Non-apparel, including handbags, small leather goods, scarves, shoes, belts and jewellery, remain a key driver of the company's growth, contributing 40% of retail sales in the last 12 months. Low prices have never been a consideration for Burberry as its management perceives that its consumers demand exclusivity and style – and these do not integrate well with low prices.

Source: www.marketline.com

20 marks, 40 minutes

1. Define the following terms:
   a. unique selling point
   b. target market. [4]
2. Describe **two** elements of Burberry's marketing mix. [4]
3. Construct a product positioning/perception map for Burberry's female clothing based on price and product quality. [2]
4. Evaluate the ways Burberry differentiates its products from its competitors in the market for female clothing. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, examine what changes globalisation brings about in a business's marketing planning. [20]

4.3

H

Sales forecasting

On completing this chapter you should be able to:

Show quantitative skills:

- Calculation and completion of moving averages using given data as an important technique of sales forecasting (AO4)

Evaluate:

- Benefits and limitations of sales forecasting (AO3)

Setting the scene

NINTENDO SLASHES SALES FORECASTS FOR WII U CONSOLE

Nintendo's Wii U console is struggling to reach sales forecasts. This is an understatement. In 2014, the Japanese games company slashed the annual sales forecast from 9 million units to 2.8 million units. As a consequence the company will record an annual operating loss – instead of the original forecasted profit.

The Wii U has been poorly received by the market after the outstanding success of the best-selling Wii console. Many potential consumers have suggested that the new version offers little more than the original. Competition has been fierce as both Sony (PlayStation 4) and Microsoft (Xbox) have upgraded their own games consoles. Both of these models are easily outselling Nintendo's Wii U. Sales of this model were particularly disappointing over Christmas when seasonal factors mean that this is the biggest buying period for consoles and games.

Disappointing sales of the console have had a knock-on effect on games sales. Nintendo has also been forced to lower its annual sales forecasts for these from 38 million to 19 million.

Points to consider

- Why do you think sales forecasts are important for strategic decision-making?
- Explain why Nintendo's original sales forecasts would have been important for the operations management and finance departments of the company.
- If the original sales forecasts proved to be so inaccurate, does this suggest that forecasting is of little value?

Key concept link

Choosing appropriate new strategies for the growth and development of a business is never guaranteed to succeed. Market research will usually be essential but so too will sales forecasting. Attempting to predict future sales levels can help in strategic choice as well as in the management and allocation of resources.

Introduction – sales forecasting

sales forecasting: predicting future sales levels and sales trends

It is impossible to predict the future with complete certainty but most businesses will attempt to forecast future sales - if only for a short period of time in the future. There are several methods of **sales forecasting**. The benefits and limitations of sales forecasting should always be considered by managers when attempting to predict future sales or when analysing sales forecast data.

Potential benefits

If marketing managers were able to predict the future sales accurately, the risks of business operations and business strategic decisions would be much reduced. If a precise forecast of monthly sales over the next two years could be made, the benefits to the whole organisation would be immense:

- The operations department would know how many units to produce and what quantity of materials to order and the appropriate level of stock to hold.
- The marketing department would be aware of how many products to distribute and whether changes to the existing marketing mix were needed to increase sales.
- Human resources workforce plan would be more accurate, leading to the appropriate number of workers and the most appropriate employment contracts – permanent or temporary.
- Finance could plan cash flows with much greater accuracy and make accurate profit forecasts.
- Strategic decision-making – such as developing new products or entering new markets – would become much better informed.

LEARNER PROFILE

Thinker

Part of being an IB student is being able to 'apply thinking skills critically'. Consider the following statements:

'I think there is a world market for maybe five computers.' – Attributed to chairman of IBM, 1943.

'640K ought to be enough for anybody.' – Attributed to Bill Gates, 1981

'There is no reason anyone would want a computer in their home.' – Ken Olson, president, chairman and founder of Digital Equipment Corp., 1977.

Discuss the reasons why the people who made these statements might have been so wrong in their predictions.

In reality, such precision in forecasting is impossible to achieve, because of the external factors that can influence sales performance. Consider the difficulties in forecasting, even for a short-term period, the sales of films on DVD. Apart from changes in film tastes, new developments in recording, playback and downloading technology will impact on DVD sales; the growth of internet shopping, rather than buying from stores, and the general economic climate will also have a great effect on future sales levels. Despite these problems, most businesses make sales forecasts in order to reduce to an acceptable minimum the unforeseen nature of future changes.

Market forecasts form an essential part of the market planning process and of the screening process before new products are launched on to the market. These forecasts will be based on market research data, gained from both primary and secondary sources. A common way of assessing future demand for a product yet to be fully launched is to use test marketing in one particular area.

For existing products sales forecasts are commonly based on past sales data.

Quantitative sales forecasting methods – 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 chronological order, they are referred to as a 'time series'.

Extrapolation

Extrapolation involves 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 4.3.1). 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.

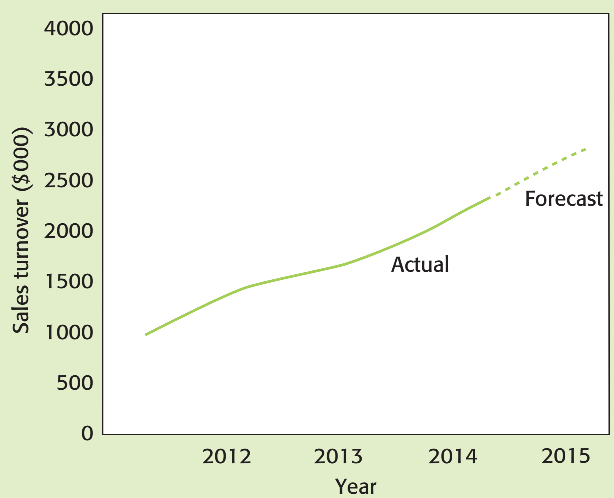


Figure 4.3.1 Extrapolation

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 trend, **seasonal variations**, **cyclical variations** and **random variations**. The moving average method is used to analyse these. This technique 'smooths out' the fluctuations in time-series data and allows managers to identify the trend more easily. The following example uses a three-period moving average. Each three-period total is at the end of the three periods it relates to but the average is located at the middle year:

seasonal variations: regular and repeated variations that occur in sales data within a period of 12 months or less

cyclical variations: variations in sales occurring over periods of time of much more than a year – they are related to the business cycle

random variations: may occur at any time and will cause unusual and unpredictable sales figures, e.g. exceptionally poor weather, or negative public image following a high-profile product failure

Year	Sales ($m)	Three-period moving total	Three-period moving average
2005	125		
2006	134		396/3 = 132
2007	137	125 + 134 + 137 = 396	402/3 = 134
2008	131	134 + 137 + 131 = 402	411/3 = 137
2009	143	137 + 131 + 143 = 411	423/3 = 141
2010	149	131 + 143 + 149 = 423	444/3 = 148
2011	152	143 + 149 + 152 = 444	456/3 = 152
2012	155	149 + 152 + 155 = 456	465/3 = 155
2013	158	152 + 155 + 158 = 465	477/3 = 159
2014	164	155 + 158 + 164 = 477	

Table 4.3.1 Three-period moving average

If the actual sales data is plotted on a graph it shows considerable variations from one year to another. When the three-period moving average data is plotted it shows a clear upwards trend in the sales data – and the upwards trend seems to be accelerating. This technique then allows a line of best fit to be drawn visually (or calculated mathematically). This process is shown on the graph in Figure 4.3.2.

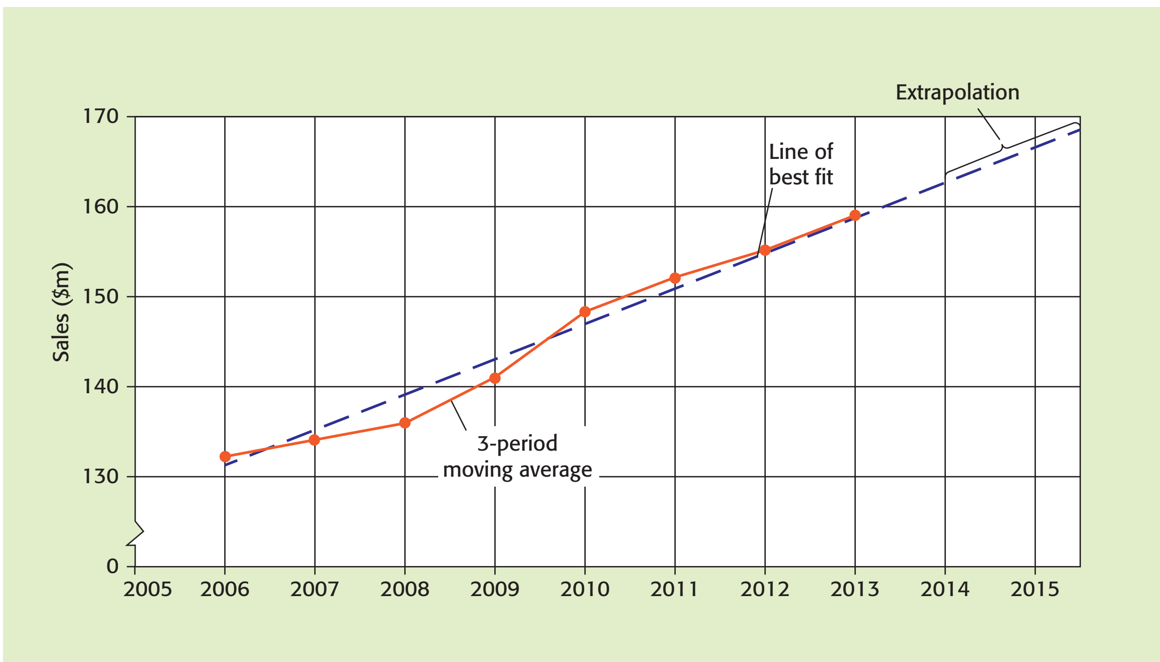


Figure 4.3.2 Three-period moving average sales data and the line of best fit

This line of best fit can then be extrapolated – as shown – to allow for sales forecasts to be made. Do note, however, that the variations that occurred in the actual data have not been allowed for and the forecasts obtained need to be treated with some caution. Using annual data such as this and using moving averages helps to smooth out the effect of cyclical fluctuations that occur over a long period of time – often caused by the business cycle. Cyclical fluctuations are much more likely to impact on income-elastic goods than necessity products and services.

Four-period moving average

This is possibly the most widely used technique as it is often employed when forecasting from quarterly data. Much macro-economic data is released quarterly but if it is collected as monthly sales then a 12-period moving total can be used.

The following table 4.3.2 (columns 1, 2 and 3) shows the quarterly sales data for an ice-cream manufacturer over a four-year period.

1	2	3	4	5	6	7	8	9
Year	**Quarter**	**Sales revenue**	**Four-quarter moving total**	**Eight-quarter moving total**	**Trend – quarterly moving average**	**Seasonal variation**	**Average seasonal variation (1 decimal place)**	**Random variation**
2011	1	120						
	2	140						
	3	190			146.25	43.75	51.7	−7.95
	4	130	580		150	−20	−15.4	−4.6
2012	1	130	590	1170	156.25	−26.25	−33.3	7.05
	2	160	610	1200	163.75	− 3.75	− 4.6	0.85
	3	220	640	1250	167.5	52.5	51.7	0.8
	4	160	670	1310	168.75	− 8.75	−15.4	6.65
2013	1	130	670	1340	172.5	−42.5	−33.3	−9.2
	2	170	680	1350	176.25	− 6.25	− 4.6	−1.65
	3	240	700	1380	181.25	58.75	51.7	7.05
	4	170	710	1410	187.5	−17.5	−15.4	−2.1
2014	1	160	740	1450	191.25	−31.25	−33.3	2.05
	2	190	760	1500	193.75	− 3.75	− 4.6	0.85
	3	250	770	1530				
	4	180	780	1550				

Table 4.3.2 Moving averages for ice-cream sales ($000)

Key stages of the four-period moving average method:

- Each total in column 4 of Table 4.3.3 is made up of four results. This is why the total is called a four-period moving total. A four-period moving total is used because the data clearly vary consistently over this period of time. For example, sales are always highest in quarter 3. If other data were used, perhaps daily sales figures, then a seven-period total would have been used, because the regular variation in sales would have been over seven days.

Quarter	Sales	Four-quarter total	Four-quarter average
1	20		
2	30		27.5
3	50		
4	10	110/4	

Table 4.3.3 Four-period moving total – but the four-quarter average is not yet centred

- If this four-quarter moving total was divided by four in order to calculate the average, the 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 4.3.3). The problem is overcome by 'centring' the average so that it lies alongside one actual quarter. This

trend: underlying movement of the data in a time series is done by adding two four-quarter moving totals together. This gives an eight-period moving total. This is divided by eight to give the moving average.

The 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 4.3.2.

  Seasonal variation (col. 7) = actual result (col. 3) − moving average (trend) (col. 6)

  Make sure you obtain the correct plus or minus sign for your results. If the result is negative, it means that in that quarter sales are usually below the trend or average for seasonal reasons.

- The average seasonal variation smoothes out the actual seasonal variations. This is obtained by adding up all of the seasonal variations for each separate quarter and then dividing by the number of results. For example, quarter 3 seasonal variations are:

$$43.75 + 52.5 + 58.75 = \frac{155}{3} = 51.67 \text{ (51.7 to 1 decimal place)}$$

Exam tip: You may be asked to calculate the four-period moving average, sales trend and seasonal variations from given data.

Any further variation in sales, not accounted for by the seasonal fluctuations in demand for ice cream, is caused either by cyclical factors or random factors. In Table 4.3.2, only random factors are assumed to exist. In quarter 4, 2012, sales were lower than average due to seasonal variation but not by as much as the average seasonal variation for that period indicated. The difference of $6650 (subtracting $8750 from $15 400) was caused by random factors – perhaps there had been production problems at a competitor's factory and this meant that sales did not fall as much as normal in quarter 4 in this year.

Forecasting using the moving average method

The results from Table 4.3.2 can now be used for short-term forecasting. You will need to:

1. Plot the trend (moving average) results on a time-series graph (see Figure 4.3.3).

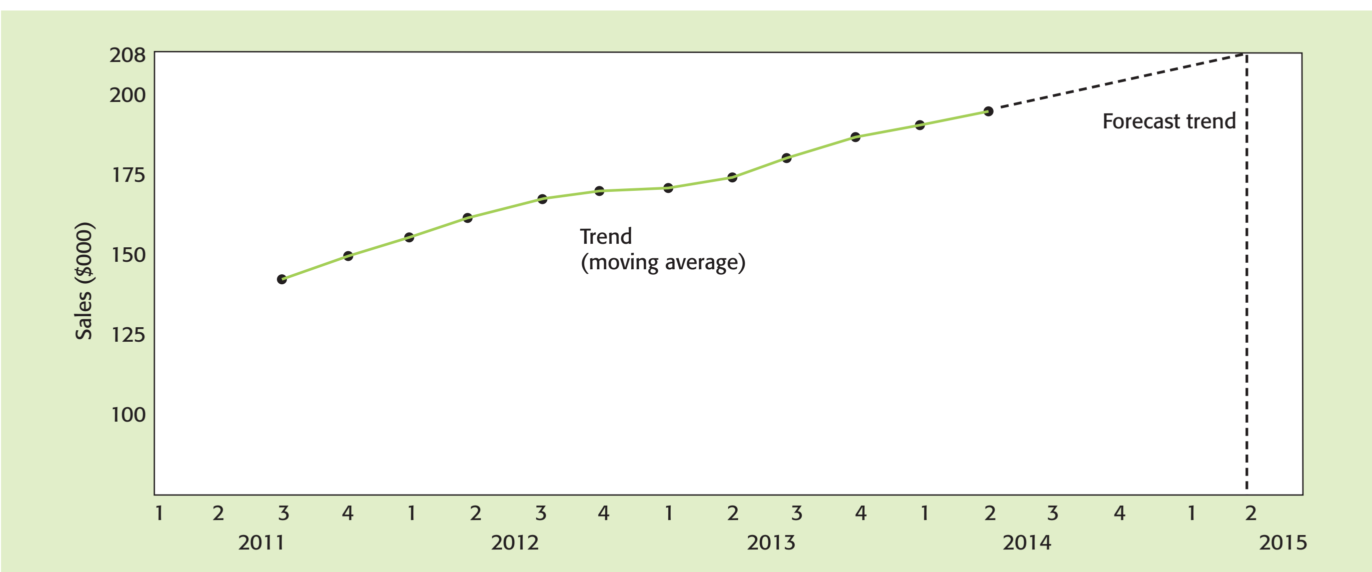


Figure 4.3.3 Forecasting future trend sales figures

2. Extrapolate this into the future – short-term extrapolations are likely to be the most accurate.
3. Read off the forecast trend result from the graph for the period under review, e.g. quarter 2 in year 2015.
4. Adjust this by the average seasonal variation for quarter 2.

Thus, for quarter 2 in the year 2015: the actual forecast will be the extrapolated trend forecast for this quarter, \$208 000, plus the average seasonal variation of –\$4580 = \$203 420.

See Table 4.3.4 for the advantages and disadvantages of the moving average method.

Exam tip: You should be prepared to discuss the limitations of sales forecasting techniques as well as the potential benefits of predicting future sales.

Benefits	Limitations
• Useful for identifying and applying the seasonal variation to trend forecasts • Reasonably accurate for short-term forecasts in stable economic conditions • Identifies the average seasonal variations for each time period and this can assist in planning resources – such as temporary workforce – for each quarter in future	• Fairly complex calculation • Forecasts further than 1–2 years into the future become less accurate as the projections made are entirely based on past data – no consideration is taken of qualitative factors such as economists' view that the economy may go into recession • Therefore, forecasting for the longer term may require the use of more qualitative methods that are less dependent on past results • Newly or recently established businesses will have insufficient data to base moving averages on – other methods of sales forecasting will be needed, possibly based on market research

Table 4.3.4 Moving average sales forecasting – benefits and limitations

ACTIVITY 4.3.1

ADS operates a small chain of exclusive 'boutique' hotels in large capital cities. The marketing manager is using the moving average method to forecast sales for 2016. Macro-economic conditions are worsening in some of the countries ADS operates in with lower GDP growth rates. Hilton International is planning to enter the boutique hotel market segment in some of the countries that ADS operates in.

PAST SALES DATA FOR ADS PLC

Year	Quarter	Sales \$m	Trend (centred quarterly moving average) \$m	Seasonal variation \$m
2012	1	23		
	2	27		
	3	35	27.5	7.5
	4	24	28	–4
2013	1	25	28.625	–3.625
	2	29	*w*	–0.375
	3	38	30.125	7.875
	4	27	31	–4

Year	Quarter	Sales $m	Trend (centred quarterly moving average) $m	Seasonal variation $m
2014	1	28	31.875	−3.875
	2	33	32.5	*x*
	3	41	32.75	8.25
	4	29	32.625	*y*
2015	1	28		
	2	32		

	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Average seasonal variation $m	−3.75	0.0625	*z*	−3.875

20 marks, 40 minutes

1. Define the term 'seasonal variation'. [2]
2. Calculate values for *w*, *x*, *y* and *z* in the table. [4]
3. Explain how the graphical approach and a line of best fit could be used, together with the information provided, to obtain a sales forecast for 2016 in quarter 2. [4]
4. Discuss the usefulness of the moving average method of sales forecasting to the marketing manager of ADS. [10]

THEORY OF KNOWLEDGE

'Prediction is very difficult, especially if it's about the future.' Niels Bohr, Nobel Laureate
This statement highlights some of the problems of using mathematics in forecasting.

Do you think there is any point in managers forecasting future sales?

OVER TO YOU

Revision checklist

1. Explain **one** reason why an operations manager would find a sales forecast useful.
2. Explain **one** reason why a marketing manager would find a sales forecast useful.
3. Explain **one** reason why a finance manager would find a sales forecast useful.
4. Explain **one** reason why a human resources manager would find a sales forecast useful.
5. Differentiate between the 'trend' and the 'seasonal variation' of time-series sales data.
6. Discuss the usefulness of the moving average sales forecasting technique for a retail business that has operated for two years.
7. Explain the term 'sales trend'.
8. Differentiate between seasonal variations and cyclical variations in time-series data.

Exam practice question

RAJESH'S SALES FORECAST

The sales of Rajesh's convenience store were recorded over a four-year period. The owner of the store has started to undertake a short-term forecasting exercise to help plan future purchases and stocks of goods.

	Quarter	Sales ($000)	Quarterly moving average (trend)	Seasonal variation	Average seasonal variation
Year 1	1	18			
	2	24			
	3	35			
	4	27			
Year 2	1	19			
	2	26			
	3	38			
	4	29			
Year 3	1	23			
	2	27			
	3	40			
	4	32			
Year 4	1	25			
	2	30			
	3	42			
	4	35			

20 marks, 40 minutes

1. Define the term 'moving average method'. [2]
2. Complete the table by calculating the quarterly moving average (trend), seasonal variation and average seasonal variation. [6]
3. Estimate the sales for Rajesh's store in year 5, quarter 4. [2]
4. Discuss the benefits and limitations of the moving average sales forecasting method for Rajesh. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, evaluate the importance of innovation and change in business forecasting. [20]

4.4

Market research

On completing this chapter you should be able to:

Analyse and apply:

- The reasons why organisations carry out market research (AO2)
- Methods and techniques of primary market research (AO2)
- Methods of secondary market research (AO2)
- The differences between qualitative and quantitative market research (AO2)
- Different methods of sampling (AO2)
- The results from data collection (AO2)

Evaluate:

- The ethical considerations of market research (AO3)

Setting the scene

PROCTOR AND GAMBLE: SOCIAL MEDIA WILL REVOLUTIONISE MARKET RESEARCH

Proctor and Gamble (P&G) is a multinational business operating in the beauty, grooming and home-care markets. Its marketing research budget of $350 million is bigger than most companies' total sales! So when Joan Lewis, the head of P&G consumer and market knowledge says that Facebook, Twitter and other social media will cause actual market research surveys to decline in importance, people listen. The two-way engagement with businesses offered by social media means that people will become a lot less willing to take part in traditional market surveys. She said: 'If I have something to say to a company, now there are lots of ways to say it.'

Market research can be costly. Many businesses are turning to social media as a relatively cheap way of gaining insight into their customers, market and brand appeal. Most platforms such as Facebook and Twitter allow simple searching of the latest posts and popular terms so a research can gain insight into emerging trends and see what customers are talking about in real time. By setting up a few searches on Twitter using hashtags related to a brand, industry or product a business can receive instant notice when customers or competitors use key terms.

Points to consider

- Explain why P&G spends so much on gaining customer and market information.
- Explain **four** pieces of information P&G would find useful when planning to introduce a new home-cleaning product.
- Comment on the potential benefits of businesses using information gained through social media sites.

Key concept link

One of the most important external factors that force businesses to adopt new strategies is variation in consumer demand. Consumer tastes and preferences are constantly changing and market research aims to establish 'how' and 'why'. Incorporating this information into the development of new business strategies increases the chances of them being successful.

Introduction – market research

Market research is a broad and far-reaching process. It is concerned not just with finding out, as accurately as possible, whether consumers will buy a particular product or not, but also with trying to analyse their reaction to:

- different price levels
- alternative forms of promotion
- new types of packaging
- different methods of distribution.

market research: process of collecting, recording and analysing data about customers, competitors and the market

Why organisations carry out market research:

1. To reduce the risks associated with new product launches

By investigating potential demand for a new product or service the business should be able to assess the likely chances of a new product achieving satisfactory sales. Although market research cannot guarantee success, market research is still a key part of new product development (NPD). Table 4.4.1 summarises how NPD is supported by market research.

2. To predict future demand changes

A travel firm may wish to investigate social and other changes to see how these might affect the demand for holidays in the future. For instance, the growth in the number of single-person households may suggest that there could be a rising demand for 'singles' holidays.

The NPD process		The market research process
Identify consumer needs and tastes	➔	Primary and secondary research into consumer needs and competitors
Product idea and packaging design	➔	Testing of product and packaging with consumer groups
Brand positioning and advertising testing	➔	Pre-testing of the product image and advertisements
Product launch and after launch period	➔	Monitoring of sales and consumer response

Table 4.4.1 Summary of how new product development (NPD) is supported by market research

3. To explain patterns in sales of existing products and market trends

Market research is not just undertaken for new or planned products; it needs to be conducted for existing products too. Sales at the fashion retailer Gap had, by the end of 2013, increased by 8% compared to a year earlier, after several years of falling sales. Gap managers were able to analyse the sales data, conduct market research and take effective action to reverse the worrying decline in sales.

4. To assess the most favoured designs, flavours, styles, promotions and packages for a product

Consumer tests of different versions of a product or of the proposed adverts to promote it will enable a business to focus on the aspects of design and performance that consumers rate most highly. These can then be incorporated into the final product.

Market research can, therefore, be used to discover information about:

- market size and consumer tastes and trends
- the product and its perceived strengths and weaknesses
- the promotion used and its effectiveness
- competitors and their claimed unique selling propositions
- distribution methods most preferred by consumers
- consumers' preferences for packaging the product.

How organisations carry out market research

Sources of market research data

primary research: the collection of first-hand data that are directly related to a firm's needs

secondary research: collection of data from second-hand sources

Primary research collects 'first-hand' data as they are being collected by the organisation for the first time for its own needs. In contrast, **secondary research** is the use and analysis of data that already exist. These data were originally collected by another organisation, often for a different purpose, and are often referred to as 'second-hand' data.

ACTIVITY 4.4.1

WE KNOW WHO OUR CUSTOMERS ARE

IKEA is one of the world's best-known furniture retailers. It now has 301 stores in 37 countries serving over 700 million customers annually. Peter Hogsted, one of its senior managers, has researched its consumer base very carefully:

- It is largely middle class and the middle class in most countries of the world is increasing.
- Its core customers are between 25 and 50 years old.
- They are fashion conscious but want good-value products.
- 80% are female.
- The majority have children.

10 marks, 20 minutes

Evaluate the benefits to IKEA's managers of having detailed research information about their customers. [10]

qualitative research: research into the in-depth motivations behind consumer buying behaviour or opinions

quantitative research: research that leads to numerical results that can be presented and analysed

Qualitative research and quantitative research – the differences

All market research investigations can be categorised as either being 'qualitative' or 'quantitative'. Finding out about the quantities that consumers might purchase and at what prices is clearly important information, but what is often even more revealing is why consumers will or will not buy a particular product. **Qualitative research** should discover the motivational factors behind consumer buying habits. For example, **quantitative research** might establish the size of the potential market for a new luxury ice cream. But will consumers buy it for its taste and the quality of its ingredients or because it will be promoted as a lifestyle product that will reflect on the consumers' image of themselves? Only qualitative research, perhaps by the use of focus groups, can establish the answer to the last question – and it is important because it will help the business in its pricing and promotional decisions for the new product.

Methods of primary research

survey: detailed study of a market or geographical area to gather data on attitudes, impressions, opinions and satisfaction levels of products or businesses, by asking a section of the population

1. Surveys

These involve directly asking consumers or potential consumers – usually by means of a questionnaire – for their opinions and preferences. They can be used to obtain both qualitative and quantitative research. For example, here are two questions asked in a recent **survey** of shoppers:

'How many foreign holidays did you take last year?'
'What do you look for in an ideal foreign holiday?'

The first question will provide quantitative data, which can be presented graphically and analysed statistically. The second question is designed to find out the key qualitative features of a holiday that would influence consumer choice. There are four important issues for market researchers to consider when conducting consumer surveys:

- Who to ask: In most cases it is impossible or too expensive to survey all potential members of a target market (the survey population). A 'sample' from this population is therefore necessary. The more closely this sample reflects the characteristics of the survey population, the less chance of sampling error.
- What to ask: The construction of an unbiased and unambiguous questionnaire is essential if the survey is to obtain useful results.
- How to ask: Should the questionnaire be self-completed and returned by post or filled in by an interviewer in a face-to-face session with the respondent? Could a telephone or internet survey be conducted instead? Increasingly, businesses use online surveys.
- How accurate is it? Assessing the likely accuracy and validity of the results is a crucial element of market research surveys.

Questionnaire design

It is not easy to write an effective questionnaire. The temptation is often to ask too many questions in the hope of gaining every last scrap of information. Yet people may become suspicious or bored with so many questions. Unless it is absolutely essential to know the names and precise ages or income levels of respondents, these questions are best avoided, as there will be reluctance to answer them. One way around this is to group income levels together, such as:

> *'Please indicate which of the following income levels you are in:*
>
> *$10 000 – $20 000*
>
> *$20 001 – $30 000 [and so on].'*

Open questions lead to results which will be difficult to collate and present numerically, but they might provide a useful insight into consumers' 'thinking' about a product. Closed questions lead to results which are easy to present and analyse, but offer little scope for explaining the reasoning behind consumers' answers.

Asking all **'open' questions** is not a good idea, although questionnaires usually end with one. They allow respondents to give their opinion. For example: 'What do you really think of Jupiter perfume?' – the answers to this will be so varied in length and content that the results will be very difficult to put together and to present statistically. A better option might be to use a **closed question** such as:

open questions: those that invite a wide-ranging or imaginative response

closed questions: questions to which a limited number of preset answers is offered

'What most attracted you to buying Jupiter perfume?

- *price*
- *image*
- *packaging*
- *widely available*
- *smell.'*

As the design of the questionnaire will greatly influence the accuracy and usefulness of the results, it is advisable to undertake an initial pilot survey to test the quality of the questions. Other principles to follow include:

- Make the objectives of the research clear so that questions can be focused on these.

- Write clear and unambiguous questions.
- Try to make sure that the questions follow each other in a logical sequence.
- Avoid questions that seem to point to one particular answer.
- Use language that will be readily understood.
- Include some questions that will allow a classification of results by gender, area lived in, occupation and so on.

2. Interviews

The response rate to most forms of self-completed questionnaires is nearly always very poor; questions could easily be misunderstood and the sample returned could be biased in favour of those respondents with the most spare time, for example retired people. Direct interviews are conducted by an interviewer, usually either in the street or in the respondent's home. Skilled interviewers will avoid bias in the way in which they ask questions, and detailed questions can be explained to the interviewee. Follow-up questions can be asked if required.

This can be an expensive method, but the interviewer will continue their work until the preset sample size has been reached – whereas the response to postal questionnaires is always uncertain.

focus groups: a group of people who are asked about their attitude towards a product, service, advertisement or new style of packaging

3. Focus groups

In **focus** discussion groups, questions are asked and the group are encouraged to actively discuss their responses about a product, advertising, packaging and so on. All members of the group are free to talk with other group members. These discussions are often filmed and this is then used by the market research department as a source of data. Information is often believed to be more accurate and realistic than the responses to individual interviews or questionnaires, where respondents do not have this discussion opportunity presented.

There might, however, be the risk of researchers leading or influencing the discussion too much, leading to biased conclusions.

Focus groups are an important method for gathering consumers' opinions and responses – qualitative research

4. Observations

This is one of the oldest techniques used in marketing research. Through direct observation of people, marketing specialists are able to identify actions and watch how customers or potential customers respond to various stimuli. For a small business, observational marketing research is one of the simplest ways that one can find out many things about their customers and clients. One of the most common ways researchers use **observational techniques** is through cookies on computers, used to track users' web views and visits. Focus groups utilise observational techniques, as does the Nielsen ratings used to track peoples' popular viewing habits of television programmes. Public transport companies use observational research to conduct traffic counts and usage patterns. Many retail businesses use observational techniques when they record purchasing behaviour through barcoded transactions and observe customers reading product packaging.

observational technique: a qualitative method of collecting and analysing information obtained through directly or indirectly watching and observing others in business environments' e.g. watching consumers walk round a supermarket

This market research method is relatively inexpensive as the main cost is that of the observer's remuneration. During observation, if the observer is completely unseen, customers often behave naturally and do not try to demonstrate their 'ideal selves' instead of their true actions. Recall error is not a problem when conducting observational research. Observational research can be modified to obtain the best results possible, if necessary. For instance, if the observer cannot see clearly enough from a particular location, they may choose to move to a closer observing spot. Observational techniques often provide the only way to conduct certain research, such as determining the number of shoppers visiting a store or the behaviour of children when watching an advertisement.

However, observational research is time-consuming and does not provide qualitative evidence explaining consumers' behaviour. The observer must have patience and time to devote to watching a set number of individuals or settings to obtain the information necessary. Researchers may also become distracted while observing, which can distort the results of the research. There is also an ethical question – should customers, especially young children perhaps, be observed without their knowledge and permission?

5. Test marketing

Test marketing takes place after a decision has been made to produce a limited quantity of a new product but before a full-scale, national launch is made. It involves promoting and selling the product in a limited geographical area and then recording consumer reactions and sales figures. It reduces the risks of a new product launch failing completely, but the evidence is not always completely accurate if the total population does not share the same characteristics and preferences as the region selected.

test marketing: marketing a new product in a geographical region before a full-scale launch

THEORY OF KNOWLEDGE

Do we really know what consumers think?

Market research disasters: New Coke

At the start of the 1980s Coca-Cola was losing market share to Pepsi-Cola. In response to this Coca-Cola's senior managers decided to reformulate Coca-Cola to a sweeter taste. It was called Project Kansas. In their research Coca-Cola made the following errors:

- Taste tests showed that consumers preferred the sweeter taste of Pepsi to Coke.
- Taste tests using 'New Coke' suggested consumers preferred it to Original Coke and Pepsi.
- Focus groups used by Coca-Cola suggested Coke's consumers would react positively to the new product.

What unfolded for Coca-Cola was a huge marketing disaster. Coke's consumers reacted furiously to New Coke. Many were disgusted that the original product was being discarded and felt that 'New Coke' was an inferior replacement. In reality many people just did not like the sweeter taste of new Coke.

After just 77 days Coca-Cola reintroduced Original Coke and in time phased out New Coke.

Evaluate the difficulties Coca-Cola would have faced in really knowing what their consumers felt about their product.

ACTIVITY 4.4.2

CARLOS PLANS A NEW RESTAURANT

Carlos Sanchez is a chef specialising in Spanish cuisine. He has always wanted to work for himself and has decided to open his own small restaurant. Property prices are too high in the capital, so he has moved to a small coastal resort about 100 kilometres from the capital. He has many important decisions to make. He is not sure whether Spanish cooking will be popular with the locals and the tourists. He is able to prepare many other types of dishes too. He could open just a restaurant or a takeaway too. If Carlos offers takeaway meals, he could either serve these in plastic containers for microwave heating, which are expensive, or in paper trays, which are cheaper. Carlos has noticed that there are few other restaurants in the area and no takeaways, although one well-known fast-food chain has recently closed down. There are no other Spanish-based restaurants. After finding a suitable shop site, Carlos then has to decide whether to decorate it for younger people's tastes and have loud pop music or in a more sober style with traditional Spanish music.

20 marks, 40 minutes

1. List **two** sources of secondary research Carlos could refer to as part of his market research. [2]
2. Outline how Carlos could conduct primary research as part of his market research. [4]
3. Explain **two** benefits to Carlos of undertaking primary research before he opens his new business. [4]
4. Evaluate the usefulness of market research to Carlos as he plans his new restaurant. [10]

Table 4.4.2 summarises the advantages and disadvantages of primary research.

Advantages	Disadvantages
• Up to date and therefore more useful than much secondary data • Relevant – collected for a specific purpose – directly addresses the questions the business wants answers to • Confidential – no other business has access to this data	• Costly – market research agencies can charge thousands of dollars for detailed customer surveys and other market research reports • Time-consuming – secondary data could be obtained from the internet much more quickly • Doubts over accuracy and validity – largely because of the need to use sampling and the risk of sampling error

Table 4.4.2 Primary research – advantages and disadvantages

Sources of secondary data

Secondary research is often undertaken before primary research – but only if the data exists, which it may not if the planned product is so different that no second-hand data exists. Why undertake secondary research first? It is because of the benefits that secondary research offers over primary methods. Activity 4.4.3 helps to examine these.

ACTIVITY 4.4.3

EXPORTING TO TRINIDAD AND TOBAGO

A US-owned food exporting business plans to enter the market in Trinidad and Tobago for the first time. The directors have yet to decide whether to sell high- or low-priced products and which type of shops they should sell through. The marketing manager obtained the following data from secondary sources, without leaving his desk – which is why it is sometimes called desk research.

- The two-island republic has one of the highest per capita GDPs in the Caribbean – over US$20 000 in 2013.
- GDP grew by 2% in 2013.
- The retail market is made up of over 500 stores (supermarkets, grocery stores and petrol stations), with sales estimated at just over US$1 billion in 2013.
- Aiming for a 'one-stop' shopping experience, many supermarket chains have begun to renovate and remodel their stores.
- The market leader is Hi-Lo Food Stores.
- In-house bakeries and delis are becoming more common.
- Retail food sales rose by nearly 50% between 2000 and 2013.
- Supermarkets are increasing the number of premium-priced low-fat and health-food products on offer.

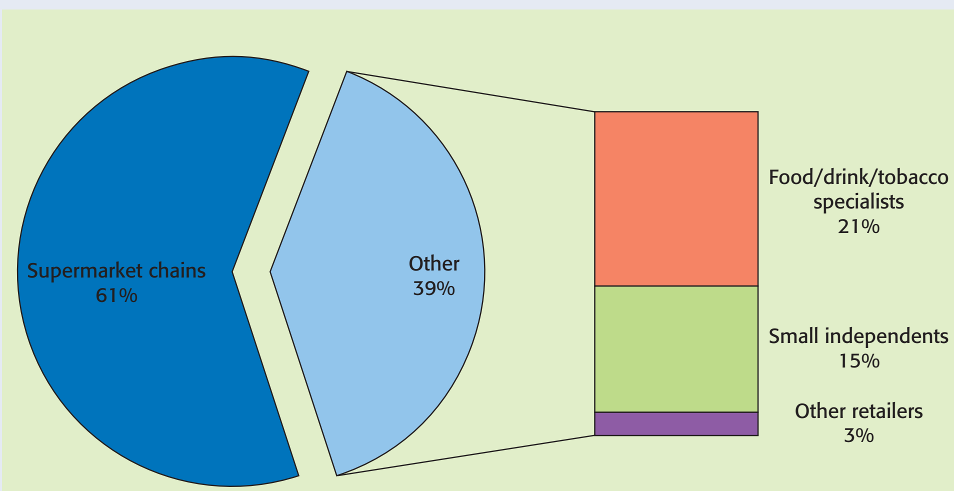


Figure 4.4.1 Trinidad and Tobago: distribution of retail grocery sales, 2011

Source: Derived from data from Euromonitor International.

20 marks, 40 minutes

1. Define the term 'secondary research'. [2]
2. Outline **two** benefits to the US food exporter of the data researched from secondary sources. [4]

3. Analyse how two pieces of information in the secondary research on Trinidad and Tobago might guide a US food exporter trying to market its goods in the country. [4]
4. Evaluate the usefulness of secondary research to the US food exporter trying to market its goods in Trinidad and Tobago. [10]

This activity demonstrates that a great deal of information can be gathered about a market and market trends from secondary sources. These results can help to give focus to the primary research that the business will now undertake. However, secondary data:

- is never completely up to date
- may not provide answers to specific questions the business wants answers to
- is available to competitors too.

Secondary data can be obtained from the following sources.

1. Market intelligence analysis reports

These are extremely detailed reports on individual markets and industries produced by specialist market research agencies. They are very expensive, but they are usually available at local business libraries – though these might not be the most up-to-date versions, which are sold directly to businesses in the market being researched. Examples of market research analyses are:

- Mintel reports
- Key Note reports
- Euromonitor International.

If the owner of a small hotel planned to expand the business by opening a hotel in the capital city, one of these reports on the hotel and catering market would provide huge amounts of detail on market and consumer trends, eating and holiday habits of consumers, number of tourists and so on.

2. Academic journals

Several academic journals are published which focus on the science and techniques involved in market research. These would be of particular interest to the market research department of businesses – not so much for the 'market research data' that they contain but for the discussion of market research methodology. Some websites of these journals are:

www.marketingpower.com
www.mrs.org.uk
www.journals.elsevier.com/international-journal-of-research-in-marketing

3. Government publications

In most countries, sources, such as the following from the UK, could be referred to:

- population census
- Social Trends
- Annual Abstract of Statistics
- Living Costs and Food Survey.

Therefore, if a furniture manufacturer was undecided whether to produce new designs for teenagers' bedrooms or electric reclining armchairs for the elderly, reference to government publications for the forecasted age distribution of the population over the next ten years would be a useful starting point.

4. Local libraries and local government offices

If the research data needed were only for a small area – investigating the viability of a new café, for example – then local not national data would be necessary:

- local population census – total population size, age and occupation distributions
- number of households in the area
- proportions of the local population from different ethnic and cultural groups.

5. Trade organisations

Trade organisations produce regular reports on the state of the markets their members operate in. For example:

- Society of Motor Manufacturers and Traders
- British Furniture Manufacturers
- Engineering Employers Federation.

If a garage owner wanted to start stocking new cars for sale, then details of the type and size of car that is most popular with consumers could be obtained from the first source listed above. Clearly, further research might then be needed to see if, locally, these national data were reflected in consumer demand in the garage's own area.

6. Media reports and specialist publications

These are widely available although some can only be obtained via subscription. Before a business uses market evidence from these publications, questions should be asked about the primary resource of the data, who collected it and whether any potential for bias – intentional or not – exists.

- *Marketing* – this journal provides weekly advertising spend data and consumer 'recall of adverts' results
- The *Grocer*
- *Motor Trader*
- The *Financial Times* – regular articles on key industries such as IT and detailed country reports – essential for potential exporters.

7. Internal company records

If the business has been trading for some time, a large quantity of secondary data will already be available for further analysis from:

- customer sales records
- guarantee claims from customers
- daily, weekly and monthly sales trends
- feedback from customers on product, service, delivery and quality.

8. The internet

The internet has transformed secondary data collection. Whenever secondary research is conducted just from the internet, the accuracy and relevance of the source should always be checked.

Initial secondary research will nearly always indicate the focus that subsequent primary research should have. However, on its own, it is rarely sufficient, which is why primary research is also usually undertaken. Table 4.4.3 summarises the advantages and disadvantages of secondary research. Secondary research gathers background data, but only primary research can provide detailed, up-to-date information from consumers within the firm's target market.

Advantages	Disadvantages
• Often obtainable very cheaply – apart from the purchase of market intelligence reports • Identifies the nature of the market and assists with the planning of primary research • Obtainable quickly without the need to devise complicated data-gathering methods • Allows comparison of data from different sources	• May not be updated frequently and may therefore be out of date • As it was originally collected for another purpose, it may not be entirely suitable or presented in the most effective way for the business using it • Data-collection methods and accuracy of these may be unknown • Might not be available for completely new product developments

Table 4.4.3 Secondary research – advantages and disadvantages

ACTIVITY 4.4.4

RESEARCHING MARKETS IN MALAYSIA

If you are prepared to pay for it, the range of secondary market research data available for businesses operating in Malaysia is incredible. Four examples, from many thousands of reports available, are:

- Clothing and footwear in Malaysia (Euromonitor International)
- Pet food in Malaysia (Euromonitor International)
- Gardening in Malaysia (Euromonitor International)
- Malaysian desktop and notebook demand 2009–13 (IDC).

Research into a market for a product or service in your own country. Find out as much as you can about the size of the market, any segments that exist within it and the features of 'typical' consumers for this product.

Ethical considerations of market research

The gathering, presentation and storing of market research data raises a number of ethical considerations. Some of these are outlined below – *with further discussion points included.*

- Researchers should have the permission of the people who they will be studying to conduct research. *Is this possible with all observational methods?*
- Data collection methods should not cause physical or emotional harm to the respondents. This requires being careful how the researcher words sensitive or difficult questions during interviews. *Some topics are always sensitive – for example, research into how patients were treated by staff in hospital.*
- Objectivity versus subjectivity in research is another important consideration. Researchers should be sure their own personal biases and opinions do not get in the way of interpreting research results. *This is why the source of all data should be carefully checked and verified, if possible.*
- Many types of research, such as surveys or observations, should be conducted on the assumption that findings are kept anonymous. *Respondents should be told whether research results will be anonymous or not – but how can they check on this with online surveys, for example?*
- Researchers should not take advantage of easy-to-access groups of people (such as children at school gates) simply because they are easy to access. *Should parents always be present when people under the age of 18 are subjects of market research?*

- When presenting and analysing results they should accurately represent what was observed or researchers were told. Interview responses or small parts of observations should not be taken out of context. *Should respondents be given the right to refuse to have their responses included in the survey results if they are concerned about the overall findings?*

LEARNER PROFILE

Inquirers

Effective business people have to be inquirers in order to understand the consumers in their markets.

Market research facilitates enquiry by enabling managers to find out about consumer behaviour. Effective market research could, for example, tell an organisation that 'mindfulness' is a powerful influence over today's consumer behaviour. Mindfulness can be summarised by the view that people are seeking more depth and meaning in their lives. Market research could tell organisations that consumers are increasingly aware of the ethical impact of their buying decisions.

Discuss the importance of market research in helping a business establish that its consumers are becoming more mindful.

ACTIVITY 4.4.5

USING DATA FROM PATIENT RECORDS

The UK government has now demanded that the National Health Service stops the practice of selling patient records to insurance companies. These data were being used by insurance companies to make more accurate assessments of the risk of insuring patients. Such research information was also used to assist in the setting of insurance premiums to increase the chances of making a profit from each insurance policy.

Insurance companies use other forms of market research – such as gathering data on death rates by postcodes. There are substantial differences in the average life expectancies in different regions of the UK and these data can also be used to adjust insurance premiums.

10 marks, 20 minutes

Evaluate the ethical issues involved in insurance companies using research data collected from patient records. [10]

Sample size and sampling methods

In most cases of primary data collection it is impossible or too expensive to ask the 'entire population'. In data collection, the term population does not mean 'the population of the region/country/world' but the total number of people under study, as defined by the objectives of the market research. For example: 'All people aged 21–25 years old still in full-time education'.

Owing to the problems of cost and time of gathering data from the whole population, sampling is essential when using primary research methods. Generally speaking, the larger the sample, the more confidence can be given to the final results. In surveying 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

sample: group of people taking part in a market research survey selected to be representative of the target market overall a positive reaction to the new advertisement. Yet another ten might show a majority with negative reactions. A sample of ten is too small to be confident about the result, as chance variations from the views of the whole target population occur because of the limited number of respondents. A sample of 100 or even 1000 will produce results that will reflect much more accurately the total preferences of the whole survey population. There will be much less risk of pure chance distorting the results causing **sampling error**.

sampling error: errors in research caused by using a sample for data collection rather than the whole target population

What prevents all primary research being based on a sample size of 1000? Cost and time are the two major constraints here – the bigger the samples, the greater the cost and the longer the time needed to collect and interpret results.

There are several different ways of selecting an appropriate sample. The ones below are the most commonly used.

1. Quota sampling

The population is first segmented into mutually exclusive sub-groups – such as male and female. Then the interviewer or researcher uses his or her judgement to select people from each segment based on a specified proportion – for example, an interviewer may be told to sample 200 females and 300 males between the ages of 45 and 60 years. In **quota sampling** the selection of the sample is non-scientific and may therefore be biased – interviewers might be tempted to interview those who look most helpful or most attractive. The main weakness of quota sampling is that not everyone gets a chance of selection.

quota sampling: gathering data from a group chosen out of a specific sub-group, e.g. a researcher might ask 100 individuals between the ages of 20 and 30 years

random sampling: every member of the target population has an equal chance of being selected

2. Random sampling

Each member of the target population has an equal chance of being included in the sample. To select a **random sample** the following are needed:

- a list of all of the people in the target population
- sequential numbers given to each member of this population
- a list of random numbers generated by computer.

If a sample of 100 is required, then the first 100 numbers on the random number list are taken and the people who had these numbers allocated to them will form the sample – but it may take time to contact these specific people. Just asking the first 100 pedestrians who pass by during a survey on a main shopping street is *not* random sampling – it is called convenience sampling and will be biased because different groups of people tend to frequent the main shopping streets at different times.

3. Stratified sampling

This method recognises that the target population may be made up of many different groups with many different opinions. These groups are called strata or layers of the population and for a sample to be accurate it should contain members of all of these strata – hence the term, **stratified sampling**.

stratified sampling: this draws a sample from a specified sub-group or segment of the population and uses random sampling to select an appropriate number from each stratum

If you were asked to sample 100 students in a school about soft drink preferences for the school shop, it would be more accurate if, instead of asking 100 friends, you split the school up into certain strata, such as class groups, ages or gender. So, if the whole school or college contains 1000 students of whom 50 are girls in year group 8, an accurate sample of 100 would contain five girls from year group 8 $\left(\frac{50}{1000} \times 100\right)$. This process would be repeated with all year groups until the total required sample of 100 was reached. The people to be surveyed in each stratum should be selected randomly. Stratified sampling may also be used when a product is designed to appeal to just one segment of the market – for example, if a computer game is aimed at 16–24-year-olds, only people from this stratum of the population will be included in the sample.

4. Cluster sampling

When a full list of potential sample members is not available or the target population is too geographically dispersed, then **cluster sampling** will take a sample from just one or a few groups – not the whole population. This might be just one town or region and this will help to reduce costs – but it may not be fully representative of the whole population. Random methods can then be used to select the sample from this group. A multinational wanting to research global attitudes towards its product would save time and money by concentrating on just a few areas for its research.

5. Snowball sampling

The first respondent refers a friend who then refers another friend . . . and so the process continues. **Snowball sampling** is cheap and can be operated through social networking sites. However, it is likely to lead to a biased sample, as each respondent's friends are likely to have the same kind of lifestyle and opinions.

6. Convenience sampling

The advantages of **convenience sampling** are the availability and the quickness with which data can be gathered. The disadvantages are the risk that the sample might not represent the population as a whole, and it might be biased by volunteers. For example, if a study to determine the average age and gender of customers at a supermarket is conducted for three hours on a weekday afternoon it might be overrepresented by elderly people who have retired and underrepresented by people of working age.

cluster sampling: using one or a number of specific groups to draw samples from and not selecting from the whole population, e.g. using one town or region

snowball sampling: using existing members of a sample study group to recruit further participants through their acquaintances

convenience sampling: drawing representative selection of people because of the ease of their volunteering or selecting people because of their availability or easy access

ACTIVITY 4.4.6

PEPSICO

This company recently commissioned a primary market research report. The details are highlighted below:

Aim: To measure PepsiCo's brand's consumer perception as a 'healthy' product

Sample size: 1000 people in the USA from different age and income groups and from different regions

Sampling method: Random – from grocery store loyalty card lists

Survey method: Online questionnaire coupled with focus groups to gain first-hand knowledge of consumers' opinions

Potential research problems: There may be a potential bias from the surveyed population. Surveyed people may have issues that prevent them from answering accurately – the questionnaire has been designed to ask questions in the easiest and least embarrassing way possible. The possibility of not being able to contact a respondent has been addressed by setting the computer to select an alternative customer to add to the sample.

Initial secondary research: Last year Coca-Cola's brands had 41% market share to PepsiCo's 29.9%. Coca-Cola's sales fell by 20% in USA last year compared to PepsiCo's 8%.

20 marks, 40 minutes

1. Define what is meant by the term 'sampling method'. [2]
2. Explain why PepsiCo undertook secondary research before commissioning the primary research report. [4]
3. Analyse the benefits of the primary research methods used by PepsiCo. [4]
4. Discuss the possible problems PepsiCo might have faced when conducting its market research. [10]

Exam tip: Each method of sampling has its own advantages and limitations – so which is best? This depends on the size and financial resources of the business and how 'different' consumers are in their tastes between different age groups and so on. Remember, cost-effectiveness is important in all market research decisions.

Results from data collection

Once market research data has been collected it must be used – otherwise, what was the point of gathering it? Before most data can be used effectively it needs to be *presented* and *analysed*.

The main methods of data presentation are examined in Table 4.4.4. The most common way of analysing data is to calculate 'averages' of results. Table 4.4.5 explains the uses and limitations of the three most commonly used measures of average.

Method of presentation	Most useful for
Tables	• when a wide range of results needs to be recorded • when the results need to be analysed by statistical means and it is essential to have the numbers themselves – it is generally more accurate to take results from a table than to interpret a graph or a chart • when there is a lot of text to include with the results, such as detailed headings for each column
Line graphs	• when time is one of the variables • when the trend and regular variations need to be identified – this might be the first stage in undertaking sales forecasting, which can aid future decisions such as production and staffing levels • when two or more sets of time-series data need to be compared – for instance, when a competitor's sales are compared with a company's own performance
Bar charts	• when the absolute size or magnitude of results needs to be presented and compared • when component and percentage component charts can be used to show how the total figure is comprised of different sections
Pie charts	• showing the relative importance of sections or segments out of a total result – these can then be visually compared with other time periods; they are less effective when comparisons between totals are needed or when precise comparisons of segments over time are required
Histograms	• visually presenting frequency data when the range of the data has been broken into class ranges; they can be used for some simple statistical analysis such as identifying the modal class
Pictograms	• when the user wants to attract the reader towards looking at the data; they are often rather imprecise when using one symbol to represent a large number of results

Table 4.4.4 Methods of data presentation

Average measure	Uses	Advantages	Disadvantages
Mean	• When the range of results is small, the mean can be a useful indicator of likely sales levels per period of time. This could be used to help determine reorder levels. • Often used for making comparisons between sets of data, e.g. attendance at football clubs.	• The mean includes all of the data in its calculation. • It is well recognised as *the* average as it is so widely used – and therefore easily understood. • It can be used to analyse data further in other ways that assist in understanding the significance of the results collected.	• The main problem is that the mean is affected by one or two extreme results. For instance, a mean income figure for employees of a business is likely to be distorted by the high salary of the chief executive officer. • It is commonly not a whole number. Is it really useful for stock-ordering purposes to know that the mean shoe size sold was 6.38?
Mode	• As the most frequently occurring, the result could be used for stock-ordering purposes. For instance, if a shoe shop knows that size 6 is the most popular size this will influence its stock orders.	• It is easily observed and no calculation is necessary. The result is a whole number. Easily understood.	• For grouped distributions, the result is estimated from the modal group – a fairly complex calculation could be made if this estimate was not accurate enough. • The mode does not consider all of the data. As a consequence, it cannot be used for further statistical analysis. • There may be more than one modal result, which could cause confusion.

Table 4.4.5 Evaluation of the three types of averages [*table continues over*]

Average measure	Uses	Advantages	Disadvantages
Median	• Could be used in wage negotiations, e.g. 'Half of our union members earn less than $xx per week.' • Often used in advertising, e.g. 'The reliability records show that our products are always in the best-performing 50% of all brands.'	• It is less influenced by extreme results than the mean is. This makes it more representative than the mean when there are a few significantly high or low results.	• Calculation from grouped data is not straightforward and there is an element of inaccuracy when doing this. • When there is an even number of items in the results, its value is approximated. • It cannot be used for further statistical analysis.

Table 4.4.5 *Continued*

Market research

ACTIVITY 4.4.7

MARKET RESEARCH DILEMMA AT GCB LTD

The highly competitive world of garden machinery is characterised by a large number of quite small manufacturers. One of these firms is called GCB Ltd. This business has a good reputation for producing high-quality lawnmowers for small to medium-sized gardens. A recent survey conducted by consumers completing a 'Guarantee card' immediately after purchase had indicated that 90% of sales were to private households and not commercial gardeners. Social media users were commenting favourably on the reliability of GCB's machines. Other information regarding existing sales and the sizes of consumers' gardens is given in Figure 4.4.2 and Tables 4.4.6 and 4.4.7.

The research and development director, James, has been given the task of coming up with a new design of lawnmower that would appeal to a different market segment. 'The demand from local government, schools with large playing fields and other commercial users is huge,' the sales director told him. 'We have no products large enough to enter this market segment. We need a new type of mower to break into this sector.' James thought that he had come up with the ideal machine, called the Robomow. 'It is a large motor mower that, with the latest electronic controls, can be programmed to work robotically – without any driver at all,' he told his fellow directors. 'It can be programmed to mow an entire field without any labour costs at all. It is then taken to the next field and reprogrammed, and so on.'

The problem was that the largest annual trade fair for garden equipment was coming up in just two months' time. 'There is no time to do any market research,' said James. 'If we can show the new machine at the fair and promise early delivery for the summer months, then I am sure that it will be a great success.' The other directors were concerned about the lack of qualitative and quantitative market research data.

	Sales of existing products (units) 2013	Sales revenue ($) 2013
Rotor mower	3000	300 000
Hover mower	5000	250 000
Strimmer mower	2000	50 000
Motor mower	1000	200 000

Table 4.4.6

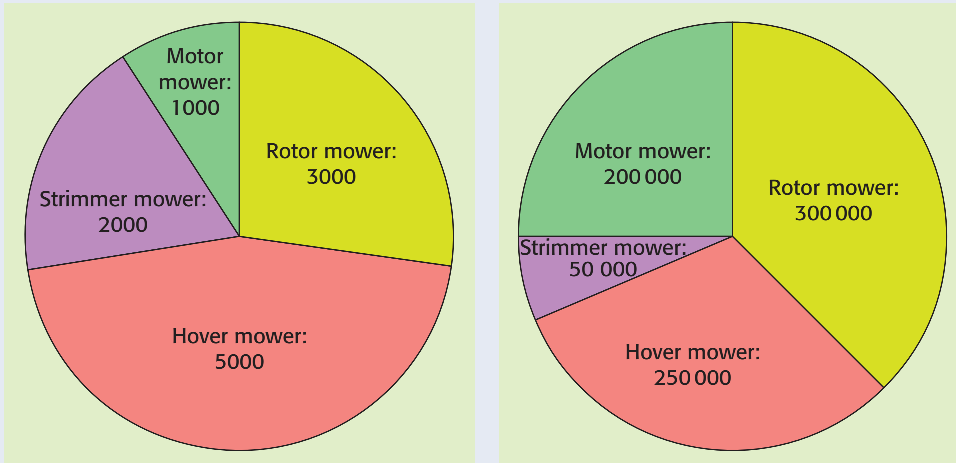


Figure 4.4.2

Garden size (sq. metres)	Number of consumers (2012)
10–100	1500
101–200	2000
200–400	1000

Table 4.4.7

20 marks, 40 minutes

1. Define the term 'quantitative market research'. [2]
2. Using data from Figure 4.4.2, calculate for the rotor mower in 2013:
   a. the proportion of total sales accounted for by this product. [2]
   b. the proportion of total sales revenue accounted for by this product. [2]
3. Analyse **two** potential problems GCB might face as a result of launching the new product before market research has been fully undertaken. [4]
4. Evaluate the usefulness of qualitative market research to GCB Ltd. [10]

OVER TO YOU

Revision checklist

1. Distinguish between primary and secondary market research data.
2. Briefly explain why it is important to use secondary data, when available, before investing in expensive primary market research.
3. List **two** reasons why secondary data might prove to be inaccurate for a firm's specific purposes.
4. Explain the advantages primary research has over secondary research.
5. Outline **two** reasons why primary research data might prove to be inaccurate.
6. Explain why it is important to consider the type of market that a new product is aimed at before starting primary research.
7. Explain why sampling is so frequently used in consumer surveys.
8. Explain the difference between a quota and a stratified sample.
9. Outline the advantages and disadvantages of using a small sample.
10. Explain **three** features of an effective questionnaire design.
11. Differentiate between qualitative and quantitative research.
12. Explain why both types of data are necessary for a firm to analyse the sales performance of an existing product.

13. Explain why sample size influences the reliability of research results.
14. How might a business try to assess whether expenditure on market research had been cost-effective?
15. Explain **three** pieces of information a sports-shoe retailer might need to gain from market research before opening a new store.
16. The sports-shoe retailer in question 15 decides to conduct primary research from existing customers. Explain **three** ways in which this might be done.
17. The pie chart in figure 4.4.3 shows results from a survey of cinema customers. The sample size was 40. How many customers preferred:
    a. action movies
    b. drama movies?

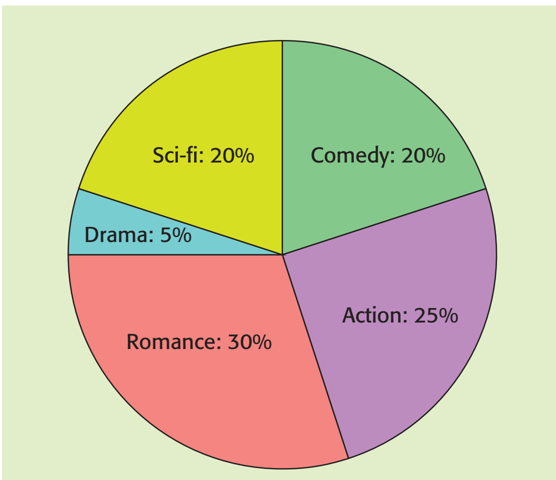


Figure 4.4.3 Favourite type of movies
Source: www.mathsisfun.com

Exam practice question

LOW MARKET SHARE AT COSMOS

The Cosmos Soft Drink Co. Ltd was concerned about its low market share. Despite extensive advertising in newspapers and magazines and colourful displays in most large retailers, sales remained disappointingly low compared to the well-known brands in the market. The image for its drinks that the company was trying to create was a sporty and youthful one. One of the reasons for this was because the directors had found out that the proportion of the population under 18 was expected to increase in the next ten years and the sports-participation rates of most age groups were increasing. The directors were in agreement that the image was the correct one to have and that other factors were to blame for the poor sales performance. They decided to use primary research and conduct a survey of the general public. This was to be a telephone survey as they believed that quick results were essential to allow them to take the right measures to boost sales. A questionnaire of 30 questions was drawn up asking for details of soft drinks bought and the reasons for purchase decisions, names and addresses of the respondents so that free vouchers could be sent, income levels to identify consumer profiles and many other details that the directors thought might be useful. About 120 people were to be contacted by picking names using random sampling from the telephone directory.

The results of the survey proved to be very disappointing because many calls were not answered, some people refused to answer some of the questions and some of the elderly respondents said that all soft drinks were too sweet and fizzy for them anyway. In total, there were 35 completed questionnaires. The directors were no clearer after the survey than before as to what could be done to increase sales of Cosmos soft drinks.

20 marks, 40 minutes

1. Define the term 'primary research'. [2]
2. Analyse **two** possible reasons why the results of the telephone survey were so disappointing. [4]
3. Explain **two** secondary research sources that Cosmos could have used. [4]
4. Evaluate an alternative primary research technique that Cosmos could have used to try to achieve more useful research results. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, evaluate the importance of innovation and globalisation in market research. [20]

4.5

The four Ps – product, price, promotion and place

On completing this chapter you should be able to:

Analyse and apply:

- Product: The relationship between the product life cycle and the marketing mix (AO2)
- Product: The relationship between the product life cycle, investment, profit and cash flow (AO2)
- Product: Aspects of branding: awareness, development, loyalty and value (AO2)
- Promotion: Aspects of promotion: above and below the line; promotional mix (AO2)
- Place: The importance of place in the marketing mix (AO2)

Evaluate:

- Product: Extension strategies to the product life cycle (AO3)
- Product: Boston Consulting Group matrix (BCG matrix) (AO3)
- Product: The importance of branding (AO3)
- Product: The importance of packaging (AO3)
- Price: The appropriateness of pricing strategies: cost-plus (mark-up); penetration; skimming; psychological, loss leader; price discrimination; price leadership; predatory (AO3)
- Promotion: The impact of changing technology on promotional strategies (AO3)
- Promotion: Guerrilla marketing and its effectiveness (AO3)
- Place: The effectiveness of different types of distribution channels (AO3)

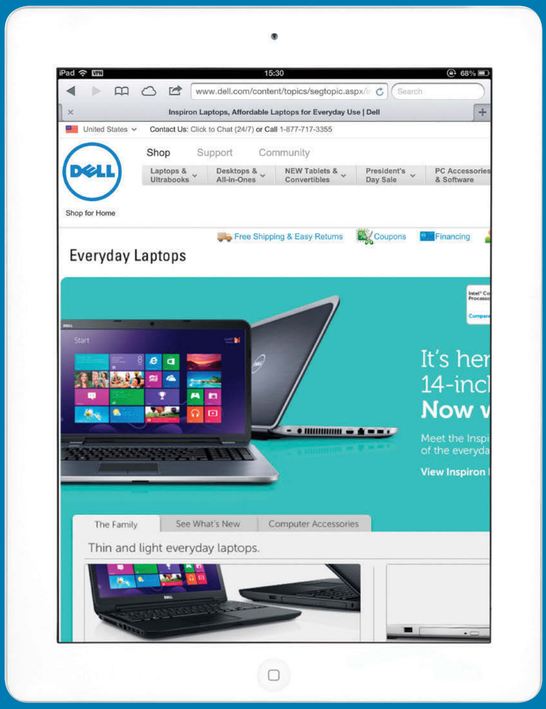
Construct:

- Product: Product life cycle (AO4)
- Product: Boston Consulting Group matrix (AO4)

Setting the scene

GLOBAL BRANDS INCREASINGLY USE SOCIAL MEDIA

The best builders of brand image are the companies that focus on developing simple, integrated messages consistent with the products they sell, in every market around the world and with every customer they have contact with. The best brand builders are also very creative in getting their products' message across to consumers. Establishing and selling a brand these days has to be done through a variety of media: the web, live events, smartphones and tablet computers.



JUSTFAB.COM

JustFabulous uses Facebook, Twitter and Pinterest to develop a one-on-one relationship with their customers. 'It's like having a friend that gives you fashion advice' tweeted one customer.

STARBUCKS.COM

Starbucks recently announced a programme allowing customers to send a gift card to their friends with Twitter. Customers simply link their Starbucks account to their Twitter account. They can send a $5 gift card by posting '@Tweetacoffee to…' and Starbucks will charge the sender's account. The recipient will not only spend the money at Starbucks, but will talk about it on social media accounts.

DELL

Dell has been using Twitter to reach its customer base for years. Dell says, 'Twitter has produced $1 million in revenue over the past year and a half through sales alerts.' The company has gone beyond Twitter with a network of blogs and a very active Facebook page.

Points to consider

- What do you understand by the idea of a product's brand?
- Why is establishing a distinctive global brand important for multinational companies?
- Is the use of social media appropriate for the 'building of all brands'?

Key concept link

The marketing strategy of a business is a crucial factor that is likely to determine the success or failure of the entire operation. Marketing is changing rapidly with technological innovations impacting on all four elements of the marketing mix. Being able to adapt effectively to technological and other changes is becoming an increasingly important factor in marketing management.

Introduction – product

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'. If the product does not meet customer expectations, as discovered by market research, regarding:

- quality
- durability
- performance
- appearance . . .

then no matter how low the price or how expensive the advertisement, it will not sell successfully in the long term.

The term '**product**' includes consumer and industrial goods and services. Consumer goods can be both **consumer durables** – washing machines – and single use – as with chocolate bars. Industrial products such as mining equipment are purchased by businesses, not final consumers. Services have no physical existence but satisfy consumer needs in other ways – hairdressing, car repairs, childminding and banking are examples of services.

product: the end result of the production process sold on the market to satisfy a customer need

consumer durables: manufactured products that can be reused and are expected to have a reasonably long life, such as cars

product life cycle: the pattern of sales recorded by a product from launch to withdrawal from the market

Product life cycle

Knowing when to launch a new product or update an existing one can give a business a crucial advantage. Allowing existing models of cars or computers to 'soldier on' in the market when other firms are introducing attractive new or revamped ones is a classic business error that has led to many failures. An awareness of the **product life cycle** principle can assist greatly in dealing with this problem. The life cycle of a product

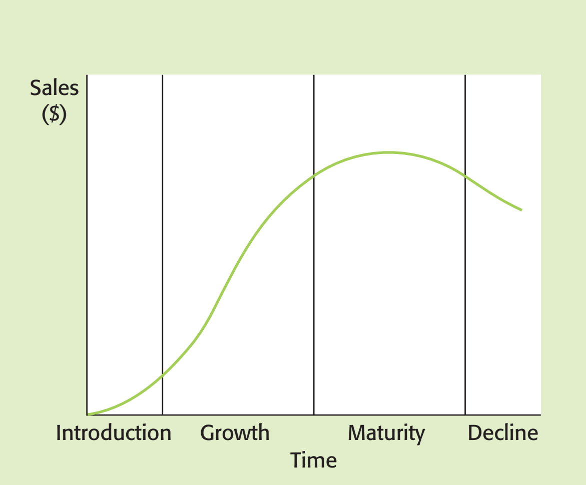


Figure 4.5.1 Product life cycle – the length of each stage will vary from product to product

records the sales of that product over time. There are several stages in this life cycle and these are shown in Figure 4.5.1.

Points to note on the first three stages:

- **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 DVD by a major rock star.
- **Growth.** If the product is effectively promoted and well received by the market, then sales should grow significantly. This stage cannot last forever, although all firms wish that it would. Eventually, and this may take days, weeks or even years, sales growth will begin to slow and might stop altogether, which leads the product into the next stage. The reasons for declining growth 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, for example Coca-Cola. The saturation of consumer durables markets is caused by most consumers who want a certain product having already bought one. The best recent example is mobile phones. Although the world market has grown phenomenally in recent years, in 2009 sales growth ended altogether. This was put down to the vast number of consumers who already possessed a mobile. It is only when their own phone breaks down or is replaced by newer technology that a further spurt to sales growth will be received. This is why all phone companies are working so hard on the next generation of mobile phones – to make existing models obsolete.

extension strategies: marketing plans that extend the maturity stage of the product before a brand new one is needed

Extension strategies

Such strategies include developing new markets for existing products, for example export markets, new uses for existing products and product relaunches involving new packaging and advertising (see Figure 4.5.2).

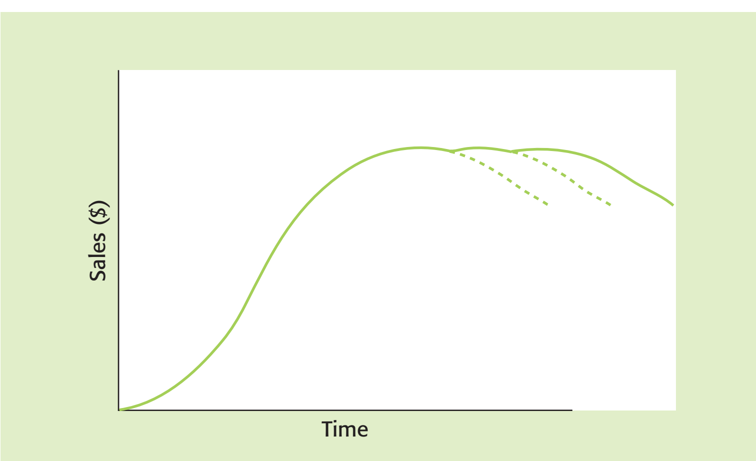


Figure 4.5.2 Product life cycle – showing the effect of extension strategies

During the 'decline' phase, sales will fall steadily. Either no extension strategy has been tried, or it has not worked or the product is so obsolescent that the only option is replacement. Newer competitors' products are the most likely cause of declining sales and profits – and when the product becomes unprofitable or when its replacement is ready for the market, it will be withdrawn. An evaluation of possible extension strategies is outlined in Table 4.5.1.

Evaluation of extension strategies

Strategy	Example	Benefits	Limitations
Adding features to the original product	Adding a camera and bigger screen to an old tablet computer design	Can usually be developed and marketed more quickly – and at lower cost – than a completely new product	The basic original product is still ageing and at maturity/decline so consumers may not 'buy into' a slightly revised product
Repackage a product	Breakfast cereal box changes its design	Relatively cheap and quick method	Consumers may quickly realise the product is the same and feel that they are being misled
Discount the price	Reduce price of an older model of smartphone before new model is released	Lower-income consumers can now afford the product – product promotion might actually target different market segments	Impact on long-term image of the brand and the company – better to replace the product earlier to avoid discounting
Rebrand	Changing the name, packaging and promotion of a confectionery bar so it can be sold to different market segments	Opens up new market segments; can be presented as a substantially 'new product'	Expensive – is this rebranding strategy really worthwhile if a product has the perception of being old-fashioned and is shortly to be replaced?
Sell into new markets, e.g. export markets	Sell ageing model of car in a low-income country that has few manufacturers and limited choice of products	Market development can increase sales especially if the product is not perceived as being too old or 'mature' in these markets	Product and promotion may need to be redesigned to meet local laws and cultural requirements

Table 4.5.1 Benefits and limitations of extension strategies

ACTIVITY 4.5.1

CHOCOLATE WARS LEAD TO MELTDOWN

Jupiter Confectionery Ltd manufactures four brands of chocolate bar. It is a well-established business and relies heavily on the traditional qualities of rich-tasting chocolate and prestige packaging to sell its products. It rarely introduces new brands – its last launch was three years ago and this required substantial investment. The other three brands are over ten years old. The products are:

Orion – the newest brand, designed to appeal to teenagers with 'Star Wars' wrappers and a competitive price. Sales are increasing at a steady rate.

Venus – the original product of the company, a rich, dark chocolate bar with a black and gold wrapper. The same size as most bars, but slightly more expensive – to suit its image. Sales and cash flow from this product have helped to finance the launch of the other three.

Sun – the firm's only attempt at boxes of chocolates. There was intense competition in this high-value and high-profit margin market sector. Sales figures are given below.

Year	Sales of Sun boxes of chocolates (units)
2010	120 000
2011	125 000
2012	115 000
2013	123 000
2014	124 000

Mercury – this is a very sweet, soft-centred bar that has been very popular with older consumers. Sales have declined in recent years because of imports of healthier 'low-fat' chocolates. Old stocks are being returned by retailers.

The marketing manager is concerned both about sales of Mercury bars and the sales record of Sun boxes. Should they both be dropped or could sales be revived? The manager decides to analyse the current sales of the range of products by using the product life cycle concept.

20 marks, 40 minutes

1. Define the term 'product life cycle'. [2]
2. **a.** Draw a product life cycle diagram. [2]
   b. Plot the position of the Sun brand of chocolates on the product life cycle diagram. [2]
   c. Explain the reason for putting the Sun brand of chocolates in the stage of the product life cycle you have chosen. [4]
3. Evaluate **three** extension strategies that Jupiter Confectionery could adopt for the Sun brand of chocolates. [10]

The product life cycle and the marketing mix

- When would you advise a firm to lower the price of its product – at the growth or at the decline stage?
- In which phase is advertising likely to be most important – during introduction or at maturity?
- When should variations be made to the product – during introduction or at maturity?

One of the key applications of the product life cycle concept is as a guide to making changes to elements of the marketing mix. Table 4.5.2 explains how marketing-mix decisions can be influenced by knowledge of the product life cycle.

Product life-cycle phase	Price	Promotion	Place (distribution outlets)	Product
Introduction	• May be high compared to competitors (skimming) or low (penetration)	• High levels of informative advertising to make consumers aware of the product's arrival on the market	• Restricted outlets – possibly high-class outlets if a skimming strategy is adopted	• New model launched
Growth	• If successful, an initial penetration pricing strategy could now lead to rising prices	• Consumers need to be convinced to make repeat purchases – brand identification will help to establish consumer loyalty	• Growing numbers of outlets in areas indicated by strength of consumer demand	• Planning of product improvements and developments to maintain consumer appeal
Maturity	• Competitors likely to be entering market – there will be a need to keep prices at competitive levels	• Brand imaging continues – growing need to stress the positive differences with competitors' products	• Highest geographical range of outlets as possible – developing new types of outlets where possible	• New models, colours, accessories, etc. as part of extension strategies

Table 4.5.2 The marketing mix and phases of the product life cycle [*table continues over*]

Product life-cycle phase	Price	Promotion	Place (distribution outlets)	Product
Decline	• Lower prices to sell off stock – or if the product has a small 'cult' following, prices could even rise	• Advertising likely to be very limited – may just be used to inform of lower prices	• Eliminate unprofitable outlets for the product	• Prepare to replace with other products – slowly withdraw from certain markets

Table 4.5.2 *Continued*

ACTIVITY 4.5.2

DIFFERENT PRODUCT LIFE CYCLES

Draw a product life cycle, with an estimation of the time duration at each stage, for each of the following products:

- music download for a track by Eminem
- breakfast cereal by Kellogg's
- new model of iPhone by Apple
- women's fashion clothes by Zara.

Exam tip: When discussing the product life cycle it is important to remember that no two products are likely to have exactly the same pattern of sales growth/maturity and decline.

The relationship between the product life cycle, investment, profit and cash flow

Product life cycle and investment

Investment – capital spending which aims to return a profit – is likely to be heaviest towards the end of a product's life cycle. Newer replacement products will be needed to 'take over' when the existing products cease to sell in sufficient numbers and profits are falling or non-existent. The time period required to research and develop (R&D) new products will determine the timing of this new investment. With pharmaceutical products it may well be a continuous process as the R&D can take many years before a potentially profitable new drug is ready for launch.

Product life cycle and profit

The profitability of products will vary considerably during the life cycle. High profit margins are most likely during the growth and maturity phase – but towards the end of the latter stage, prices might have to be made more competitive and this might start to lead to lower margins. At the decline stage, prices could fall further, hitting gross profit margins. However, if the fixed costs of developing the product and the machinery required to produce it have been fully covered, sales of the product might still yield some net profit.

Product life cycle and cash flow

Cash flow is vital to business survival and ignoring the link between cash flow and product life cycles could lead to lack of liquidity for the business. Figure 4.5.3 shows this typical relationship.

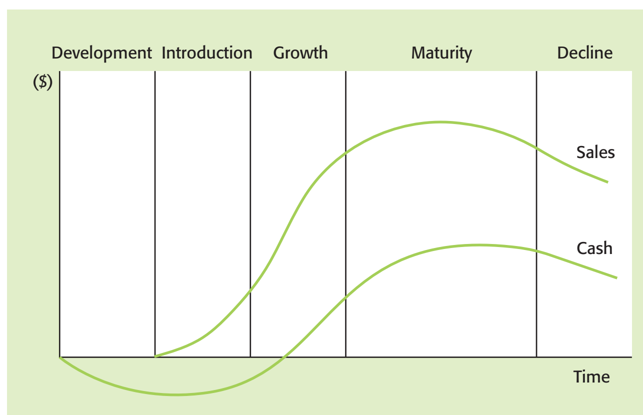


Figure 4.5.3 The link between cash flow and product life cycle

Cash flow is negative during the development of the product as costs are high, but nothing has yet been produced or sold. At introduction, the development costs might have ended but heavy promotional expenses are likely to be incurred – and these could continue into the growth phase. In addition, there is likely to be much unused factory capacity at this stage which will place a further strain on costs. As sales increase, then cash flow should improve – precisely when will depend on the length of consumer credit being offered.

The maturity phase is likely to see the most positive cash flows, because sales are high, promotional costs might be limited and spare factory capacity should be low. As the product passes into decline, so price reductions and falling sales are likely to combine to reduce cash flows. Clearly, if a business has too many of its products either at the decline or the introduction phase then the consequences for cash flow could be serious. Firms will benefit from a balanced portfolio of products, at different stages of their life cycles, so that cash from those entering maturity can be used to provide investment funds for developing eventual replacement products.

Boston Consulting Group matrix: a method of analysing the product portfolio of a business in terms of market share and market growth

Boston Consulting Group matrix – product portfolio analysis

This method of analysing the market standing of a firm's products and the firm's overall product portfolio was developed by the Boston Consulting Group (see Figure 4.5.4).

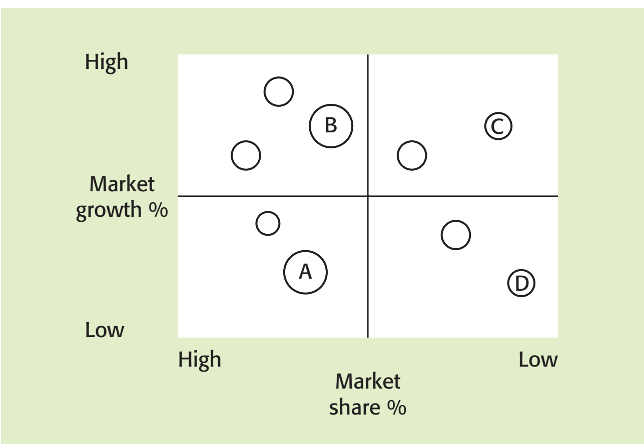


Figure 4.5.4 The Boston Consulting Group matrix

It highlights the position of each of a firm's products when measured by market share and market growth. This allows not only an analysis of the existing product portfolio but also what future strategies the firm could take next. The size of each circle 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 creates a high positive cash flow and is profitable. 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, especially if the high market share can be maintained with little additional promotional spending.

High market growth – high market share: product B 'star'

This is clearly a successful product as it is performing well in an expanding market – because of this it is often called a 'star'. The firm will be keen to maintain the market position of this product in what may be a fast-changing market – therefore, promotional 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. If their status and market share can be maintained, they should become the cash cows of the future as the market matures and market growth slows.

High market growth – low market share: product C 'problem child'

The 'problem child' consumes resources but it generates little return – at least in the short term. If it is a newly launched product, it is going to need heavy promotional costs to help it 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, such as revised design, relaunch or even withdrawal from the market. It should, however, have potential as it is selling in a market sector that is growing fast and businesses need to analyse carefully which problem children are worth developing and investing in and which are the best ones to drop and stop selling.

Low market growth – low market share: product D 'dog'

'Dogs' seem to offer little to the business either in terms of existing sales and cash flow or future prospects, because the market is not growing. They may need to be replaced shortly, or the firm could decide to withdraw from this market sector altogether and position itself into faster-growing sectors.

Boston Consulting Group matrix and strategic analysis

By identifying the position of all of the firm's products a full analysis of the portfolio is possible. This should help focus on which products need support or which need corrective action. This action could include the following strategies:

- Building – supporting problem child 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 can 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 in other products in the portfolio.
- Divesting – identifying the worst performing dogs and stopping the production and supply of these. 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 for another product.

These strategies can only be undertaken if the business has a balanced portfolio of products. If there are too many dogs or problem children, then the overall shortage of cash may not allow the firm to take appropriate action.

Evaluation of the Boston Consulting Group matrix

This analytical tool has relevance when:

- analysing the performance and current position of existing products
- planning action to be taken with existing products
- planning the introduction of new products.

No technique can guarantee business success – this will depend on the accuracy of the analysis by the marketing managers and the skills they possess in employing appropriate marketing strategies.

The Boston Consulting Group matrix helps establish the current situation in which the firm's products find themselves – but it is of little use in 'predicting' future success or failure for the following reasons:

- On its own it cannot tell a manager what will happen next with any product. Detailed and continuous market research will help – but at all times, decision-makers must be conscious of the potentially dramatic effects of competitors' decisions, technological changes and the fluctuating economic environment.

- It is only a planning tool and it has been criticised as simplifying a complex set of factors determining product success.
- The assumption is made that higher rates of profit are directly related to high market shares – this is not necessarily the case if sales are being gained by reducing prices and profit margins.

ACTIVITY 4.5.3

'CASH COW AT THE DAIRY'

Salman Gasim is looking at the latest sales data for FarmGate dairies. As usual, there is some good news and bad news. The four main products are organised into business units. They record very different sales performances, and marketing decisions have to be made concerning the company's product portfolio. Here are the sales data:

% market share of the market segment each product is sold in			
	2012	2013	2014
Gold Seal milk	25	26	24
Lo Fat yoghurts	–	7	6
Churn butter	8	6	5
Hi Energy spread	30	28	31

Gold Seal milk is the oldest-established product. Sales have not risen greatly over the last few years, but it is in a mature market. FarmGate has not promoted the brand for the last three years.

Lo Fat yoghurts were launched two years ago with a substantial marketing campaign. Although there is great competition in this 'health segment' of the market – it is becoming one of the fastest-growing segments in the high-profit-margin yoghurt market – FarmGate's Lo Fat product initially caught the public's imagination. Product developments might be needed to sustain consumer interest.

Churn butter had for many years been a weak brand in its sector. Frequent promotional campaigns and special offers had failed to create much consumer loyalty. Butter sales in general were suffering because of increasing health concerns.

Hi Energy spread was introduced to the market only five years ago. Sales took off immediately – partly due to very competitive pricing. Healthy eating habits were driving the market forward, but new brands are now making their presence felt. Should a further advertising campaign be introduced? Should the product be developed with a wider range of flavours?

30 marks, 60 minutes

1. Define the term 'market share'. [2]

2. a. Draw a Boston Consulting Group matrix diagram and position each of FarmGate's products on the matrix you have drawn. [4]

b. Outline the reason why you have put each of FarmGate's products in the place you have chosen in the Boston Consulting Group matrix. [4]

3. Examine a strategy FarmGate could adopt to increase the sales of Lo Fat yoghurts and a strategy to increase the market share of Hi Energy spread. [10]

4. Evaluate the usefulness of the Boston Consulting Group matrix as a model to guide marketing strategy. [10]

THEORY OF KNOWLEDGE

Three technological product failures in 2013

1. The anointed successor to Nintendo's wildly successful Wii game console, the Wii U was launched with all the fanfare expected of one of the three big players in the console arena. Sales were, however, disappointing and the Wii U fell behind the competition.
2. After leading the pack for years in the smartphone market, BlackBerry has quickly watched its products become also-rans – falling behind touchscreen devices such as the iPhone and the Android-powered devices by Samsung. Launched over the summer of 2013, the keyboard-equipped Q10 – as well as its touchscreen sister, the Z10 – were considered BlackBerry's last chance to get back in the game but they weren't successful.
3. Despite a very clever advertisement campaign showing Samsung's smartwatch as the logical progression from those fantasy wrist communication devices we've seen in movies and cartoons, Samsung's Galaxy Gear never took off with consumers or critics.

Source: Adapted from 247wallst.com

Discuss with your class the roles emotion, intuition and reasoning play in judging whether a product is going to be successful or not.

Branding

Mobile phones are an example of a product, but Samsung 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 a 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 one firm's products a unique identity. Successful brands can often charge premium prices as consumers are loyal to the product and the image that it generates. This helps to make the demand for products less price-sensitive.

However, attempting to establish a new brand is often expensive. Increasing **brand awareness** and **brand loyalty** are primary goals of promotional activity in the early months or years of a product's launch. It can cost millions of dollars to attempt to create an effective brand image – and success cannot be guaranteed. If a brand image receives bad publicity – such as Nestlé's marketing of powdered baby milk in developing countries – then the image of all products in the 'corporate brand' will be damaged.

If both brand awareness and **brand development** are high then the equity of the brand is likely to be substantial. **Brand equity** is the total amount that customers are prepared to pay extra for a branded product than they would pay for a generic non-branded product.

The importance of branding

Effective branding can lead to the following benefits:

- Promotes instant recognition of the company and product – especially through the use of logos and images

brand: an identifying symbol, name, image or trademark that distinguishes a product from its competitors

brand awareness: extent to which a brand is recognised by potential customers and is correctly associated with a particular product – can be expressed as a percentage of the target market

brand loyalty: the faithfulness of consumers to a particular brand as shown by their repeat purchases irrespective of the marketing pressure from competing brands

brand development: measures the infiltration of a product's sales, usually per thousand population; if 100 people in 1000 buy a product, it has a brand development of 10

brand value (or brand equity): the premium that a brand has because customers are willing to pay more for it than they would for a non-branded generic product

- Helps differentiate the company and its products from rivals – this is especially important when the products themselves might be difficult to differentiate, e.g. petrol/gasoline
- Aids in employee motivation – they can become committed to the brand
- Generates referrals from customers – especially through the use of social media
- Customers know what to expect from the company and products
- An emotional attachment can develop between the brand and customers, increasing customer loyalty
- Increases the value of the business above the value of its physical assets (brand equity).

Branding is now increasingly an international process, not confined to one country or region. Establishing a successful brand image across national borders opens up the potential for increased sales and economies of scale – especially in terms of globally marketing products with the same range of promotions under the same name. It is increasingly important that businesses which have a multinational presence build up a consistent and recognisable brand image that is transferable between countries. UBS Bank has achieved this. Created by a series of mergers and takeovers that gave it many separate brand names and products, the bank lacked recognition in markets outside Switzerland. It merged many products under the UBS name and relaunched itself as a global bank serving local needs but with the prestige and image that come from being the sixth-largest bank in the world. Globalised branding and marketing can have substantial benefits, but there are limitations too if the international brand and image fail to link in with localised culture and customer tastes.

Types of branding

Table 4.5.3 outlines the different types of branding, their benefits and limitations.

family branding: a marketing strategy that involves selling several related products under one brand name (also known as umbrella branding)

product branding: each individual product in a portfolio is given its own unique identity and brand image (also known as individual branding)

company or corporate branding: the company name is applied to products and this becomes the brand name

Type of branding	Examples	Benefits	Limitations
Family branding	• Mars Bar was the original product – now joined by Mars ice cream, Mars energy drink and Mars muffins	• Marketing economies of scale when promoting the brand • Makes new product launches easier	• Poor quality of one product under the brand may damage them all
Product branding	• Toyota created the Lexus brand of luxury cars • Procter & Gamble sells Head and Shoulders, Pampers, Duracell and Braun with separate brand identities	• Each product is perceived as its own unique and separate brand – unconnected in consumers' minds with the parent company	• Loses the positive image of a strong company brand
Company or corporate branding	• Virgin – airlines, rail services, mobile phone provider – all marketed under single brand name • Disney products	• Similar points to family branding – but now applies to all products produced under the company's brand name	• Poor quality of one product may damage image of company

Table 4.5.3 Different types of branding – limitations and benefits [*table continues over*]

Type of branding	Examples	Benefits	Limitations
Own-label branding	• Walmart has numerous own brands, e.g. Sam's Choice (premium food products), Faded Glory (Americana clothing), Life (men's wear), Metro 7 (women's wear)	• Often cheaper than name-brand products • Each own-brand label appeals to different consumer groups and tastes • Often little spent on advertising – in-store promotions used instead	• Consumers often perceive products to have a lower-quality image
Manufacturers' brands	• Levi's • Coca-Cola • Mercedes-Benz	• Successful branding by manufacturers establishes a unique 'personality' for the product which many consumers want to be associated with – and will often pay premium prices to purchase	• The brand has to be constantly promoted and defended

Table 4.5.3 *Continued*

own-label branding: retailers create their own brand name and identity for a range of products

manufacturers' brands: producers establish the brand image of a product or a family of products, often under the company's name

ACTIVITY 4.5.4

BRITISH AIRWAYS 'IS KING OF UK BRANDS'

According to the most recent Superbrands survey of 3000 consumers, the British Airways brand came top of the list. It was followed by Rolex watches, Coca-Cola, the BBC, Heinz and Microsoft.

According to Superbrands the main criteria in determining a brand's league rankings are:

'It has established the finest reputation in its field. It offers significant emotional and tangible benefits which customers want and recognise.'

Customers were asked to consider: Does the brand offer quality products and services? Can the brand be trusted to deliver consistently? Is it well known in its sector and is it suitably different from its rivals?

Source: superbrands-uk.s3.amazonaws.com

20 marks, 40 minutes

1. Define the term 'brand'. [2]
2. Explain **two** reasons why brand awareness is important to a business. [4]
3. Analyse **two** factors that contribute to a successful brand. [4]
4. Compare and contrast company/corporate branding and own-label branding. [10]

The importance of packaging

Protection (or function)

The main purpose of product packaging is to protect the product from damage. Product packaging should not only protect the product during transport from the manufacturer to the retailer, but it should also prevent damage while the product is on the retailer's shelves – including vacuum packaging of fresh meat and other foods to slow down their deterioration. Most products have some form of packaging. For example, milk must have a container and package while apples may have packaging for transport but could be sold 'loose' without packaging in grocery stores.

Attracting customers

The packaging of a product may be the key factor that attracts a consumer who may be undecided on which brand to buy when confronted with choice in a shop. For this reason, many companies conduct extensive market research on colour schemes, designs and different materials for product packaging to try to determine the most appealing package to its potential consumers.

Promotion and information

Packaging also plays an important role for giving information about the product. Outside packaging may contain directions on how to use or make the product. There might be details of 'special offers' or competitions that consumers can engage in. The packaging might also support other promotional material by making references to messages advertised on TV or other media.

Packaging may list ingredients and nutritional information about the product. This information can help to sell the product because it allows potential customers to obtain the necessary information they need to make a purchase decision. Information given on a package may propel the reader to buy the product without ever having to speak to a store assistant.

Differentiation and brand support

Packaging can also differentiate one brand of product from another brand. Product packaging can display company names, logos and the colour scheme of the company and its brands. This all helps consumers to identify the product as it is located among the competition's products on shop shelves. For example, as a shopper walks through the coffee aisle of the local grocery store, the bright orange, pink and white packaging of the Dunkin' Donuts coffee brand may be easily recognisable for the consumer to pick up. The consumer may identify with the company brand, which encourages them to buy the product. If the product packaging changes, it may alter the brand perception of the company, which does not mean that the consumer would not still purchase the product, but it may delay the purchase until the person is able to identify the product according to its new packaging.

Packaging – evaluation

Packaging is only one element of the product/promotion marketing mix and it needs to be fully integrated with the other elements so that consumers gain a consistent message about the product. The most expensive, glossiest and most dramatic packaging can lead to a customer backlash if there is growing environmental concern. Product packaging contributes substantially to the problems that most societies have regarding waste disposal. More businesses – especially those with an environmental objective – are trying to balance the need to cut packaging volume and cost with the constant requirement to protect the product and project the 'emotional message' about the product that customers of the brand will be expecting.

Introduction – price

Price is the amount paid by consumers for a product. Price is a vital component of the marketing mix as it impacts on the consumer demand for the product.

The pricing level will also:

- determine the degree of value added by the business to bought-in components
- influence the revenue and profit made by a business due to the impact on demand
- reflect the marketing objectives of the business and help establish the psychological image and identity of a product.

Get the pricing decision wrong and much hard work in market research, product development and branding can be put at risk.

Factors determining the price decision

There are a number of factors that will determine the pricing decision for a product:

1. costs of production
2. competitive conditions in the market
3. competitors' prices
4. marketing objectives
5. price elasticity of demand
6. whether it is a new or an existing product.

The significance of these is discussed in this chapter.

Pricing strategies

Cost-based pricing

The central idea is that firms will assess their costs of producing or supplying each unit, and then add an amount on top of the calculated cost. There are a number of different methods of cost-based pricing that may be adopted.

Cost-plus pricing

This method is often used by retailers, who take the price that they pay the producer or wholesaler for a product, and then just add a percentage mark-up. The size of the mark-up usually depends upon a combination of the strength of demand for the product, the number of competitors and the age and stage of life of the product. Sometimes it also depends on traditional practice in the industry.

cost-plus pricing: adding a fixed mark-up for profit to the unit price of a product

Example:

Cost of bought-in materials: $40

50% mark-up on cost = $20

Selling price: $60

Market-based pricing strategies

These are normally split into two different approaches depending on the marketing objectives of the business.

penetration pricing: setting a relatively low price often supported by strong promotion in order to achieve a high volume of sales

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

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.

Market skimming

This aims to maximise short-run profits, before competitors enter the market with a similar product, and to project an exclusive image for the product. If rivals do launch similar products, it may be necessary for the price to be reduced over a period of time. An example of this is pharmaceutical firms, which are often given a legal monopoly for a certain number of years for new drugs. They are able to charge high prices in order to recoup their considerable investments in research and to make high profits. It is not uncommon 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 market-skimming price strategy (see Figure 4.5.5).

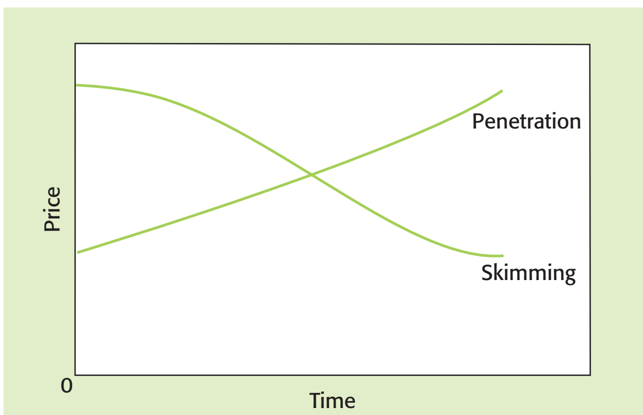


Figure 4.5.5 Market-skimming and penetration pricing strategies

psychological pricing: setting prices that take account of customers' perception of value of the product

Psychological pricing

This has two aspects. First, 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 used instead of $1001, and $1.99 not $2.01. In addition, psychological pricing also refers to the use of market research to avoid setting prices that consumers consider to be inappropriate for the style and quality of the product. A very low price for cosmetics or perfume, even though the costs of production may not be high, will not create the status and exclusive image that the firm is trying to portray. Potential consumers may be put off by the fact that too many people can now afford the product and the idea that the quality may not be as high as they originally believed. Similarly, prices can be so high that they exceed consumer perceptions of the quality and image of the product, and sales will be damaged as a result.

loss leader: product sold at a very low price to encourage consumers to buy other products

Loss leaders

Loss leaders are widely used by supermarkets. Selling milk or bread at very low prices – perhaps below cost price – will encourage consumers into the stores to buy other goods on which the supermarket makes a higher profit margin. Is this fair on smaller retailers of milk and bread who cannot buy in supplies as cheaply as the large supermarkets? Other examples include computer printers sold for $40 – but the replacement ink cartridges can cost $30 each.

Price discrimination

This takes place in markets where sub-groups of consumers exist and it is possible to charge different consumer groups different prices for the same product. An example of this would be airline operators which charge many different rates for the same journey. Firms can price-discriminate if there are different groups of consumers with different price elasticities of demand. Also the firm must avoid resale between the groups and it must not cost too much to keep the groups of consumers separate. Other examples of price discrimination include selling train and bus tickets more cheaply to children or the elderly and setting different prices for products in different export markets.

price discrimination: occurs when a business sells the same product to different consumers at different prices

promotional pricing: special low prices to gain market share or sell off excess stock – includes 'buy one get one free'

price leadership: exists when one business sets a price for its products and other firms in the market set the same or similar prices (they 'follow suit')

Promotional pricing

A very widely used pricing strategy, it tends to operate for limited periods only to boost sales at times of low demand or to support the opening of a new store.

It can be used to encourage the purchase of 'multiple buys' and to entice consumers to try a product for the first time. If they then continue to purchase the product when the price has been returned to its normal level, the profit made from these purchases should compensate for the lower profit margin made when the promotional price was in force.

Price leadership

Price leadership usually exists when a company is the dominant firm in the market – i.e. it has highest market share. It is quite possible, though not necessarily the case, that this business benefits from economies of scale and has the lowest unit costs in the industry. However, do not confuse low costs with low prices – one does not necessarily follow the other! It may be possible, even with a dominant firm, that all businesses in the industry remain profitable even though the market leader has led the way by setting the market price.

When a dominant company aggressively lowers prices specifically because it knows the smaller companies in the industry cannot sustain a lower price, this is called predatory pricing (explained below).

Exam tip: Price leadership is often confused with cost leadership – achieving the lowest unit cost in the industry. This cost difference does not always mean lower prices, though it often does. A low-cost company with a reputation for quality may be able to charge a premium and just makes a much larger profit margin than its competitors.

Predatory or destroyer pricing

This is an illegal pricing strategy in the countries that make up the European Union and in other countries as it favours the strong, established companies unfairly compared to new entrants. In practice, it is very difficult to prove – businesses often claim that they are just adopting a loss-leader strategy.

predatory pricing: deliberately undercutting competitors' prices in order to try to force them out of the market

A sign of predatory pricing is when the price of a product gradually becomes lower, which can happen during a price war. This is difficult to prove as predatory pricing because it can be seen as a price competition and not a deliberate act of eliminating competitors.

In the short term, a price war can be beneficial for consumers because of the lower prices. In the long term, however, it is not beneficial as the company that wins a predatory price war, effectively putting its competitor out of business, will have a monopoly where it can set higher prices, offering consumers little option but to pay these (see Table 4.5.4 for a summary of pricing methods).

ACTIVITY 4.5.5

CAR PRICES TO RISE IN CHINA?

Although Volkswagen has denied the rumour of ‘general price hikes in April’ for its cars in China, business analysts are predicting substantial car price rises. Due to rising costs of production – steel and other raw materials and higher labour costs – the cost of making each car in China increased on average by $400 last year. Can manufacturers resist these cost pressures? By how much are they prepared to cut their profit margins to stay competitive?

However, the fierce competition in China’s car market has deterred many manufacturers from putting up prices using ‘cost-plus’ principles. In recent years, due to increased numbers of cars being made in China and more manufacturers exporting to China, competitive pressures have put car prices on a downwards trend, but that could change now that costs are rising so fast.

To avoid consumer resistance to price increases, manufacturers are increasing their profit margins in other ways. Dealers are promising quick delivery of cars to customers if they order expensive accessories and luxury items – such as leather seats. The profit margin on these decorative accessories can be as high as 30–40%, which helps to make up for very low margins on the cars themselves – in fact, the cars are almost loss leaders. So, indirect price increases could be the solution to the very small profit margins on selling basic car models.

20 marks, 40 minutes

1. Define the term ‘cost-plus pricing’. [2]
2. Explain why Volkswagen might be considering an increase in the price of its cars in China. [4]
3. Analyse how a car manufacturer can use loss leadership to increase its profits. [4]
4. Evaluate the usefulness of cost-plus pricing as a pricing strategy in the Chinese car market. [10]

Methods	Advantages	Disadvantages
Cost-plus pricing	• Price set will cover all costs of production • Easy to calculate for single-product firms where there is no doubt about fixed cost allocation • Suitable for firms that are ‘price makers’ due to market dominance	• Not necessarily accurate for firms with several products where there is doubt over the allocation of fixed costs • Does not take market/competitive conditions into account • Tends to be inflexible, e.g. there might be opportunities to increase prices even higher • If sales fall, average fixed and average total costs rise – this could lead to the price being raised using this method
Penetration	• Low prices should lead to high demand – important to establish high-market share for new products	• Profit margins might be very low – prices might have to rise in the future and there could be consumer resistance to this
Skimming	• High profit margins that will help to pay for development costs of new product	• High prices might discourage consumers – unless they are convinced the integrated marketing mix justifies the high prices • High prices might encourage more competitors to enter the market

Table 4.5.4 Summary of main pricing methods [*table continues over*]

Methods	Advantages	Disadvantages
Psychological	• Prices reflect what consumers expect and this means that the price is likely to be consistent with other aspects of other marketing mix	• Price level and demand for the products need to be constantly reviewed as 'consumer expectations' can change over time – especially with new product developments from competitors
Loss leader	• Makes a loss on one product but more than compensated by profits on other products – perhaps complementary to the loss leader • Increases market share	• Cheaper generic alternatives might be sold by rival firms so the 'profit-making' complementary products are not purchased from the loss-leading business
Price discrimination	• Uses price elasticity knowledge to charge different prices in order to increase total revenue	• Administrative costs of having different pricing levels • Customers may switch to lower-priced market • Consumers paying higher prices may object and look for alternatives
Price leadership	• Smaller businesses know what price they have to 'aim to set' • Price leader may have lower unit costs so it remains more profitable than competitors even with low prices	• Can be perceived as being 'predatory' • Only really operates effectively for products that are undifferentiated – may begin to break down if some competitors are successful in establishing 'differentiation'
Predatory	• Drives down prices to benefit consumers and likely to increase demand for the business • May reduce the number of competitors in the long term and increase monopoly power of the 'predator'	• If proven, it is illegal in many countries and heavy fines can be imposed • Consumers may try to find alternative products if the newly created monopolist increases prices in the long term
Promotional	• Attracts new customers who may continue to buy when price is restored to original level • Allows selling off of out-of season stock • Encourages multibuys	• If this method is used frequently, consumers may suspect that the higher non-discounted price can never be justified • Lower price might become established in consumers' minds as being for a lower-quality product

Table 4.5.4 *Continued*

ACTIVITY 4.5.6

DELL TO CONTINUE PRICE CUTS AS PC SALES SLOW DOWN

Dell Inc., one of the world's largest computer makers, promised to continue its price-cutting offensive (some industry insiders described this as destroyer or predatory pricing). This is bad news for other, smaller, computer manufacturers. The company pledged further cuts in the price of laptop and desktop PCs, storage units and computer servers to increase its share of the slowing US PC market. It said its low stock levels enabled it to pass on price falls in microchips faster than rivals in the industry; recently, there have been profit warnings from Apple and Hewlett-Packard. Dell has dismayed some analysts because of its falling profit margins. But Michael Dell, chairman and chief executive, said the move was intended to undercut high-margin rivals such as EMC and Sun Microsystems. 'You have not seen the last of our price-cutting,' Mr Dell said yesterday. 'It's only a price war if you are losing money and losing market share. We are gaining market share and increasing sales revenue.'

20 marks, 40 minutes

1. Define the terms:

a. destroyer or predatory pricing

b. sales revenue. [4]

2. State **two** reasons why Dell might have seen a fall in its profit margins. [2]
3. Explain the impact a reduction in the price of computers might have on the demand for computer software. [4]
4. Discuss the advantages and disadvantages to Dell of reducing the price of its computers to increase market share. [10]

Introduction – promotion

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

Promotion is about communicating with actual or potential customers. Effective promotion not only increases awareness of products, but can create images and product 'personalities' that consumers can identify with. Advertising is only one form of promotion and other techniques include direct selling and sales promotion offers. The combination of all forms of promotion used by a business for any product is known as the 'promotion mix'. The amount firms spend on promotion – the promotion budget – is often a key decision, but 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 – and company budgets are increasingly being diverted to social media and other technology-based forms of promotion.

Promotional objectives

Exam tip: When writing about promotion of a product try to consider the marketing objectives of the business. Is the promotion being used likely to help achieve these objectives?

Promotional objectives should aim to:

- increase sales by raising consumer awareness of a new product
- remind consumers of an existing product and its distinctive qualities
- encourage increased purchases by existing consumers or attract new consumers
- demonstrate the superior specification or qualities of a product compared to those of competitors – often used when the product has been updated or adapted in some way
- create or reinforce the brand image or 'personality' of the product
- correct misleading reports about the product or the business and reassure consumers after a 'scare' or an accident involving the product
- develop or adapt the public image of the business – rather than the product
- encourage retailers to stock and actively promote products to the final consumer.

Above-the-line promotion

Advertising

above-the-line promotion: a form of promotion that is undertaken by a business by paying for communication with consumers, e.g. advertising

Advertising is a form of **above-the-line promotion** which aims to communicate information about a product or business through the media such as radio, TV and newspapers. These advertisements are usually directed towards the appropriate target market by selecting the right media – but it is possible that many people who are unlikely to purchase the product may see the advertisements too. Successful advertising campaigns have led to substantial increases in consumer awareness and sales, and this effect can last for a considerable length of time if brand loyalty can be established. Advertisements are often classified into two types, but in practice this distinction is often quite blurred.

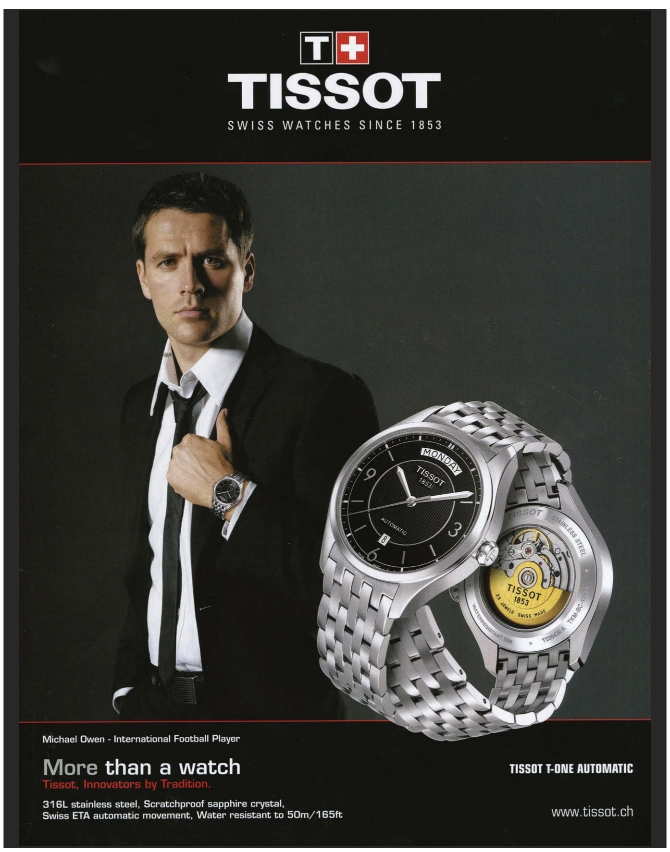
1. Informative advertising – these are advertisements that give information to potential purchasers of a product, rather than just trying to create a brand image. This information could include price, technical specifications or main features and places where the product can be purchased. This style of advertising could be particularly 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.
2. Persuasive advertising – this involves trying to create a distinct image or brand identity for the product. It may not contain any details at all about materials or ingredients used, prices or places to buy it. This form of advertising is very common, especially in those markets where there might be little actual difference between products and where advertisers are trying to create a perceived difference in the minds of consumers.

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*, New York: Ballantine Books, 1971).

Advertising decisions – which media to use?

The bigger the firm and the greater the advertising budget, the more 'media' choice there is. Limited resources will restrict options to the cheaper media. However, the most expensive forms of communication are not always the most effective. Choosing the right media means considering a number of factors:

1. Cost – TV and radio advertising can be very expensive per minute, but the actual cost will depend on the time of day that the advertisements are to be transmitted and the size of the potential audience. National newspapers will be more expensive than



An example of persausive advertising

An example of informative advertising

local ones. Other media include posters, magazines of general and specific interest and cinema advertising. Marketing managers compare the cost of these media and assess whether they fall within the marketing budget. Buying media time or space is not the only cost. The advertisement still has to be written and produced and the use of celebrities in TV, radio or cinema advertisements can soon increase the total cost greatly.

2. The profile of the target audience in terms of age, income levels, interests and so on – this should reflect as closely as possible the target consumer profile of the market being aimed for. For instance, there is likely to be little point in advertising a new children's toy after 10 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.
3. The type of product and the message to be communicated – written forms of communication are likely to be most effective for giving detailed information about a product that needs to be referred to more than once by the potential consumer. However, if an image-creating advertisement is planned, perhaps for a new range of clothes or sports equipment, then a dynamic and colourful TV advertisement is possibly more effective.
4. The other aspects of the marketing mix – the link between the other parts of the mix and the media chosen for advertisements 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.
5. The law and other constraints – a widespread ban on tobacco advertising in Formula One Grand Prix racing has 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.

ACTIVITY 4.5.7

DOES ADVERTISING INCREASE SALES?

The Cadbury Gorilla advertisement was one of the most famous and effective advertisement campaigns of recent years. The aims of the campaign were to:

- improve the public image of Cadbury and the Dairy Milk chocolate brand
- increase sales of Dairy Milk, which seemed to be in the maturity stage of its life cycle.

The TV advertisement featured an actor in a gorilla costume enthusiastically playing a well-known drum solo from the Phil Collins hit record 'In the Air Tonight'. The 90-second performance faded to a computer-generated shot of a Dairy Milk bar over the slogan 'A glass and a half full of joy' (Cadbury has always claimed that each bar contains a glass and a half of fresh milk). Producing the advertisement and paying for the TV time slots cost US$12 million. One TV advertisement during the Rugby World Cup cost $1.4 million alone. The campaign was very successful. The advertisement was uploaded on to YouTube and was viewed over 500 000 times in the first week. Market research reported that the public's view of Cadbury and Dairy Milk had improved and sales rose by 9% in one year – higher than the original target.

Evian's 'Roller Babies' video holds the official Guinness World Record for the most viral video advertisement of all time. It has already been viewed over 50 million times on YouTube. But viral success is not the same as sales success. After Roller Babies was released in 2009, sales of the water brand, owned by the Danone Group, actually declined, according to Jonah Berger, a professor of marketing at the University of Pennsylvania. Forbes noted:

In the year the Evian 'Roller Babies' video went viral and attracted 50 million views, the brand lost market share and sales dropped 25%. The Evian brand continued to lose market share in the UK in 2013, but overall the Danone Group's water business is growing.

20 marks, 40 minutes

1. Define the term 'above-the-line promotion'. [2]
2. Explain whether the promotional activity in the examples above are 'above-the-line' or 'below-the-line' promotions. [4]
3. Analyse **two** reasons why the sales of Evian water might have declined despite the apparent success of their online advertising. [4]
4. Evaluate the effectiveness of viral and social media marketing as methods of promoting a business's products. [10]

Below-the-line promotion

Examples of **below-the-line promotion**:

Sales promotion

Sales promotion generally aims to achieve short-term increases in sales. There is a huge range of incentives and activities that come under the umbrella term 'sales promotion' (see Table 4.5.5). They include:

- price deals – a temporary reduction 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, e.g. 'aisle interrupter' – a sign that juts into the supermarket aisle from a shelf; and 'dump bin' – a free-standing bin centrally placed and full of products 'dumped' inside to attract attention
- 'buy one get one free' (BOGOF)
- games and competitions, e.g. on cereal packets
- public relations
- sponsorship.

Sales promotion can be directed either at:

- the final consumer to encourage purchase (pull strategy)

  or

- the distribution channel, e.g. the retailer, to encourage stocking and display of the product (push strategy).

below-the-line promotion: promotion that is not a directly paid-for means of communication but based on short-term incentives to purchase, e.g. sales promotion techniques

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

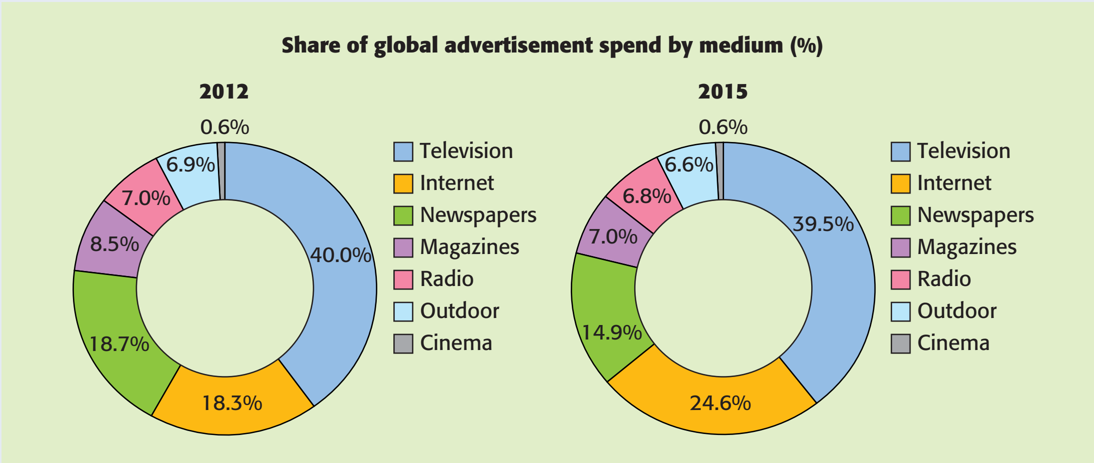
The possible impact of sales promotions are shown in Table 4.5.5.

Method explained	Possible limitations
Price promotions – these are temporary reductions in price, also known as price discounting. They are aimed at encouraging existing customers to buy more and attracting new customers to buy the product.	• Increased sales gained from price reductions will affect gross profit on each item sold. • There might 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 advertisements or on an existing product pack.	• They may simply encourage consumers to buy what they would have bought anyway. • Retailers may be surprised by the increase in demand and not hold enough stocks, leading to consumer disappointment. • Proportion of consumers using the coupon might be low if the reduction it offers is small.
Customer loyalty schemes such as air miles or customer loyalty cards – focused on encouraging repeat purchases and discouraging consumers from shopping with competitors. Information stored through loyalty cards provides a great deal of information about consumers' buying preferences.	• The discount offered by such schemes cuts the gross profit on each purchase. • There are administration costs to inform consumers of loyalty points earned and these 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 filling in and posting off a form and this might be a disincentive. • Delay before a refund is received may act as a disincentive.
BOGOF – **'buy one get one free'** – this encourages multiple purchases, which reduces demand for competitors' products too.	• There could be substantial reduction in gross profit margin. • Consumers may consider that if this scheme is able to operate, are they paying a 'normal' price that is too high? • Is the scheme being used to sell off stock that cannot be sold at normal prices – 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 best positions in stores – unless big discounts are offered to retailers.
Public relations – the use of free publicity provided by newspapers, TV and other media to communicate with and achieve understanding of the public.	• This is not easily controllable as some 'free publicity' might not be positive towards the company or its products, e.g. newspaper reviews.
Sponsorship – payment by a company to team owners or event organisers so that the company's name becomes associated with the team or event.	• The success of the sponsorship is largely out of the company's control. If the team loses every match or the event is a failure, this might reflect badly on the sponsor.

Table 4.5.5 Common methods of sales promotion

ACTIVITY 4.5.8

GLOBAL ADVERTISEMENT SPENDING US$503 BILLION IN 2013



Share of global advertisement spend per medium (%)

Global expenditure on advertising increased by 3.5% in 2013 to reach US$503 billion with an increasing proportion spent on internet (digital) advertising. In the USA digital advertising accounted for 21.8% of all advertisements spend in 2013, up from 19% the year before. Meanwhile, mobile advertisements (cell phone advertising) in the USA accounted for 3.7%.

Mobile advertising is growing more rapidly than any other media, growing by 81% in 2013 in the US market. Compare that to internet advertising, which is growing by around 16% and will account for 27.8% of all US advertisements spend by 2015. Globally, mobile advertising is worth $8.3 billion, 1.7% of advertising across all media. 'By 2015 we forecast this total to rise to $33.1 billion, which will be 25.2% of internet expenditure and 6.0% of all expenditure,' the analysts write.

The rapid adoption of smartphones and tablets is driving the growth in mobile advertising. On top of the fact that some believe sales of tablets are set to overtake those of PCs by the end of 2015, for many consumers smartphones are becoming the primary way that they go online.

20 marks, 40 minutes

1. State **two** types of advertising media that are expected to see a fall in their share of advertising expenditure by 2015. [2]
2. Explain **two** reasons why the share of advertising spending on the internet is expected to grow by 2015. [4]
3. Analyse **one** implication for television companies of a decline in their share of advertising expenditure. [4]
4. Evaluate the impact of a rise in the adoption of smartphones and tablets on the promotional strategy of a business. [10]

The promotion mix

The **promotional mix** is part of the wider marketing mix. A successful promotional mix uses a balance of advertising, public relations, sales promotion, direct marketing and personal selling in a planned and structured way. A single 'tool' rarely works well in isolation. There are eight stages in deciding on a promotional mix:

promotion mix: the combination of promotional techniques that a firm uses to communicate the benefits of its products to customers

1. Decide on the image of the product.
2. Develop a profile of the target market.

3. Decide on the messages to communicate.
4. Set an appropriate budget.
5. Decide how the messages should be communicated.
6. Establish how the success of the promotional mix is to be assessed.
7. Undertake the promotional plan and the mix elements of it.
8. Measure its success.

Different stages of a product's life cycle often require variations in the promotional mix. These are outlined in Table 4.5.6.

Exam tip: Do not confuse advertising and sales promotion – they are both forms of promotion, but they are not the same.

Stage of the cycle	Promotional options
Introduction	• Informative advertising and PR to make consumers aware of the product • Sales promotion offering free samples or trial periods to encourage consumers to test the product
Growth	• Focus shifts to 'brand' building and persuasive advertising • Sales promotion to encourage repeat purchases • Attempt to develop brand loyalty
Maturity	• Advertising to emphasise the differences between this product and competitors • Sales promotion incentives to encourage brand development and loyalty
Decline – assuming no extension strategy	• Minimal advertising • Sales promotion – there may be little additional support for the product if the intention is to withdraw it

Table 4.5.6 How promotional mix may vary over the life cycle of a product

internet (online) marketing: refers to advertising and marketing activities that use the internet, email and mobile communications to encourage direct sales via electronic commerce

The impact of changing technology on promotional strategies

It is not an exaggeration to state that the internet is transforming the ways in which businesses market and promote their products.

Promotion using the latest technologies and social media sites – **internet marketing** – can have some significant benefits and limitations. These are examined in Table 4.5.7.

Benefits	Limitations
Improved audience reach – Internet promotion has a global audience and this reduces the unit cost of reaching potential consumers compared to traditional forms of promotion. **Targeted marketing** – Social networking websites give advertisers the ability to target audiences based on site users' personal interests and what their friends like. If a consumer lists rock music as one of their interests on a social networking site, then they will be seeing advertisements about rock concerts and artists. Some sites' advertising will also highlight which rock artists your friends like to provide a personal connection. This is called 'smart' marketing. Companies effectively reach the people who are most interested in what they have to offer. In addition, social networking enables word of mouth to promote products beyond what advertising alone does – and many consumers trust this type of referral more than traditional advertising.	**Lack of skill** – Large businesses will have dedicated teams of people monitoring social media. Small businesses or newly set up enterprises may be led by people who do not have the skills to choose the appropriate social media or engage with customers in the most effective ways. **Time investment** – Setting up a social media account takes less than 30 minutes, but managing a social media account day to day is a time investment many small businesses omit to make. A successful social media campaign counts on almost constant interaction between a company and its customers. This means time has to be set aside each day to post engaging information, ideas and tips and respond to comments left by consumers and followers. Not responding to customers' questions can be damaging to reputation and followers could quickly lose interest.

Table 4.5.7 Benefits and limitations of using latest technologies such as social media for promotion [*table continues over*]

Benefits	Limitations
Interactivity – One benefit of social network marketing is that businesses can interact with potential customers using conversation threads and forums. Engaging customers in conversation makes them more likely to take a deeper interest in your product. **Performance metrics** – Some IT-based promotional services provide feedback and assessment services to their advertisers. With these forms of measurement, businesses can track which type of advertisements are attracting the most web traffic. Also consumer profile and demographic information such as the age of people most interested in the company's product can help direct future promotional efforts. **Speed of transmission** – The speed at which social media transmits news about a business and its products can be an advantage. One well-placed, critical feedback comment can be responded to almost immediately with instant updates. Social networking also gives businesses the ability to notify followers instantly about product updates, new product launches and even product recalls. Live, current content through social media makes business advertising seem dynamic and makes products more attractive, especially to younger consumers.	**Negative feedback** – While it is beneficial for businesses to get feedback from their customers, social media makes the feedback public. If a customer has a bad experience with a product, he or she is likely to share the experience on the social network profile. This could quickly damage the brand's image unless it is responded to quickly and satisfactorily. **Performance metrics** – When a business uses an email marketing program such as MailChimp or ConstantContact, the business can track how many emails are sent, how many people opened the email and the number of sales generated as a result. Social media does not offer the same measurability. Business owners find themselves wondering if it is worth investing time and dedicating human resources. Business owners who want immediate marketing results may have to accept that if they use social media as a tactic, they may not be able to track results until months later. **Security issues** – Not everyone is a fan of social media – either they lack time or they are concerned about security of information issues. Social media cannot, therefore, be the only form of promotion used by businesses if they want to contact the widest range of potential consumers possible.

Table 4.5.7 *Continued*

Viral marketing

This is a recent marketing phenomenon that facilitates and encourages people to pass on a marketing message to others. Viral promotions can be in the form of video clips, interactive flash games, e-books and text messages. It is claimed that a customer tells an average of three people about a product or service he/she likes and 11 people about a product or service which he/she did not like. **Viral marketing** is based on this form of communication. Marketing managers try to identify individuals with high social-networking potential – called 'influencers' – and create viral messages that appeal to them and have a high chance of being passed on to many people who may be impressed that the 'influencer' has contacted them about the product.

viral marketing: the use of social media sites or text messages to increase brand awareness or sell products

ACTIVITY 4.5.9

MARKETING NIKON

Nikon wanted to do something a little different during the recent Warner Music Group's SXSW Music Festival. So rather than just record all of the great musical performances, the company gave cameras to the fans. Selected festival-goers – potential influencers – were given Wi-Fi-enabled cameras to record and take photos of the three-day musical extravaganza, and instantly share them via social media. Music lovers who attend SXSW tend to be ahead of the curve when it comes to music and technology, so they were the perfect influencers to spread awareness of Nikon's great new camera. The live streams of the concerts that Nikon uploaded as part of the campaign were watched for 11 minutes on average – far surpassing the industry average of just two minutes.

The campaign resulted in over 166 million social impressions, thanks in large part to the tweeted photos and videos from concert-goers. Part of the social media goodwill generated for Nikon during SXSW was no doubt because they took a risk and put their new cameras – and their brand's reputation – in the hands of their fans.

The 'I AM Nikon' advertisement campaign was launched in order to achieve the marketing objective of improving market positioning in the compact segment for Nikon. This advertisement campaign was launched with the concept of Nikon camera customers speaking from their perspective. Through this campaign, brand awareness in 12 European countries increased dramatically with a 37% rise in Germany alone. The marketing strategy was based around the idea that the photos people take tell a powerful story about the character that they want to project.

Supermarket distribution and point-of-sale displays were essential to achieving a successful sales increase, so Nikon's marketing agency created a partnership between Hollyoaks characters (a popular TV show in the UK), the supermarket chain Asda and Nikon. Buyers of Hollyoaks-branded cameras distributed in Asda could win a part in the Channel 4 show. Sales of the cameras through Asda increased by 332% over the course of the campaign.

20 marks, 40 minutes

1. Define the term 'marketing objective'. [2]
2. Describe Nikon's marketing objective from the 'I AM Nikon' advertisement campaign. [4]
3. Outline **two** ways Nikon used social media and new technology to promote its products. [4]
4. Evaluate Nikon's decision to use new technology and social media as part of its promotional strategy. [10]

guerrilla marketing: an unconventional way of performing marketing activities on a very low budget

Guerrilla marketing

The original term was coined by Jay Conrad Levinson in his 1984 book *Guerrilla Advertising*. This alternative advertising style relies heavily on unconventional marketing strategy, high impact and imagination. **Guerrilla marketing** is about taking the consumer by surprise, making a memorable impression and creating a social buzz via the new media forms. As it is usually much cheaper than traditional forms of mass advertising or promotion it is said to be particularly relevant for new businesses or small businesses with limited promotion budgets.

Guerrilla marketing is often low cost but effective

The risks of guerrilla marketing

Being unconventional, guerrilla marketing tactics might not be well received by conventional consumers! Perhaps this is why the more extreme guerrilla tactics tend to be reserved for 'edgy youth culture' products, especially those that tend to have many potential consumers using social media frequently. The devices used in 'guerrilla' campaigns could result in misunderstandings with consumers who are not at all expecting the tricks that it usually entails. It is also possible that a promotional event receives lesser attention than expected and develops no meaningful feedback from consumers and fails to achieve the desired brand awareness. However, the event may be successful in getting the attention of a large audience, but the image created could be negative, then it is possible for the tactic to backfire. This is the main reason why marketing managers should make sure that the campaign they develop could convey a positive image about their brand.

ACTIVITY 4.5.10

M&M'S GANGNAM STYLE IN PARIS

Many brands and company advertisement managers tried their best to ride the success of the Korean pop star Psy's hit song 'Gangnam Style', since it became YouTube's most watched video ever. M&M'S was one of them. Five people dressed up as M&M'S characters roamed around the streets of Paris fooling with people, greeting them and dancing in Gangnam Style. This was a very simple street marketing example which turned out to be effective because these five characters managed to interact with people first hand and actually made hundreds of them dance to the Gangnam Style beat.

The video is available on the following link:

Source: www.advergize.com/advertising/13-great-guerrilla-advertising-examples-2013

14 marks, 28 minutes

1. Explain why M&M'S' Gangnam Style in Paris is a form of 'guerrilla marketing'. [4]
2. Evaluate whether guerrilla marketing tactics are likely to be an effective form of promotion for all products. [10]

'Place' decisions in the marketing mix

'Place' decisions are concerned with how products should pass from manufacturer to the final customer. Several different **channels of distribution** are available for firms to use.

channel of distribution: the chain of intermediaries a product passes through from producer to final consumer

The main reasons why the choice of distribution channel is an important element of the marketing mix are:

- Consumers may need easy access to a firm's products to allow them to see and try them before they buy, to make purchasing easy and to allow, if necessary, for the return of goods.
- Manufacturers need outlets for their products that give as wide a market coverage as possible, but with the desired image of the product appropriately promoted.
- Retailers – firms that sell goods to the final consumer – will sell producers' goods but will demand a mark-up to cover their costs and make a profit, so, if price is very important, using few or no intermediaries would be an advantage.

Channel strategy

When deciding on an appropriate channel strategy, a business must answer these questions:

- Should the product be sold directly to consumers?
- Should the product be sold through retailers?
- How long should the channel be (how many intermediaries)?
- Where should the product be made available?

- Should electronic methods of distribution be used?
- How much will it cost to keep the stock of products on store shelves and in channel warehouses?
- How much control does the business want to have over the marketing mix?
- How will the distribution channel selected support the other components of the marketing mix?

Factors influencing choice of distribution channel include the following:

- Industrial products tend to be sold more directly with fewer intermediaries than consumer goods.
- Geographical dispersion of the target market – if the target market is large but widely dispersed throughout the country, then the use of intermediaries is more likely.
- The level of service expected by consumers, e.g. after-sales servicing of a car means that internet selling is not appropriate for most manufacturers.
- Technical complexity of the product, e.g. business computers are sold directly as they require a great deal of technical sales staff know-how and a supporting service team.
- Unit value of the product – it may be worth employing sales staff to sell directly to customers if the unit cost is high. For example, employing sales staff would be worthwhile for selling a luxury yacht worth $5 million, but would not be worthwhile for jewellery being sold for $5.
- Number of potential customers – if the number of potential customers is few, as with commercial aircraft, direct selling might be used, but Nike, Inc. or Reebok with their millions of customers for sports shoes worldwide would use intermediate channels to distribute their products.

Exam tip: Do not confuse 'place' or 'distribution' decisions with transportation methods. Place is about how and where the product is to be sold to a customer; transportation is about how the product is to be physically delivered.

The channel strategy must be integrated with the marketing objectives of the business. For example, if the aim is to secure a niche market with a high-quality image product (e.g. branded cosmetics), then selling it through street vendors will not achieve this objective. If, however, the marketing aim is to achieve maximum sales and distribution coverage (e.g. sweets), then selling through a few carefully selected and exclusive food retailers will not be successful. As with all components of the marketing mix, distribution channel strategy must be clearly linked to marketing objectives and to the other components of the mix for an effective and convincing overall marketing strategy to be developed.

Distribution channels

The most commonly used distribution channels are shown in Figures 4.5.6–4.5.8. Figure 4.5.6 shows the direct route which gives the producer full control over marketing of products. This is sometimes known as direct selling or direct marketing. The growth of the internet has led to a rapid rise in the popularity of this channel of distribution.

With the increasing size of many modern retailers, the 'single-intermediary channel' depicted in Figure 4.5.7 is becoming more common. These huge retailers have great purchasing power. They are able to arrange their own storage and distribution systems to individual stores.

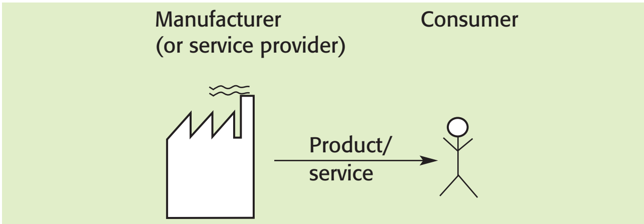


Figure 4.5.6 Direct selling to consumer

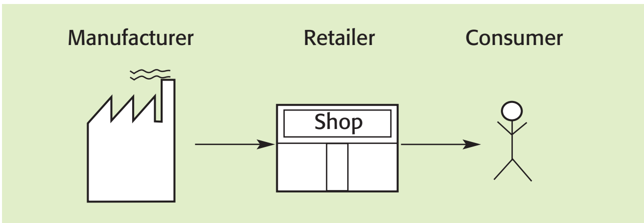


Figure 4.5.7 Single-intermediary channel

In Figure 4.5.8 we see what is often known as the traditional two-intermediaries channel as, until recent developments in retailing and the internet, it was the most common of all channels of distribution.

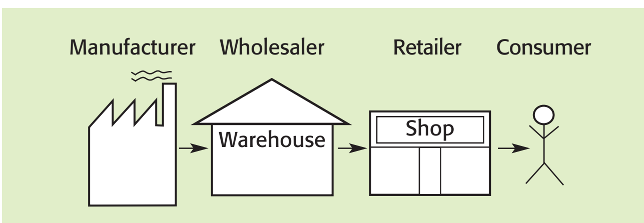


Figure 4.5.8 Two-intermediaries channel

H

Effectiveness of distribution channels

See Table 4.5.8 for the benefits and limitations of distribution channels.

Appropriate distribution channels

Recent trends in distribution channels in recent years include:

- The increased use of the internet for direct selling of goods and services. In the service sector this can be seen with internet banking and direct selling of insurance policies online.
- Large supermarket chains perform the function of wholesalers as well as retailers, as they hold large stocks in their own central warehouses. By owning another link in the distribution chain, the business is engaging in vertical marketing.
- Businesses are increasingly using a variety of different channels – for example, an ice-cream manufacturer may have its own ice-cream vans to sell directly to consumers as well as supplying retailers. Hotels may sell room accommodation directly as well as through travel **agents** and holiday companies.
- There is increasing integration of services where a complete package is sold to consumers – for example, air flights, car hire, hotel accommodation all sold or distributed to consumers at the same time.

agent: a business with the authority to act on behalf of another firm, e.g. to market its products

Type and main features	Examples of products or services often using this channel	Possible benefits	Possible drawbacks
Direct selling: no intermediaries – sometimes referred to as 'zero intermediary' channel	• Mail order from manufacturer • Airline tickets and hotel accommodation sold over the internet by the service providers • Farmers' markets – selling produce directly to consumers	• No intermediaries so no mark-up or profit margin taken by other businesses • Producer has complete control over the marketing mix – how the product is sold, promoted and priced to consumers • Quicker than other channels • May lead to fresher food products • Direct contact with consumers offers useful market research	• All storage and stock costs have to be paid for by producer • No retail outlets limits the chances for consumers to 'see and try' before they buy • May not be convenient for consumer • No advertising or promotion paid for by intermediaries and no after-sales service offered by shops • Can be expensive to deliver each item sold to consumers
Single-intermediary channel – usually used for consumer goods but could also be an agent for selling industrial products to businesses	• Holiday companies selling holidays via travel agents • Large supermarkets that hold their own stocks rather than using wholesalers • Where the whole country can be reached using the one-level route, e.g. a single agent in a small country	• Retailer holds stocks and pays for cost of this • Retailer has product displays and offers after-sales service • Retailers often in locations that are convenient to consumers • Producers can focus on production – not on selling the products to consumers	• Intermediary takes a profit mark-up and this could make the product more expensive to final consumers • Producers lose some control over marketing mix • Retailers may sell products from competitors too, so there is no exclusive outlet • Producer has delivery costs to retailer
Two-intermediaries channel – wholesaler buys goods from producer and sells to retailer	• In a large country with great distances to each retailer, many consumer goods are distributed this way, e.g. soft drinks, electrical goods and books	• Wholesaler holds goods and buys in bulk from producer • Reduces stock-holding costs of producer • Wholesaler pays for transport costs to retailer • Wholesaler 'breaks bulk' by buying in large quantities and selling to retailers in small quantities • May be the best way to enter foreign markets where producer has no direct contact with retailers	• Another intermediary takes a profit mark-up – may make final goods more expensive to consumer • Producer loses further control over marketing mix • Slows down the distribution chain

Table 4.5.8 Distribution channels – main benefits and potential limitations

LEARNER PROFILE

Principled/caring

You only have to look at the marketing mix of a major fast-food chain to see why they are successful. The product tastes good – it really does. You would need to be a top food scientist to explain why burgers, chicken nuggets and deep-fried chicken is just so delicious. And it's cheap. A family of four can eat out at a burger restaurant for not much more than they could eat a similar meal at home. If you go to any high street, shopping centre, motorway service station you are going to see plenty of those iconic KFCs, giant Ms and BKs. The fast-food majors get everywhere – you even get them in hospitals! Finally, they are brilliant at telling us how good they are. McDonald's, for example, promote themselves like no-one else: toys linked to Hollywood blockbuster films, scratch cards, mobile banner advertisements on websites, product placement in top rating TV programmes, the list is endless.

The success of the marketing mix applied by businesses in the fast-food industry raises interesting ethical questions when you relate it to an obesity crisis in so many countries.

Discuss this question in your class: As a principled, caring IB student could you work for a fast-food business?

ACTIVITY 4.5.11

WHY THE MARKETING MIX MUST BE INTEGRATED

Here are four examples of marketing-mix decisions:

	Product	Price	Place	Promotion
Mix A	Six-year-old design of family car made in low-wage-cost country – few additional extras or features	Skimming strategy to try to develop exclusive image	Car showrooms in town centre with personal selling by experienced sales staff	Advertised in high-income segment magazines only
Mix B	Range of furniture for mid-income families with unique, modern designs	Low – low prices to be set below competitors' to establish high market share	Sold over the internet and in some well-known department stores	Advertised on TV at times of most popular programmes
Mix C	Ladies' fashion hairdressing salon with cutting by well-known stylists	High prices to create top market image	Salon located in out-of-town shopping centre	Advertised in fashion and beauty magazines
Mix D	High-technology computer games with advanced interactivity functions	Skimming price strategy	Sold exclusively through the internet	Advertised on commercial radio stations at times most likely to be heard by young listeners

1. In each case, identify which marketing-mix decision is not integrated with the other decisions.
2. In each case, recommend a change to one of the marketing decisions to create an integrated mix. Explain and justify your recommendations.

OVER TO YOU

Revision checklist

1. Identify different products which could be classified into the stages of a typical product life cycle.
2. Explain **one** use of the product life cycle to a car manufacturer.
3. Explain the links between a product life cycle, investment and cash flows.
4. Explain **one** use of the Boston Consulting Group matrix to a multi-product firm of your choice.

5. Differentiate, with examples, between brands and products.
6. Explain why environmental concerns might impact on the packaging decisions made by a business.
7. State **two** reasons why the pricing decision is such an important one.
8. Why should pricing decisions not be taken in isolation to other marketing-mix decisions?
9. Define 'cost-plus pricing'.
10. Differentiate between skimming pricing strategies and penetration pricing strategies.
11. Explain **one** situation in which psychological pricing would seem to be more appropriate than cost-plus pricing.
12. What do you understand by 'price discrimination'?
13. Under what circumstances would it seem to be relevant to use a loss-leader strategy?
14. How could variations in the price of a product be used to extend its life cycle?
15. Explain the differences between advertising and sales promotion.
16. State **three** reasons why a business might advertise an existing product.
17. Explain **one** example of how a sports-shoe manufacturer might use both above- and below-the-line promotions to support the launch of a new product.
18. Outline **three** reasons why spending more money on advertising might fail to increase sales to the expected level.
19. State **three** ways, other than an increase in sales, that a business might use to assess the effectiveness of a promotional campaign.
20. How can promotion be used to extend a product's life cycle?
21. Explain why promotion via social media is likely to become much more important in future.
22. Outline **two** functions performed by wholesalers in a traditional channel of distribution.
23. Compare the promotional mix of two large stores in your area. Consider advertising, sales promotions, own-branded goods and public relations. Analyse the differences between the two promotional mixes and suggest how effective they might be in attracting customers to the stores.
24. Suggest **two** channels of distribution that could be used by a manufacturer of mountain bikes. Compare the advantages to the business and consumers of these two channels.

Exam practice question

APPLE OPENS MORE OF ITS OWN STORES

Apple has announced plans to open more of its own branded stores in the USA and China as it continues to develop this distribution channel. Just a few years ago, the Silicon Valley company, famous for the first popular personal computer in the 1970s and more recently the iPad Air, always relied on other retailers and its website to sell its ever-growing range of products. The new retail stores are likely to be well received by consumers if recent reports from London and New York are any guide. They will be supported by a varied promotional mix including extensive use of social media.

Some business analysts believe that Apple runs a real risk of coming into conflict with its existing retail partners – including the US chain CompUSA. 'Why should other retail stores bother to sell and promote Apple products if the company is going to compete directly with them on the high street?' said one investment specialist. There are also fears that Apple could fall into the same trap as Gateway, another PC maker focused on the consumer market. Gateway had to close about 40% of its North American stores, saying it had over-extended itself at a time of slowing sales of PCs. Apple is investing heavily in property and there is always the risk of stock build-up at a time of slower world economic growth. Apple plans to open its two new stores in high-profile shopping centres near Las Vegas in the USA and in the Chaoyang district of China. Apart from selling the usual Apple products – computers, iPads, Apple TV and the like – the main draw in the shops will be the Genius Bar – a counter where shoppers will find several highly trained Mac Geniuses ready to advise on any technical questions. There will be a hands-on Apple Retail Store Experience giving consumers the chance to test-drive Apple's entire product mix. The stores will also run a series of daily creative workshops to teach customers how to make the most of the programs available.

20 marks, 40 minutes

1. Define the term 'distribution channel'. [2]
2. Explain **two** reasons why Apple might want to open more of its own stores as part of its distribution strategy. [4]
3. Analyse **two** effects on existing retailers of Apple products of the opening of new Apple stores. [4]
4. Evaluate the importance of distribution as part of Apple's overall marketing strategy. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, examine what changes innovation brings about in the management of marketing mix. [20]

4.6

H

The extended marketing mix of seven Ps

On completing this chapter you should be able to:

Analyse and apply:

- The seven Ps model in a service-based market (AO2)

Evaluate:

- The importance of people and employee–customer relationships in marketing (AO3)
- The importance of delivery processes in marketing (AO3)
- The importance of tangible physical evidence in marketing (AO3)

Setting the scene

EE IMPROVES CUSTOMER SERVICE

EE, the UK's biggest mobile operator, is bringing 1000 call-centre jobs back onshore to solve the complicated smartphone and tablet problems customers are increasingly having. EE's call centres in South Africa and the Philippines will be scaled back or closed. Simple transactions will still be handled by cheaper overseas customer-services employees.

Mr Swantee, CEO of EE, said: 'Within 18 months, I want to be able to say that EE has done for customer service in the UK what it has done for networks. UK call centres' performance has been shown to exceed that of overseas contact centres.'

One possible reason for this has been the people employed in the UK centres. They have been, according to customer feedback, able to give a higher standard of customer service in response to technical enquiries than their colleagues abroad. EE is receiving more complicated queries about smartphone and tablet software that require more guidance to resolve. By increasing its investment in UK employees, EE believes it can increase customer loyalty. It could also introduce subscription plans with tiered levels of customer service.

EE plans to open a further 50 retail outlets as part of efforts to increase the proportion of its customers who buy direct rather than through third parties such as Carphone Warehouse and Phones 4U. Vodafone and Three are pursuing similar strategies: all these companies believe that direct employee–customer contact is essential to help build long-term relationships.

Points to consider

- In the mobile phone market, why is customer service important?
- How can EE justify the higher cost of UK-based customer call centres?
- Why is customer feedback important for improving the service a business offers?

Key concept link

Customer-focused marketing strategies are still not universal but failing to offer the level of service that customers expect is increasingly important in competitive globalised markets. Service-oriented businesses in particular, which do not offer a tangible product, have to create a culture of customer service throughout the business to differentiate their offer to customers.

Introduction

Chapter 4.5 explained the importance of integrating the four Ps into a cohesive and coordinated marketing mix. Most marketing managers now recognise that the traditional four Ps approach is rather limiting and that there are three other factors – making seven Ps – that must be considered important when devising an appropriate marketing mix. These additional three Ps are: people, process and physical evidence.

Marketing mix – people

Why people?

This element of the marketing mix refers to the employees and managers of a business and how they relate to customers and communicate with them. The people employed by a business – especially service businesses where customers cannot judge a company by the attributes of physical products – can either give it a competitive advantage *or* can lead to poor customer reaction and disloyal consumers. Poor customer experiences can soon be posted on social media and then the whole world knows about it!

Customers make judgments about service provision and delivery based on the people representing the organisation. This is because people are one of the few elements of the service that customers can see and interact with. The praise received by the volunteers ('Games Makers') for the London 2012 Olympics and Paralympics demonstrates the powerful effect people can create during the delivery of a service.

People online

Even online retailers must think about their 'people'. When they employ people who genuinely believe in the products or services that the online business sells then it is much more likely that they will perform the best that they can. In addition, they are more likely to give managers honest feedback and input into the types of products the business is producing and selling.

Getting good people

Well-trained, confident and well-motivated employees who deal with customers in an efficient, speedy manner also help to create customer loyalty – and it is always much cheaper to keep existing customers than to find and attract new ones. Employees require appropriate interpersonal skills and training, an aptitude for dealing with people, and service knowledge in order to deliver a quality service.

In his best-selling book, *Good to Great*, Jim Collins claimed that the most important factor applied by the best companies was that they first of all 'got the right people on the bus, and the wrong people off the bus'. Once these companies had hired the right people, the second step was to 'get the right people in the right seats on the bus'.

Managers need to plan carefully exactly who is going to carry out each task and responsibility. An important part of any business is having the right people to support the company's products and/or service. Excellent customer-service personnel who can provide support with clearly known expectations, such as hours of operation and average response time, is key to maintaining a high level of customer satisfaction.

ACTIVITY 4.6.1

APPLE EMPLOYEE TRAINING

Business analysts claim that Apple has reinvented the customer experience to help it become the USA's most profitable retailer. Retail store employees are trained in the following five stages of customer service:

Approach customers with a personalised and warm greeting

Probe politely to understand the customer's needs

Present a solution for the customer to take home today (i.e. an Apple product!)

Listen for and resolve any issues or concerns

End with a fond farewell and an invitation to return.

12 marks, 24 minutes

1. Explain **one** reason why people are important to retailers. [4]
2. Outline the method Apple has used to get the best from its people in a retail environment. [4]
3. Analyse **one** other way Apple could improve the performance of its people in a retail environment. [4]

THEORY OF KNOWLEDGE

So how does Amazon rank one in customer service?

The digital age has forced the evolution of customer service. In a world where emails and texts have replaced more intimate forms of communication, where shoppers can complete a sale 24/7 via online transactions, and where showrooming is linking the physical shopping experience with the virtual, the modern definition of customer service seems to have downgraded the importance of direct human interaction.

As the world's largest online retailer, Amazon has been a driving force behind the e-commerce movement and changing standards for customer-service excellence. Some of the words consumers used in their reasons to nominate Amazon for Customers' Choice included 'efficient', 'fast', 'reliable', 'no hassle', 'easy' and of course, 'free shipping'. Note that these terms differ vastly from traditional customer service: 'experience', 'friendly', 'personal' and 'knowledgeable'.

Consider the factors that consumers have given for making Amazon the number one in customer service. To what extent has emotion been replaced by reason in customer service?

Marketing mix – process

Why process?

The sixth factor to consider within the marketing mix is the system used to deliver the goods or services – the **process**. What processes has McDonald's put in place if a customer walks into one of its restaurants, orders a Big Mac Meal and it is delivered within two minutes? What were the stages in the process that allowed the customer to obtain this service delivery? Could it be made even more speedy? The speed and efficiency of service delivery are determined by the 'process' that has been put in place.

process: procedures and policies that are put in place to provide the service or the product to the consumer

Banks that send out debit cards automatically when their customers' old one has expired require an efficient process to identify expiry dates and renewal. An efficient service that replaces out-of-date debit cards will be likely to create consumer loyalty and confidence in the company. All services need to be underpinned by clearly defined and efficient processes. This will avoid delays in providing the service and promote a consistent customer experience. In other words, processes mean that everybody in the organisation knows what to do and how to do it.

Short waiting times, quality information given to customers and the helpfulness and knowledge of employees are all expectations of customers that should be met if the process is effective and well tested.

The importance of changing process

Processes must change for businesses to remain competitive. Online shopping offers customers a much quicker and more convenient ordering/payment/delivery process than traditional retail shopping. If a business selling goods did not embrace this technology then its processes would seem outdated.

The rapid growth of internet and 'mobile' banking have allowed customers access to their accounts and banking services 24/7. The use of mobile phones to make cashless payments is helping to transform commerce in less developed economies that have relatively poor physical infrastructure. Banks or financial service providers that failed to adopt these technologically advanced processes will not attract customers – perhaps younger customers, in particular – who are demanding changing processes to fit in with their lifestyles and expectations.

ACTIVITY 4.6.2

NON-US CUSTOMERS KEPT IN DARK AS ZAPPOS CLEANS UP AFTER DATA BREACH

When online shoe and apparel shop Zappos.com advised over 24 million customers to change their passwords following a data breach, its website was inaccessible to people outside the US.

Zappos employees received an email from CEO Tony Hsieh, alerting them about a security breach that involved the online shop's customer database.

'We were recently the victim of a cyber attack by a criminal who gained access to parts of our internal network and systems through one of our servers in Kentucky. We are cooperating with law enforcement to undergo an exhaustive investigation,' Hsieh said in the email.

Hsieh revealed that the attacker had accessed customer records including names; email, billing and shipping addresses; phone numbers, and the last four digits of their credit card numbers.

The hacker also gained access to password hashes for the accounts registered on the website, prompting the company to reset everyone's access codes. Zappos is currently in the process of emailing its 24 million customers in order to notify them about the security breach and advise them to change their passwords.

Non-US residents could not access most of Zappos' website, leaving them unable to follow important instructions. 'We are currently undergoing some system maintenance that has limited our international customers in accessing our website,' the company said via Twitter.

Source: Computerworld Online

10 marks, 20 minutes

1. Define the term 'process'. [2]

2. Explain why process is important to online retailers like Zappos. [4]

3. Analyse **one** problem for Zappos following the data breach. [4]

Physical evidence

Why physical evidence?

This element of the mix was defined by Booms and Bitner (1981) as *'the environment in which the service is delivered and where the firm and customer interact, and any tangible components that facilitate performance or communication of the service'*.

This refers to the way the business's goods or service 'appears from the outside'. **Physical evidence** includes where the service is being delivered from, such as the location, and the appearance and state of repair/decoration of retail shops. This element of the marketing mix can help distinguish a company from its competitors. Physical evidence can be used to support the charging of a premium price for a service and establish a positive customer experience. For example, all hotels provide a bed to sleep in but one of the things affecting the price charged is the condition of the room containing the bed. Customers will make judgments about the organisation based on the physical evidence.

physical evidence: the ways in which the business and its products are presented to customers

Physical evidence – examples

Customers who walk into a restaurant expect a clean and friendly environment; if the restaurant is smelly or dirty, customers are likely to walk out. This is before they have even ordered or received the service. Physical evidence can also refer to the appearance of employees and how they dress and act. If the waiting staff in the restaurant appear unclean or dishevelled, this will not inspire customer confidence!

Services are examples of **intangible products** as they provide a benefit to the customer but they do not have a physical form. With **tangible products**, the packaging is a key part of physical evidence. Decisions need to be made about the size, shape, colour, material, printed information for customers, barcode and label of the packaging. This should be customer-tested and updated when needed. Visual packaging of a tangible product can make or break a purchase. Small improvements in the packaging or external appearance of a product or service can lead to completely different reactions from customers.

intangible products: a non-physical product – a service – provided to a consumer such as an insurance policy or a car repair

tangible products: a physical object that can be touched such as a building, car, tablet computer, or clothing

Physical evidence – consistency with other elements of the mix

It is important that the physical environment is consistent with the other elements of the marketing mix. For example, it is difficult to justify a high-quality restaurant status that has excellent food, a strong positive brand image and a price to match if the premises themselves are of poor quality.

To the customer or potential customer, the physical environment has to feel right and be in line with their expectations. Customers have expectations of an airline when a ticket is booked based on other aspects of the marketing mix – for example, price, promotional activities and the route and timings being offered. However, customer expectations of the physical environment may well differ depending upon which airline the booking is with. Customers may be prepared to accept an aircraft that is perhaps in need of some internal refurbishment if booked with a budget airline. They would be less understanding if they had paid a higher price to book with a prestigious airline. This is another example of where the physical environment is inconsistent with other aspects of the marketing mix, leading to customer dissatisfaction.

Customers use other senses apart from sight to make judgements about the physical environment they find themselves in. The smell of freshly baked bread is now a common feature of supermarkets and this helps to convince customers that food is freshly prepared for them. Similarly, customers expect to smell food in a food establishment not cleaning products. Company vehicles are another example of physical evidence that customers take note of. UPS courier vans are, generally, cleaned daily – does this help to inspire customer confidence in the professionalism of the service the company offers?

ACTIVITY 4.6.3

CARREFOUR: CUSTOMER-DRIVEN RENOVATIONS

Carrefour is renovating its supermarkets and the car parks attached to them to reflect the needs expressed by its customers. Customers are surveyed before each renovation so that they can share their opinions about the access facilities, car park, quality and appearance of the shopping centre, department layout in the store, the product mix, and checkout procedure. Here is an example of what has been accomplished, at Saint-Quentin-en-Yvelines hypermarket in France:

- Refurbishment of the buildings and infrastructure by repainting and restoring the floor, ceilings, car parks, facades, restrooms, flooring and electrical equipment so that customers enjoy a flawless shopping experience
- Reorganisation of the store around identifiable sections, including attractive and appealing visuals, to feature organic and gourmet foods, clothing, multimedia, home and paper goods, etc.
- Revised layout of a 'marketplace' to give customers an overview of the diverse range of fresh produce, with stalls brimming over with local and seasonal goods, samples for tasting, and professionals (bakers, butchers, cheesemongers, fishmongers, etc.) preparing products on site. This helps accentuate Carrefour's points of difference from its rivals: a dynamic offer, a market atmosphere, fair prices, and high-quality products.

Source: www.carrefour.com

14 marks, 28 minutes

1. Explain what 'physical evidence' means in Carrefour's marketing mix. [4]
2. Compare and contrast 'physical evidence' with the 'people' and 'process' elements of Carrefour's marketing mix. [10]

Customers expect supermarkets to be clean, convenient and attractive

Seven Ps model in a service-based market

The crucial importance of the additional three Ps to a service-based business has already been explained. The combined seven Ps marketing mix now forms the overall strategy that a service-based business will adopt to win and keep customers. Each element of the mix must be integrated with all other elements to ensure a consistent image of the business and its services. For example, there will be considerable customer confusion if they are charged high prices for what they are told is 'the best and fastest internet service available' if they find it almost impossible to communicate with the business through its own website.

ACTIVITY 4.6.4

BRITISH AIRWAYS (BA)

BA is not the lowest-price operator for many of the routes it flies on but it aims to offer the best customer service. It has a modern fleet of aircraft, an excellent safety record and a network of routes that is one of the most extensive in the industry. Tickets can be purchased through a variety of channels. Promotion is based around the famous strapline of 'To fly. To serve' and includes TV advertising and paper-based adverts in prestigious magazines and quality newspapers. This image is further promoted by web-based promotion: toflytoserve.britishairways.com.

BA reported an increase in both passenger numbers and overall profitability in 2013.

10 marks, 20 minutes

Examine the importance of people, physical evidence and process to British Airways' marketing strategy. [10]

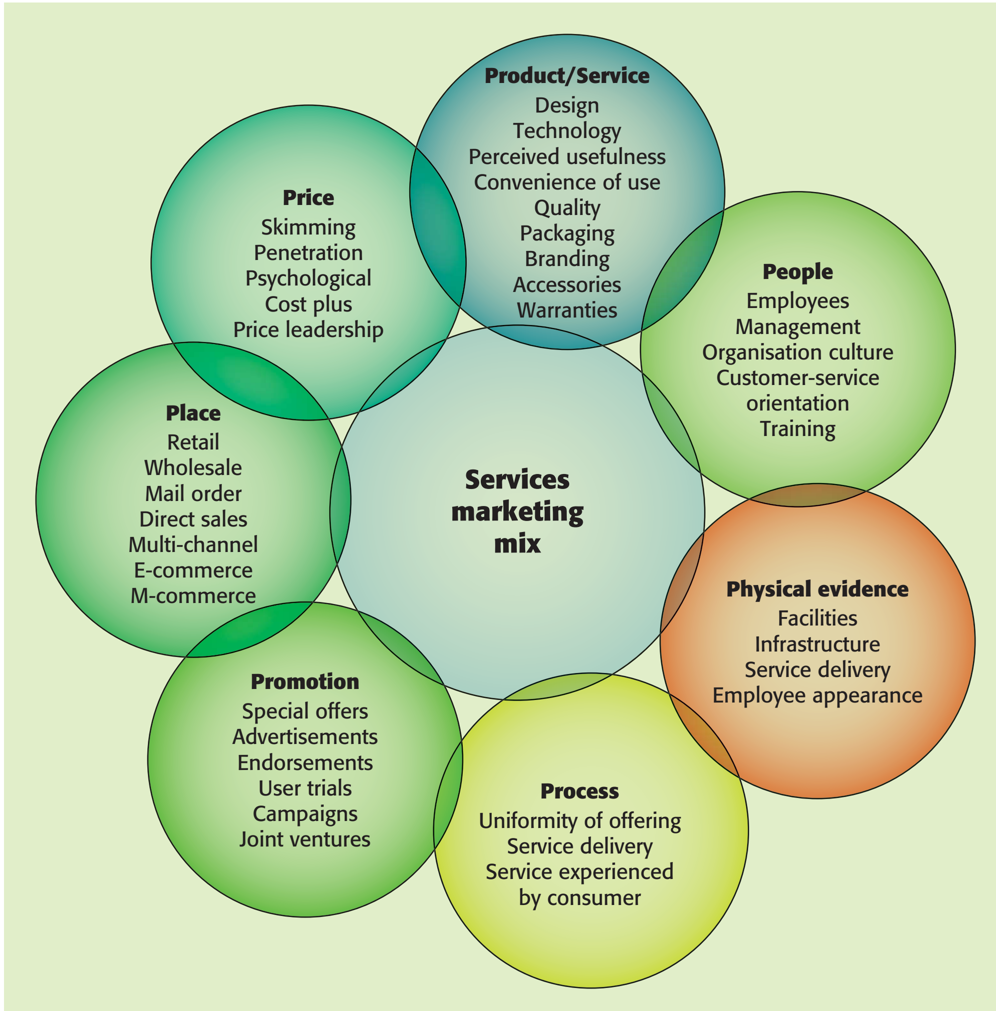


Figure 4.6.1: Services marketing mix

LEARNER PROFILE

Open-minded

Your Malaysian-based business has just entered into a joint venture with an American coffee-shop business. Your business is going to open five outlets in Kuala Lumpur. You see this as a fantastic business opportunity to exploit a growing trend amongst Malaysians for the American-style coffee shop. There are, however, significant challenges for your business in working with the American multinational. The American approach to the people, process and physical evidence aspects of running a coffee shop is at odds with the Malaysian approach in a number of different ways.

Research some of the cultural differences that might exist between the USA and Malaysia which could affect the extended marketing mix of a coffee shop.

In your class discuss the need for managers to be open-minded in their approach to joint ventures between businesses from different countries.

OVER TO YOU

Revision checklist

1. Explain what is meant by the 'people' element of the marketing mix.
2. Explain what is meant by the 'process' element of the marketing mix.
3. Explain what is meant by the 'physical evidence' element of the marketing mix.
4. Explain why the additional three Ps are so important to service-based businesses.
5. Explain why it is important for all seven elements of the extended marketing mix to be fully integrated.

Exam practice question

UGG – THE SEVEN Ps MIX

The origin of UGG in Australia lies in the wide-open beaches of Byron Bay – a surfers' paradise. Surfers looked for ways to keep their feet dry and warm – and handmade sheepskin boots offered natural warmth and comfort. The foundation was laid for a marketing phenomenon as the global brand now has sales of over US$1 billion.

The UGG boot is now globally well known; the promotion focuses on celebrity endorsements and prices are high to reflect the image of the brand. UGG offers online, premium outlets and, increasingly, its own stores as places for customers to purchase just UGG products. These products include more than just boots as there are now UGG men's footwear products and even a range of bridal shoes called 'I Do'!

The shift towards increasing its retail operation means that UGG has put more emphasis on the extended marketing mix such as physical evidence. In its shops it has tried to match the fun-loving, free-wheeling image of its brand and its customers. Stores are in high-street locations with a welcoming exterior. Inside, the layout is spacious, light and colourful with quality fittings and furniture. There is ample seating to allow customers and their partners to relax as they try UGG products on for size.

In line with its retail expansion, UGG has upgraded its IT platform to improve the ordering and delivery process. The new software will gather sales, stock and orders in a single system, collecting data from the point of sale. From a customer-service perspective this means that orders can be filled more quickly and a closer relationship established.

20 marks, 40 minutes

1. Define the term 'extended marketing mix'. [2]
2. Suggest **two** ways UGG uses physical evidence as part of its extended marketing mix. [4]
3. Explain how UGG has improved its process as part of its retail marketing strategy. [4]
4. Evaluate the importance of the people element of the extended marketing mix to the success of UGG's retail outlets. [10]

Key concept question

20 marks, 40 minutes

With reference to two organisations that you have studied, discuss how the extended marketing mix may differ in two cultures that you are familiar with. [20]

4.7

H

International marketing

On completing this chapter you should be able to:

Analyse and apply:

- Methods of entry into international markets (AO2)

Evaluate:

- Opportunities and threats posed by entry into international markets (AO3)
- Strategic and operational implications of international marketing (AO3)
- Role of cultural differences in international marketing (AO3)
- Implications of globalisation on international marketing (AO3)

Setting the scene

IKEA EXPANDS IN CHINA

Since being set up in Sweden in 1943, IKEA has grown to become the world's largest furniture retailer with 310 stores. The company's latest plans include the opening of two huge shopping centres in China – one in Beijing and one in Wuxi City. These will take the total number of IKEA stores worldwide to over 310. The products sold in each of these stores are remarkably similar. IKEA has largely ignored the retailing 'rule' that international success involves tailoring product lines to match national tastes and consumer preferences. The founder of the company – Ingvar Kamprad – had the vision that stores should sell a product range that is 'typically Swedish'. This has led to substantial cost benefits (huge production runs of identical products lead to economies of scale), which have helped to cancel out the high transport costs that international furniture retailers experience. The largely product-oriented company sells largely 'flat-pack' furniture that has to be assembled at home, further reducing the cost of supplying to stores around the globe.

Some consumers object to the standardised product formula. IKEA did have to make some product design changes in the highly competitive US market where furniture such as beds and wardrobes tend to be larger than average. The company recognises that in China, it only seems to appeal to middle-class consumers and that there are other market-segment opportunities. Apart from its out-of-town shops, IKEA also has a highly developed internet-selling division with an advanced website. This accounts for a small – but increasing – proportion of total sales.

Points to consider

- Outline likely reasons why IKEA is planning expansion in China.
- What advantages and disadvantages might IKEA have from using the same marketing strategy (e.g. product ranges and low prices) in all the countries in which it operates?
- Examine whether IKEA stores could one day be entirely replaced by internet sales (e-commerce).

Key concept link

Globalisation has had many effects on business activity, none greater than the impact on marketing strategies. Even small businesses have opportunities to sell in international markets – aided by e-commerce – and many larger businesses' success and growth depends on selling in international markets. Different marketing strategies are possible when entering foreign markets and when promoting products to adapt to national cultural differences.

Introduction

Selling in foreign markets was once too risky and expensive for most firms, so only large businesses that were growing too large for their national markets used this form of **international marketing**. Improved communications, access to e-commerce, better transport links and freer international trade – all key features of **globalisation** – have changed all this. For many businesses, international marketing is now an opportunity to profitably expand their sales, and indeed for some companies it is no longer an option but a necessity.

international marketing: selling products in markets other than the original domestic market

globalisation: the growing trend towards worldwide markets in products, capital and labour, unrestricted by national barriers

Methods of entry into international markets

Once a decision has been taken by senior management to start selling products in international markets, further decisions have to be made. One of the most important is 'How should the business enter the international markets?'

Exam tip: When discussing international marketing there should be opportunities to make reference to the many cultural differences between national markets that you should be aware of from your studies.

Exporting

Exporting can be undertaken either by selling the product directly to a foreign customer – perhaps the order has been placed via the company website – or indirectly through an export intermediary, such as an agent or trading company based in the country.

International franchising

International franchising means that foreign franchisees are used to operate a firm's activities abroad. This can take the form of either one foreign company being used as a franchisee for *all* the branches in their own country or individual franchisees being appointed to operate each outlet. McDonald's uses just one franchisee business to operate its branches in Argentina, for example.

Joint ventures

These are agreements between at least two companies to own and operate a new business venture. An example of 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 involves the business allowing another firm in the country being entered to produce its branded goods or patented products under licence, which will involve strictly controlled terms over quality. This means that goods do not have to be physically exported, saving on time and transport costs – and making food products fresher too.

The parent firm avoids the capital cost of setting up its own operating bases abroad. The limitations of this approach include quality issues and unethical production methods being used by the licensee to cut costs, reflecting badly on the business offering the licence.

Direct investment in subsidiaries

Studies have shown that setting up company-owned subsidiaries in foreign countries can achieve higher success rates than taking over or merging with locally based companies.

The business cultures, organisational structures and technology differences between the company and the locally acquired business can often present obstacles too great to be overcome. Subsidiaries can be factories set up in foreign countries, as with Toyota in the EU and South America, or retailing operations, as with 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.

Method	Advantages	Disadvantages
Direct exporting	• Selling directly via e-commerce has the same benefits as all online selling – see chapter 4.8 • Profit is not 'shared' with another business unless an agent in the importing country is used to promote/distribute the products • Complete control of marketing strategy rests with the exporting business	• No knowledge gains from businesses/partners based in international markets • Exporting business bears all the risks • May be import tariffs imposed by governments to protect markets for products produced nationally
International franchising	• Using franchisees based 'in country' gives each franchised unit local knowledge • Franchisees contribute to the capital cost by purchasing a franchise licence • Some operational issues are now the responsibility of the local franchisee	• Some loss of centralised control • Careful selection of each franchisee is essential as damage to business brand name in one country could spread globally
Joint ventures	• Venture partner is likely to be based in the international market being targeted so local knowledge will be obtained – customs, laws, culture, etc. • Capital injection will be shared • Management responsibilities and risk will be shared • May be the only means of entering some markets if governments insist on 'local partners'	• Management problems due to clash of business cultures or personalities • Profits will be shared • Local partner needs to be chosen carefully to avoid risk of fraudulent operations • Loss of complete control of operations and marketing strategy
Licensing	• Reduces capital costs of setting up own operations • Licensee will benefit from local knowledge	• Loss of control over quality and marketing strategy • Profit margin may be reduced compared to maintaining complete control and eliminating a third part in the production/marketing of products
Direct investment in subsidiaries	• Gives complete control over the operations of the subsidiary • Local subsidiary will have managers with local knowledge • Existing operations will allow quicker entry to the market than setting up new facilities	• Culture clash is possible between the parent company and the management of the subsidiary • May be strict local laws regarding takeovers and retrenchment of local employees • Valuation of foreign subsidiaries may be difficult – parent company must avoid 'overpaying' for local knowledge and existing facilities

Table 4.7.1 Advantages and limitations of international-market entry methods

ACTIVITY 4.7.1

THE FRANCHISING PATH TO INTERNATIONAL MARKETING

Dunkin' Donuts, a US-based coffee and baked-goods franchise, has opened its 50th United Arab Emirates (UAE) store. Continental Foods is the UAE-based business that owns the master franchise for Dunkin' Donuts in this country. Michael Cortelletti, Dunkin' Donuts' International Director for the Middle East, said, 'UAE is an important growth market for the brand and has seen groundbreaking innovation, such as the opening of the first drive-through.'

Cartridge World, the ink-cartridge-filling business, founded in South Australia in 1988, is set to continue its Asian expansion. It already has franchised outlets through AFL Pvt. Ltd, the leading logistics, cargo and courier company. This company is the master franchisee for Cartridge World in India, Sri Lanka, Nepal, Bangladesh, Bhutan and Maldives. Without the rapid growth offered by franchising and the local market expertise offered by local franchisees, the business would not have been able to grow to over 1500 branches in 36 countries so rapidly.

Yogen Früz, a Canada-based frozen yoghurt chain, has signed franchise deals for Argentina and Peru with Fruzco Chile SA. This company already owns and operates Yogen Früz franchises in Chile. Argentina has one of the fastest-growing economies in South America and has a high GDP per head. The president of Yogen Früz said, 'We needed a locally based company with experience of the region to introduce our brands in these other countries.' Yogen Früz does not have to pay the high capital costs of setting up its own subsidiaries in these other countries.

Source: Adapted from Franchise International

20 marks, 40 minutes

1. Define the term 'franchise'. [2]
2. Explain **one** benefit to a business of franchising as a method of entering an international market. [4]
3. Outline **two** other methods a business could use to enter an international market. [4]
4. Assess the opportunities and threats to Yogen Früz, Dunkin' Donuts and Cartridge World of entering international markets. [10]

A Dunkin' Donuts franchise in China

Opportunities and threats posed by entry into international markets

Deciding to market products internationally has potential rewards in terms of higher sales and profit but also carries considerable risk. Table 4.7.2 explains these opportunities and threats.

Opportunities	Threats
• Develop marketing operations in expanding markets when the domestic market is saturated/mature – in 2014 sales of cars in France increased by just 1% but in China by 8.8%. • Potential to increase profits through rapid sales growth and low costs in emerging markets. The average GDP growth rate of the BRIC countries (Brazil, Russia, India and China) has been over two times greater than the growth of developed economies in the last decade. • Spreading risks between different markets at different stages of the economic cycle – selling luxury products in Cyprus in 2013, where GDP fell by 8%, was more challenging than in Kazakhstan and Kenya, both of which recorded growth rates of 5%. • Poor trading conditions in the home market – perhaps due to the entry of new rivals – means that international marketing can allow sales to continue to grow despite increased competition in the domestic market. • Economics of scale in production and marketing – increased sales should result in lower unit costs of production. Marketing products in similar ways to global markets should also reduce the average cost of promotion.	• Differences in consumer needs and wants, and in usage patterns for products in international markets will mean increased costs of adapting products and their marketing to meet these differences. Failure to respond to these differences – on the grounds of cost – can lead to expensive marketing failures. • Differences exist in the legal environment, some of which may conflict with those of the home market. Businesses will have to meet all legal requirements in the markets they operate in and they will need to obtain specialised knowledge of these legal constraints for each market traded in. • High levels of competition from national producers, some of which may receive subsidies or 'special treatment' from national governments. • Growth of the 'counterfeit' and 'grey market' in international markets – either copies of branded products or branded products sold through unauthorised channels – can undermine the reputation and profit margins of well-known global brands.

Table 4.7.2 Opportunities and threats of entering into international markets

Strategic and operational implications of international marketing

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. Levitt) the world is becoming more standardised in the goods and services that it is demanding. This suggests that the same standard products can be marketed successfully throughout the world. If this is true, then the opportunities for companies to use technology to gain massive economies of scale by selling the same product across the globe are huge.

Other writers (e.g. Douglas and 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 owing to national and regional differences in consumer tastes. The alternative is for businesses to adapt a global marketing mix to local needs and conditions – this is called localisation.

The two broad approaches to selling goods and services internationally are known as 'pan-global marketing' and 'global localisation'. See Table 4.7.3 for the advantages and disadvantages of a pan-global or pan-regional marketing strategy.

pan-global marketing: adopting a standardised product across the globe as if the whole world were a single market – selling the same goods in the same way everywhere

Pan-global marketing may continue to be important for two groups of products in particular: firstly, 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 international celebrities is the key promise made by these brands. Consumers do not want them adapted to their markets. Secondly, mass-appeal brands, such as Levi's, Apple and Nike, have substantial opportunities for global campaigns and standardised products – and the economies of scale that result from these.

Advantages	Disadvantages
• A common identity for the product can be established. This aids consumer recognition, especially in a world of increasing international travel by consumers and the widespread use of satellite TV channels with 'international' advertising. • Cost reduction can be substantial. The same product can be produced for all markets allowing substantial economies of scale. This is particularly important for firms that have to spend huge sums on developing new products that may have only a short product life cycle. The same marketing mix can be used. This allows just one marketing agency and advertising strategy to 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! Therefore, a pan-global strategy for a product aimed at teenagers could be developed.	• Despite growing similarity between consumer tastes in different countries, it might still be necessary to develop different products to suit cultural or religious variations – see the revision activity on McDonald's at the end of this chapter. Market opportunities could be lost by trying to sell essentially the same product everywhere. • Legal restrictions can vary substantially between countries. This does not just apply to product restrictions, e.g. it is illegal to use promotions involving games or gambling in certain countries. There may also be restrictions on what can be shown in advertisements. • Brand names do not always translate effectively into other languages. They might even cause offence or unplanned embarrassment for the company if the selection of the brand name to be used in all markets is not made with care. • Setting the same price in all countries will fail to take into account different average income levels that exist.

Table 4.7.3 Pan-global or pan-regional marketing strategy – advantages and disadvantages

However, with growing concern about 'cultural imperialism' from US and European businesses and an expanding anti-globalisation movement, there will be increasing scope for other businesses to benefit from adapting and selling products that are geared directly towards the particular cultural, religious and consumer requirements of each country using localisation strategies.

Global localisation

Global localisation is the opposite of standardisation and is the business strategy that responds to the drawbacks of a pan-global or pan-regional strategy.

global localisation: adapting the marketing mix, including differentiated products, to meet national and regional tastes and cultures

'Thinking global – acting local' is sometimes how this approach to international marketing is summed up. Yum! Brands, the world's largest fast-food organisation with top brands such as KFC and Pizza Hut, has adopted this approach with great success. It offers all of its franchisees and branches around the globe the benefits and security offered by 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'.
- Price levels are varied between different countries to reflect different average incomes.
- Advertisements always contain local 'ethnic' people.
- Its distribution and place decisions are tested for local markets too. In China, it tried out 14 new Chinese quick-service restaurants offering authentic Chinese food in surroundings designed in a local style.

Table 4.7.4 explains the benefits and limitations of global localisation.

Benefits	Limitations
• 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/ advertisements on regional markets.	• 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.

Table 4.7.4 Benefits and limitations of global localisation *[table continues over]*

Benefits	Limitations
• The products are more likely to meet local, national and legal requirements than if they are standardised products. • There will be less local opposition to multinational business activity.	• There will be additional costs of adapting products, advertisements, store layouts, etc. to specific local needs – these costs might lead to higher prices than a global marketing strategy would result in.

Table 4.7.4 *Continued*

LEARNER PROFILE

Principled

You are the CEO of a major multinational sports brand and the morning's news makes ugly reading. The sports star who endorses your products and is always seen with your distinctive logo on his clothing and footwear has disgraced himself once again. As the CEO of a company with a global brand image that everyone in the world knows, the image of that brand is crucial. When sports stars get involved with drugs, have affairs, behave violently and turn to corrupt betting it tarnishes all the organisations associated with the sports stars. But as CEO you desperately need this sports star to promote your goods.

Research some situations where sports stars have affected the businesses they are associated with.

As a principled CEO do you drop the sports star that has disgraced himself and cancel your endorsement contract with him?

ACTIVITY 4.7.2

ZUMO THE ENERGY DRINK

This energy product is aimed at fitness-conscious men and women aged between 20 and 45. Zumo is offered in four flavours. It is distributed through supermarkets and sports clubs. Advertising is based on TV and radio media, using endorsements from well-known European sports stars. It is currently sold only in Europe, where average incomes are quite high. It is priced above an equivalent non-energy soft drink, such as Coca-Cola, but is not as expensive as some energy drinks. Zumposa is the food and drinks company based in Valencia, Spain, that produces Zumo. The managers want to make Zumo a global brand through international marketing. They know that Zumo is seen as a Spanish drink and this might not be suitable when developing a global image. The board of directors has decided to focus first on South America and Asia to launch their global campaign – they aim for a 10% market share in the first year. They have to take decisions on:

- Price – should this vary to reflect different average income levels in different countries?
- Flavours – do they keep the same flavours across the globe or adapt existing products to different markets?
- Packaging – should the style and colours of the drinks be the same everywhere?
- Advertising – should different advertisements be used in each country or could a global advertisement be made with different languages added for different countries?

- Name and brand image – should these be changed or should a global image and name be established?

12 marks, 24 minutes

1. Define the term 'global brand'. [2]
2. Evaluate Zumo's 'global strategy' as a method of marketing their products in different countries. [10]

The role of cultural differences in international marketing

Cultural differences are a key factor in international marketing, yet they are often difficult to define and measure. They are not written down like laws, yet they can exercise as powerful an impact on people's behaviour. Failure to recognise cultural and language differences can have a disastrous effect on a firm's marketing strategy.

Cultural differences exist because of many reasons. People from different cultures have:

- different perceptions
- different values and ideologies
- different tastes, attitudes, lifestyles, religious beliefs, customs and rituals.

It is essential to remember the importance of local and national culture as well as different business cultures, social cultures and political cultures. A weak global marketing strategy is one that fails to acknowledge and reflect these cultural differences, which may ultimately threaten the entire global business. Examples of problems that can result from failure to consider local culture when marketing internationally include the case of Gerber, a subsidiary of Nestle. When marketing its baby food products in African countries, the company used the same packaging as in the USA with pictures of cute babies on the label. Gerber subsequently discovered that in some African countries with low levels of adult literacy, the custom is to illustrate the packet or container with an image of the contents. When Pepsi expanded sales into China they used the slogan 'Pepsi brings you back to life'. Unfortunately this slogan translated to 'Pepsi brings your ancestors back from the grave'! Undertaking local market research should help to establish local customs, language usage and culture to help prevent these marketing blunders.

Cultural differences can impact on all the elements of the marketing mix.

Promotion

A global marketing strategy also has to study cultural differences before planning its advertising strategy. Advertising should be planned in such a manner that it appeals to the customers in the international market. Some cultures show an open attitude towards advertisements – such as those promoting cigarettes or alcohol – while others may not have such an open attitude. Advertisements with less than fully clothed actors would be poorly received in many Arabic and other Muslim communities.

Product

The product should be modified to meet the taste and cultural requirements of the particular country being targeted. Sales will only meet targets if the business keeps in mind the demands of the particular culture. The success story of Nissin Food Products Company Ltd provides evidence that it is important to reflect the demands of international markets when developing products. Nissin's products are sold in more than 100 countries and the company has branches and also manufacturing units in ten countries, including China, Hong Kong, the Philippines, Thailand, Singapore, Germany, the USA and the Netherlands. The company has grown profitably because the products are manufactured according to the relevant tastes and demand of the customers in these different cultures.

Packaging is a form of promotional material that should also be adjusted to suit local conditions. Language differences should be reflected in the information on the packaging – and even a new brand name might be required: for example, Burger King China's Poo Poo Smoothies might not be very acceptable in Western cultures. Colours used might also have to be changed – for example, in the Far East, white rather than black is associated with mourning.

Price

Average income levels vary greatly across the globe (e.g. Luxembourg per capita income 2013 = US$78 670, Liberia = US$703). It is obvious that people from developed countries can afford to buy products at a higher price than consumers from developing countries who may not be able to spare money for expensive products. The product design for the countries which cannot afford to pay high prices can be modified in ways that reduce the overall cost of production and ultimately bring down the price of the product. The risk of charging lower prices is that there might be a negative impact on brand image as consumers might think the quality has been reduced. In addition this strategy can lead to opportunities for grey markets to be developed – traders buying in 'low-price' markets and reselling in 'high-price' markets.

The price factor has to be based on the cultural attitude of people. In some 'individualistic or masculine' cultures (as defined by Hofstede), it has been claimed that consumers are more price-conscious than in 'collectivist or feminine' cultures. So, consumers in the USA and Japan may be less prepared to pay very high prices than consumers in Brazil, for example! What this research demonstrates is the need for detailed market research of consumer behaviour in the target international market before entry is undertaken.

Place

The distribution of goods is also dependent on cultural differences. The transport systems, logistical systems, wholesale systems and retail systems differ across countries because of infrastructure and tradition. Supermarkets have been established in the USA and Europe since the 1950s, yet in India most consumers still support small local stores. In some countries, access to the internet is still unreliable and limited so an e-commerce 'place' strategy would be unlikely to be successful. National distribution systems in some countries can be inaccessible to foreign companies – largely owing to government restrictions. Other countries have stringent rules and the access to the national distribution systems is very difficult for international companies and these differences directly affect the global marketing strategies.

Global marketing has become so important because it allows companies to reach, potentially, billions of consumers across the world. The most successful global marketers are trying to understand the distinct and hidden cultural differences to modify the products according to the needs and demands of local populations. The consumer-oriented companies are ready to spend money, time and effort to understand and respond to cultural differences. IBM, Nike, Google and others have achieved global success because they conducted in-depth research to comprehend the obvious and the elusive cultural differences existing in the countries where they planned to sell their products.

THEORY OF KNOWLEDGE

Mattel in China

In March 2009, the US toy company opened a 3300-square-metre Barbie store on Shanghai's flashy Huaihai Road. Two years later, they shut the place and scaled back their efforts to sell Barbie in China. The skinny plastic doll was seen as too frivolous a pastime for Chinese kids. 'Chinese parents, more than American parents, emphasise education. Toys can be seen as an indulgence,' says Lavin. That's especially important considering Chinese families usually have only one child. 'You'll do anything for your child to succeed,' says Mittelstaedt. Disney, for example, has found success in China by tying its playful entertainment brand to a chain of English Learning Centres – kids aren't just playing with Mickey Mouse, they're learning new skills with him. If only Barbie could give MBA instruction.

Source: globalconnections.hsbc.com

1. Discuss how businesses can find out about a country's culture.
2. To what extent does national culture affect the way businesses market their products?

ACTIVITY 4.7.3

NIKE FACES MARKETING CHALLENGE IN CHINA: MAKE RUNNING COOL

Running is a 'cool' way to keep fit in many Western societies. Nike has a large market share for the sale of running shoes in Western countries, but why not in China? Market analysis suggests Chinese consumers don't think running is a true sport (like soccer or basketball), but see it as painful hard work and not something to do for enjoyment.

In China, most school-age children only run during obligatory physical education classes. Most Asian cities are heavily polluted and streets are teeming with traffic, pedestrians, rickshaws and roadside shops, so adults to not consider running outdoors to be a pleasant leisure activity. When a person is seen running, they are usually a Westerner.

In the US, Nike consumers are fed the marketing line: 'Never Stop Running.' In China, Nike has launched a 'Run For' campaign, spearheaded by a call-to-action video designed for social media which features runners talking about their motivation. The video interacts with viewers by asking them to submit their reasons for running.

Nike rolled out 'Lunar Runs' in several cities across China, to demonstrate that running should become a social event. The name of the event helpfully links with Nike's Lunar

Glide running shoe. The event itself is a vibrant, night-time event with bright lights, loud music, celebrities and fitness instructors, designed to remind their target market of young, urban brand-conscious Chinese that running is fun and that it can be done at night too.

There are no sales figures available, but it appears the promotion is fulfilling its goal of raising the level of interest: they engaged with over 35 000 potential runners during the Lunar Runs and a Festival of Sports event in Shanghai.

14 marks, 28 minutes

1. Explain **two** reasons why the attitude of Chinese consumers to running is different from that of Western consumers. [4]
2. Discuss the importance to Nike of understanding cultural differences between consumers in different countries when marketing their products internationally. [10]

Implications of globalisation in international marketing

multinational companies: businesses that have operations in more than one country

Globalisation is not a new process but it has accelerated in recent years with the rapid growth of **multinational companies** and the expansion of free international trade with fewer tariffs and quotas on imports. 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 to another
- freer movement of workers between countries.

Marketing opportunities of globalisation	Marketing threats of globalisation
• There is greater opportunity for selling goods in other countries. Opening up new markets, which may not have reached saturation as the domestic market may have done, gives the chance of higher sales, economies of scale and improved profitability. • Increased competition gives firms the incentive to become more internationally competitive. Hiding behind trade barriers breeds inefficiency and this will no longer be possible. • Pan-European or pan-global marketing strategies can be used to create a global brand identity. This saves on the costs of 'different markets – different products'. • There is a wider choice of locations – the opportunity to set up operations in other countries and become a multinational. These locations offer, usually, lower costs and direct access to local markets. Working within each country should lead to better market information. • Greater freedom to arrange mergers and takeovers and joint ventures with firms from other nations as restrictions on foreign acquisitions are reduced.	• Businesses from other countries now have freer access to the domestic market, so there will be increased competition. Wider consumer choices will drive firms that are not internationally competitive out of business. • The drive for international competitiveness will also be forcing other firms to become more efficient to maintain price competitiveness. • Pan-European/global strategies can fail to consider the cultural and taste differences between consumers of different nations. Firms may need to 'think global, but act local' – often called global localisation. • International marketing can lead to significant transport and communication problems. The risk of unethical practices by managers with delegated authority thousands of kilometres from head office can lead to problems. • Businesses are now increasingly at risk of foreign takeovers, e.g. Land Rover and Jaguar by Tata (India); BAA by Ferrovial (Spain). • Increasing activity from anti-globalisation pressure groups may result in bad publicity for multinationals in particular and for those firms found guilty of environmental damage in foreign countries. There is growing concern about the environmental impact of globalisation – especially in emerging economies. Coca-Cola is under pressure to limit production in some Indian states due to shortage of water supplies.

Table 4.7.5 Globalisation – the implications for marketing

OVER TO YOU

Revision checklist

1. Analyse **two** differences between selling clothing products in a home market and selling them internationally.
2. Explain **two** reasons why Apple sells its products internationally.
3. If a soft drinks manufacturer based in your country wanted to sell its products in foreign markets, explain **three** factors it should consider before deciding on the entry method into these markets.
4. Explain the benefits and limitations for a large hotel business of forming a joint venture with a hotel business in country X with the aim of establishing a new chain of hotels there.
5. Analyse the threats and opportunities for IKEA of selling its products for the first time in South American markets.
6. Differentiate, with examples, between global marketing and global localisation strategies.
7. Why are many businesses now using localisation rather than standardisation (global marketing) to compete in foreign markets?
8. Analyse whether a business could ever truly use 'global marketing' with no attempt to make concessions to local cultures.

Exam practice question

McDONALD'S – PAN-GLOBAL STRATEGY OR GLOBAL LOCALISATION?

The world's best-known fast-food restaurant has always prided itself on high standards for hygiene and levels of service in its outlets, no matter which country it is operating in. It also aims to achieve uniform product standards throughout the world. The principle of a common world approach is also extended to the marketing mix used by the business – same products, same decor, same promotions, same pricing levels. When the company first expanded internationally in the 1970s, it was selling the 'American dream' but that is no longer acceptable in many countries of the world. The emphasis has now changed to 'global brand but local marketing'.

The need to be aware of cultural and religious factors when designing a global marketing strategy was made clear to the business when it was confronted with a lawsuit from Indian Hindus. McDonald's had to apologise to all religious and secular vegetarians for failing to make clear that beef flavouring is added to its chips in the USA. It is claimed that there are at least 16 million vegetarians in the USA, who may have eaten these chips, and that they could be suffering from emotional distress as a result. In India, restaurant windows were smashed and dirt was smeared on statues of Ronald McDonald. Hindu leaders called for the food chain to be expelled from the country.

There are benefits to standardisation, however – the McDonald's double-arch logo is now the best-recognised in the world, for example, and internationally standardised advertisements as used by Coca-Cola offer economies of scale as well as reinforcing the global nature of the brand.

However, McDonald's is not alone in increasingly adopting the 'think globally, act locally' concept. Products that are too heavily focused on American culture, tastes and consumer needs are much less well received in some countries than they used to be. Adapting well-known brands to meet the cultural and social demands of countries that are becoming more independent in their approach to business and marketing is now a priority for companies like McDonald's. In India, McDonald's had to move away from reliance on beef and now has an Indian menu with local flavours, such as McCurry Pan and Chicken Maharaja Mac. In France, the changes have been even more substantial. Red and yellow colours are replaced with more 'adult' colour schemes. External restaurant signs are discreet and blend in with the neighbourhood. There are real leather seats, gas fireplaces and hardwood floors. Organic ingredients are used and healthy-eating messages are displayed on every wall. French desserts are offered instead of the standard options and a big seller is *le P'tit Moutarde* – a small hamburger with a French mustard sauce. McDonald's sales in France rose by 8% in one year after some years of much slower growth – perhaps meeting local needs and responding to national consumer tastes is the way forward.

McDonald's percentage sales revenue growth:

	4th quarter 2013 %	2012 %
USA	−1.4	5
Europe	+1.0	8
Asia, Middle East, Africa	−2.4	11

20 marks, 40 minutes

1. Define the term 'global localisation'. [2]
2. Explain **two** reasons why McDonald's decided to enter international markets. [4]
3. Analyse **one** reason why McDonald's takes cultural and religious factors into account when marketing its restaurants internationally. [4]
4. Evaluate McDonald's' decision to change from a pan-global international marketing strategy to a global localisation approach. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, compare and contrast the importance of culture and ethics in international marketing. [20]

4.8

E-commerce

On completing this chapter you should be able to:

Analyse and apply:

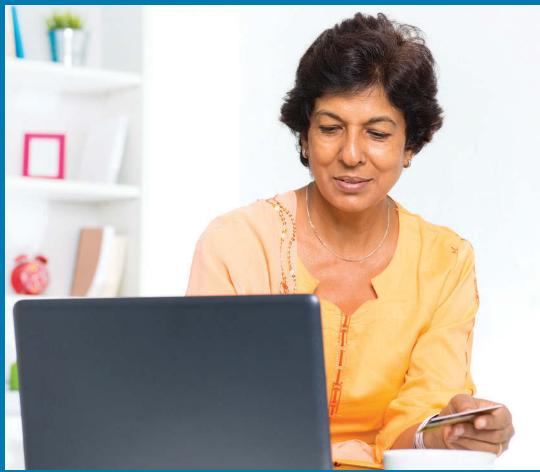
- The features of e-commerce (AO1)
- The effects of changing technology and e-commerce on the marketing mix (AO2)
- The difference between different types of e-commerce: B2B; B2C; C2C (AO2)

Evaluate:

- The costs and benefits of e-commerce to firms and consumers (AO3)

Setting the scene

E-COMMERCE – THE FUTURE FOR INDIA?



There is a common saying in India about retail consumers: 'can't touch, won't buy'. However, this attitude is gradually changing with the rising trend of online shopping.

The value of India's e-commerce business jumped by more than 80% in 2013 to US$13 billion and the momentum is likely to continue for at least the next six years, according to the founders of the country's largest e-commerce firm, Flipkart.

Flipkart co-founder and chief executive officer Sachin Bansal said the e-commerce business in India is expected to reach US$70 billion by 2020 as the growing internet-connected population and improvements in related infrastructure such as payment and delivery systems are developed.

'Over half a billion Indians will switch to smartphones in the next five to six years. This will be a big driver of e-commerce in India.'

India's e-commerce industry is still at an early stage. Online shopping accounts for less than 1% of total retail sales in the country – compared to 15% in the UK. Total global online sales reached US$1.22 trillion in 2013. In China alone it was around US$200 billion.

Just around 12% of the Indian population have made online transactions compared with more than half of the Chinese population. This proportion is much higher in developed countries like the USA, where the figure is 64%.

Internet connectivity and other logistics infrastructure are still a big problem. Only around 10000 out of the more than 150000 zip (post) codes in the country are covered by courier companies. Courier services are critically important to boost online shopping as deliveries are mostly done through them.

Source: IANS India Private Limited.

Points to consider

- Why is good infrastructure important to the continued expansion of e-commerce?
- Do you think that e-commerce will eventually lead to the decline of all high streets and shopping malls?

Key concept link

The internet is one of the main drivers of globalisation. Giving customers – retail and business – the ability to 'surf the net' looking for the best deals, the internet is transforming the purchasing experience. Businesses have to develop strategies that respond to this innovation to maintain or enhance their competitiveness in increasingly globalised markets.

e-commerce: the buying and selling of goods and services on the internet

Exam tip: It is important to assess the benefits of e-commerce and compare them with the potential limitations before recommending whether a particular business should adopt this marketing strategy.

Introduction – features of e-commerce

The rapid growth of **e-commerce**, as outlined in the Setting the scene case study, is a result of the following key features:

- **Global reach** – internet technology reaches across national boundaries and opens up global markets with potentially billions of consumers. Consumers now have access to product details sold by businesses beyond local/national boundaries.
- **Ubiquity** – the access to markets and consumer access to business is available at all times and (virtually) all locations. Shopping can take place anywhere and customer convenience is increased. The increasing use of smartphones has led to 'm-commerce' where mobile-phone shopping is now gaining greater popularity than PC or tablet shopping.
- **Interactivity** – the internet allows for two-way communication between the business and the customer. The growth in the use of social media is further enhancing this.
- **Personalisation** – marketing messages can now be targeted at individual consumers based on their previous spending habits, tastes and interests.
- **Information richness** – complex and detailed promotional messages can be delivered by the internet via video, audio and text messages. This variety of media and the detail of the content cannot be equalled by other forms of promotion.
- **Universal standards** – there is ease of access to the internet for both businesses and customers owing to the existence of a cheap universal internet system.

The effects of changing technology and e-commerce on the marketing mix

Businesses that decide to use e-commerce to sell products either to consumers or other businesses often have to adapt their marketing mix to make the move online a success.

Table 4.8.1 outlines the impact of technology and e-commerce on the marketing mix.

Marketing mix	Impact of technology and e-commerce
Product	• Individual requirements can be built into the product or service to suit different needs. Examples include airline tickets (time/class of seat/luggage/car hire) and PCs assembled to match the individual specification of each customer. • Businesses selling over the internet – because of the greater market potential – can afford to stock a much wider range of products than nearly all shops could justify, for example ASOS clothing. • Product design may have to be adjusted to meet the legal and cultural demands of the different countries that products will now be sold to (see International marketing Chapter 4.7).
Price	• Markets are now much more competitive as prices can be compared so rapidly – in both B2B and B2C in particular. Price-comparison websites will even do the search for consumers! Competitive pricing is much more likely to be used than cost plus which means customers are now more in control. • Price discrimination through geographical separation of markets is now more difficult, given the global reach of e-commerce. At the same time, the use of websites to sell holidays, tickets for events and air travel allows 'last-minute' consumers to be offered special deals, which is an extension of price discrimination.

Table 4.8.1 Marketing-mix changes in response to technology and e-commerce [*table continues over*]

Marketing mix	Impact of technology and e-commerce
Promotion	• Banners, pop-ups, text messages, web pages, blogs, viral marketing – all these terms were unheard of 15 years ago. Promotional opportunities have been greatly expanded by e-commerce and IT developments, especially the growing adoption of the smartphone. • Using the internet and other IT-based systems for promotion not only saves costs when aiming to reach huge numbers of potential customers but also allows for directed, targeted marketing at groups of consumers or even individuals. Will we still be reading newspaper advertisements and watching TV advertisements in years to come? • Promotional materials and packaging might have to be adjusted to meet legal and cultural demands in the different countries being sold to (see International marketing Chapter 4.7).
Place	• The internet is transforming the buying/shopping experience. The growth of e-commerce means that a smaller proportion of all traded goods is now being sold through traditional channels such as shops. • A key issue with e-commerce is the importance of an effective and rapid logistics system to transport products internationally. Is the day of the high-street store passed? Eventually, will all products be bought online? • Interestingly, Apple – a business that is more IT-focused than most – is expanding the number of its own stores as it considers that consumers are more confident buying some of its products from experienced 'savvy' retail assistants.

Table 4.8.1 *Continued*

Holidays bought through e-commerce are one of the most important products by value traded online

Types of e-commerce

Business to business (B2B)

business to business (B2B): transactions conducted directly between a supplying business and a purchasing business

The use of the internet by firms to make purchases from other businesses is growing rapidly. The selling business can use a similar website-based system to that used in B2C if it sells low-value products. As with B2C, payment is made at the time of ordering online. However, **B2B** transactions normally require a more complex business system. The system must be capable of accepting orders in different formats such as email, paper documents or electronic orders. It must integrate the receipt of orders with other administrative systems such as invoicing, customer records and accounting.

At a more advanced level, a business can offer products customised to different customers – if the production system is sufficiently flexible. The website is able to select the appropriate products to display when a customer logs in. This streamlines the process for business customers, as they do not have to browse a complete catalogue to find the products they want to purchase. Businesses are increasingly integrating their IT system with the systems of suppliers, customers and logistics/transport suppliers so that the whole supply chain of purchasing, stock-holding and distribution is more efficiently managed.

E-business relationships save time, require fewer people than traditional purchasing systems and lead to fewer mistakes. The internet gives the ability to obtain quotations bids from many potential suppliers and distributors helping to drive down business costs.

Business to consumer (B2C)

business to consumer (B2C): transactions conducted directly between a company and consumers who are the end-users of its products or services

Consumers browse product information pages on business websites, select products and pay for them at an online checkout, using a credit or debit card, or other electronic payment mechanism. Consumers enter their address details and select one of the delivery options. The basic **B2C** business system is relatively simple. The business needs a method of displaying products and prices on its website, a mechanism for recording customer details, and a checkout to accept payment. Many initial online enquiries are now channelled through price comparison websites and 'late booking' websites. Retailers usually perceive B2C as very important, given the growing use of social media channels by consumers to share their opinions about a specific product, which often drives increased traffic to stores.

Consumer to consumer (C2C)

consumer to consumer (C2C): a business model based on e-commerce that creates a facility that allows consumers to trade with each other (sometimes known as customer to customer)

The two main forms of **consumer-to-consumer** markets are auctions and classified advertisements on websites such as Autotrader. C2C marketing has increased greatly in popularity with the arrival of the internet, as companies such as eBay, Craigslist and other sites have fostered greater interaction between customers. C2C sites make their money from fees charged to sellers for listing items for sale, adding on promotional features and completing transactions. Products sold through C2C are often used or second hand. C2C is projected to grow in the future because of its cost-effectiveness, that is it minimises the cost of using third parties.

However, C2C has some issues such as lack of quality control (especially for used products) and no payment guarantees. There can also be the occasional difficulty in making credit card payments. The rise of Paypal in recent years has eliminated the latter problem.

THEORY OF KNOWLEDGE

If you went to buy your groceries 100 years ago you might have gone to small stall-holders in a market; some years later you might have had to go to a family-run shop; not so long ago it would have been a supermarket and then a hypermarket; and now you can buy all the groceries you want, at any time of day or night, from an online retailer.

In your class discuss using specific examples showing how the selling of products has changed over time.

To what extent are marketing practices a reflection of changing times?

The benefits and limitations of e-commerce

1. To businesses

Benefits	Limitations
• It is relatively inexpensive when compared to the ratio of cost and the number of potential consumers reached. • Businesses 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 which can be used for more focused marketing in future. • Accurate records can be kept on the number of 'clicks' or visitors, and the success rate of different web promotions can be quickly measured. • Computer ownership and usage are increasing in all countries of the world. • Selling products on the internet involves lower fixed costs than traditional retail stores – no need for expensive locations – and these cost savings could be passed on in lower prices. • There is scope to make cost savings and manage supply chains by using B2B e-commerce. • Low-cost growth is much easier than with physical locations – logistical issues are the main barrier.	• 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 – this may limit their willingness to buy certain products online. • Product returns may increase as consumers may be dissatisfied with their purchase once it has been received. • The cost and reliability of postal services in some countries may reduce the cost advantage of internet selling. • The website must be kept up to date and user friendly – 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. • Businesses have to remain competitive as price comparisons by consumers are easy. • Expensive IT infrastructure is needed with suitable qualified employees.

Table 4.8.2 Benefits and limitations of e-commerce to businesses

2. To consumers

Benefits	Limitations
• The internet is convenient for consumers to use. They can quickly compare prices from many suppliers worldwide and there is huge product choice online. • Online stores are open 24/7 – much more convenient than most shops' opening hours. • Prices are often lower than for same goods/services from traditional retailers. • No time or money are spent travelling to physical stores and no time spent queuing. • Ability to sell to other consumers, e.g. through auction sites (C2C). • Music and film downloads allow immediate access to music/film. • Ability to have businesses bid for custom through reverse auction websites – website gathers all customers' requirements and prices they are prepared to pay and businesses bid for the custom.	• Must have a reliable internet connection. May need to update computer or mobile device to ensure speed and capacity can cope with the websites' requirements. • Not able to see, touch, try on products before they are delivered – time and expense of sending back items that fail to come up to expectations. • Concern over credit card fraud and loss of personal information, e.g. eBay's loss of passwords in 2014. • Concern over the sale of fraudulent counterfeit goods online. • Delays in receiving goods – speed of delivery will depend on international/national transport infrastructure.

Table 4.8.3 Benefits and limitations of e-commerce to consumers

. Evaluate Dixons' decision to close its high-street shops and to go 'fully online' as the only method of selling its products.

ACTIVITY 4.8.1

E-COMMERCE ON THE INCREASE

Online retailing in the UK increased by 22% in 2013 compared with high-street sales growth of 1.8% according to industry analyst Verdict Research. E-tailing now accounts for almost 15% of total retail spending. In surveys, 74% of UK consumers believed the internet meant cheaper goods, and 67% agree that it is better for comparing prices than going to high-street shops. The decisions of Dixons, a major retailer of electrical products in the UK under the Dixons and Currys brand names, are typical of the changes that e-commerce is forcing on many businesses.

Dixons decided to:

- close many of its high-street stores.
- rebrand those remaining into 'Currys.digital'.
- move the Dixons brand completely online.

The strategy cost £7 million, but was expected to increase sales as well as reduce annual costs by £3 million. 'I am very excited about the prospects for the Dixons brand as a pure e-tailer,' said the chief executive of Dixons. 'Consumer buying behaviours are developing with the growth in broadband and tablet usage.'

E-commerce is now an indispensable part of the fashion industry too. The online retailer www.asos.com receives over 1.7 million searches on its site each month and is the most visible fashion retailer online. Another site, Net-a-Porter, formed a partnership with fashion label Halston. It displayed one particular dress which sold out in 45 minutes after its launch. Burberry uses digital and mobile technology to live-stream its new collections via Twitter, and Facebook allows users to make instant purchases from its website. There is also potential for young new designers keen to enter the industry to show off their styles to a huge online audience.

Burberry has an effective system for communicating interactively with its consumers – e-commerce can improve long-term relationships with customers

However, there were concerns amongst e-tailers that conversion rates (converting web page visits into sales) fell during the economic recession of 2009–11 and this problem could return if the economy hits further problems in future. There are also familiar customer complaints about difficult-to-use sites, delays in postal deliveries and 'it was not as it seemed on screen', so perhaps high-street shops are not doomed after all. 'The high street will not die,' said a director of Verdict Research. 'Internet retailing is certainly set to become more significant, but shopping is a tactile process and for many people it is a leisure activity – e-commerce does not provide those two things.'

20 marks, 40 minutes

1. Define the term 'e-commerce'. [2]
2. Describe how Currys has used business-to-consumer e-commerce to market its products. [4]
3. Analyse a potential benefit to Burberry of using e-commerce to market its products. [4]
4. Evaluate Dixons' decision to close its high-street shops and to go 'fully online' as the only method of selling its products. [10]

LEARNER PROFILE

An open-minded risk-taker

Advertisement: Start your own online shop

- Create your own online Shop by using an all-in-one internet shop builder.
- Run a professional internet shop website, sell any items, accept credit/debit card payments, manage orders – no software, downloads, programming or hosting required! Add your items and pictures and get started fast.
- Using PayPal™ merchants that offer your customers a checkout experience examined and certified by PayPal's own engineers.
- Affordable packages from $8.99/month.
- Cloud hosting included using VMware™ provider of your e-commerce website and secure checkout.

Source: Adapted from www.go-ecommerce.com

Discuss in your class what type of retail operation you might set up using this new concept of online store.

OVER TO YOU

Revision checklist

1. Explain **three** features of e-commerce.
2. Explain how e-commerce allows easier C2C transactions.
3. Explain how the marketing mix of a sports-shoe retailer might have to be adapted if it decides to close most of its shops and sell mainly online.
4. Outline **three** benefits of e-commerce for consumers of foreign holidays.
5. Outline **three** benefits of e-commerce for a holiday tour operator.
6. Explain **three** drawbacks of e-commerce to a consumer planning to purchase a new car.
7. Explain **three** drawbacks of e-commerce to a manufacturer of high-class fashion.

Exam practice question

ALIBABA IS KING OF THEM ALL

Chinese online retailing giant Alibaba recorded over $240 billion in sales in 2013 – more than Amazon and eBay combined. On its busiest day of the year, Alibaba sold $5.75 billion of goods, three times more than what all of America spent on all US shopping sites combined in the same 24 hours. Alibaba is planning to become a public limited company by selling shares on the New York Stock Exchange. This will value the company at $150 billion or more. With the capital it raises, Alibaba has plans not only to dominate China, but to launch its own US marketplace.

At first Alibaba's business was a B2B marketplace connecting American merchants with Chinese suppliers. It quickly expanded into retail B2C operations with Taoboa, where eight million small businesses now list their items. It later up-scaled with Tmall, a shopping site where premium brands such as Apple, Nike and Disney host virtual shops for Chinese consumers. During the last nine months of 2013 Alibaba made over $6.5 billion dollars in revenue from selling fees, nearly half of which was profit.

Alibaba's greatest challenge in entering the US market will be to gain customers trust. In the past it's been criticised for allowing dishonest businesses to sell illegal counterfeit goods on its sites. Customers searching for products have to go directly to Alibaba's sites as, unlike most e-commerce companies, it doesn't permit search engines to index its products. Merchants are able list for free on sites like Taobao, but it charges them a premium if they want their goods promoted in its search engine.

One New York customer has used Alibaba on several occasions in recent years. He said that although he wasn't sure whether to trust the site at first, in the end the prices for goods were too competitive to ignore. He was able to buy the products direct from the manufacturers at 10% of the price he would have paid on a US website.

The arrival of Alibaba will be a worrying prospect for Amazon, which uses its ability to undercut its competition to continue to build its business.

20 marks, 40 minutes

1. Define the term 'business to business e-commerce'. [2]
2. Explain how US businesses might have benefited by using Alibaba as a way of sourcing components from Chinese suppliers. [4]
3. Outline **one** problem businesses might have using Alibaba as a way of buying and selling goods. [4]
4. Evaluate the likely impact on American consumers of Alibaba setting up operations in the USA. [10]

Key concept question

20 marks, 40 minutes

With reference to one or two organisation(s) that you have studied, evaluate the advantages and disadvantages to businesses of using e-commerce in a globalised market. [20]

Unit 5

OPERATIONS MANAGEMENT

5.1

The role of operations management

On completing this chapter you should be able to:

Know and understand:

- Operations management and its relationship with other business functions (AO1)

Analyse and apply:

- Operations management in organisations producing goods and services (AO2)

Evaluate:

- Operations management strategies and practices for ecological, social and economic sustainability (AO3)

Setting the scene

BMW – DRIVING ULTIMATELY SUSTAINABLE MACHINES

Sean Noonan is BMW's vice president. He considers that sustainability is entrenched in BMW's corporate strategy and culture. BMW has a top-down philosophy in which the goals set are not just environmental, but also economic and social. 'We have a Sustainability Board, which is composed of the BMW AG Board of Management which agrees our sustainability strategy. The individual business divisions are responsible for the implementation of the strategy to realise the objectives and ensure sustainability is implemented throughout our value-added chain and suppliers chain.' The company's employees are directly involved.' For us, feedback is extremely positive,' Noonan said. For example, production line associates are helping to reduce waste-to-landfill to zero by sorting waste. 'Such actions empower and educate the associates'.

BMW does what it can to help associates (as employees are called) perform their work in a comfortable setting. 'The Spartanburg, South Carolina, plant has always had a cooling system, since it gets pretty hot in the summer,' Noonan said. 'We recognised early on that our associates need to be comfortable while they work, and we installed air conditioning on the plant floor to make their jobs easier.'

BMW's business impacts on the environment, its customers and society as a whole. 'Our business does have an impact – from a sustainability and environmental standpoint, we are a manufacturing facility using resources, and it is very important to BMW to minimise that impact,' Noonan said. 'We need to ensure all associates are aware of our responsibility for sustainability in our production.'

BMW continues to invest heavily in hybrid and electric vehicles, specifically the upcoming i3 and i8 models, which are part of the BMW i sub-brand within BMW. The i3, for example, is being specifically manufactured for use in big cities, and the i8 elsewhere.

Source: www.sustainableplant.com

Points to consider

- Give examples of the resources BMW needs to manufacture vehicles.
- Why do you think 'sustainability' is given such high importance within the BMW group?
- Is it possible for car manufacturing ever to be truly sustainable?

Key concept link

Operations management strategies are increasingly focused on sustainability in the use of resources. Is this because businesses are more ethical now than they used to be or are they just worried about the cost of wasted resources?

Introduction – the nature of operations

Operations management used to be known simply as 'production management'. This may still be appropriate in secondary-sector industries producing goods from factories.

As the relative importance of this sector of industry has declined in many countries, so the focus on 'manufacturing physical goods' has also changed. The issues considered by production managers in manufacturing businesses, such as location, stock levels and suppliers, are very important to these businesses. However, as these same decisions apply to all forms of business activity, the switch in name has taken place to allow all businesses, whether in primary, secondary or tertiary production, to be analysed when considering the 'management of operations'.

'Operations' or 'operations management' is concerned with the use of resources called inputs – land, labour and capital – to provide outputs in the form of goods and services. In doing this, operations managers must be concerned with:

- **efficiency of production** – keeping costs as low as possible will help to give competitive advantage
- **quality** – the good or service 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.

Essentially, operations managers are aiming to produce goods and services of the required quality, in the required quantity, at the time needed, in the most cost-effective way.

Exam tip: Sustainability is now an important element of operational decisions. An effective way of evaluating a business operational decision is to consider whether or not it is likely to result in sustainability

Relationship between operations and other business functions

Operations management decisions can never be taken in isolation to the rest of the business. Coordination between business functions is essential if obvious problems are to be avoided. These are some examples that illustrate why:

- Operations managers need to ensure that the appropriate quantity of the good or service is made available so that the *marketing* department may successfully sell it profitably.
- Operations managers need to work closely with the *human resources* department so that appropriate numbers of suitably qualified workers are employed.
- Operations decisions, such as expanding capacity, often require funding – frequent liaison with the *finance* department is essential.

Operations management

The importance of close cooperation and interdependence between business functions (departments) can be illustrated by the following situations where these links did not exist:

1. Operations continue to manufacture a product at the same output level even though it is experiencing declining sales.
2. Operations have a new product innovation but it fails to be developed effectively owing to a shortage of finance.
3. Operations' plan to increase output in a factory by introducing a third daily shift of workers is not communicated to the human resources department.
4. Operations identify a new location for the production facilities but the human resources department is not consulted.

LEARNER PROFILE

Caring/principled

You are the CEO of a European-based car manufacturer and you are faced with more European Union (EU) rules telling you that your company's new cars from 2015 have to be completely recyclable. This is going to add €2500 to the cost of each car you produce. If your business absorbs the cost it means less profit for already unhappy shareholders who have seen their dividends fall in the last three years, or your business has less profit to reinvest in the new environmentally friendly electric cars you want to produce. If you add the cost to the selling price of the firm's cars it means the less well-off car buyers are the hardest hit by the drive for sustainability.

As a caring, principled CEO, do you increase the selling price of your cars or settle for lower profits on each car you sell?

Operations management: the production process

In all businesses at all stages of production, the production process is basically the same. 'Inputs' are converted or transformed into 'outputs' and this is sometimes called the 'transformation' process. This can be simply illustrated (see Figure 5.1.1).

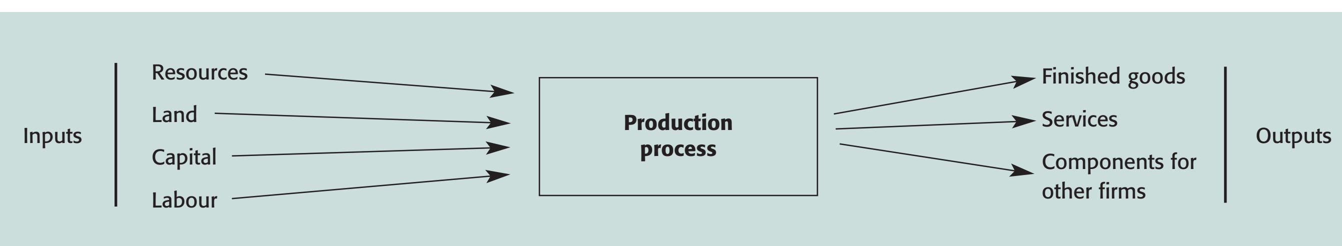


Figure 5.1.1 The transformation process

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 'add value' to the inputs that are bought in by the business so that the resulting output can be sold at a profit.

The degree of value added to the inputs will depend on a number of factors – not all of them operations management issues:

- **The design of the product or the nature of the service.** Does this allow for economic manufacture, whilst appearing to have quality features that will enable a high price to be charged? Some customers are prepared to pay higher prices for products that offer better quality than cheaper substitutes.
- **The efficiency with which the input resources are combined and managed.** For example, by reducing waste, the operations management department will increase the value added by the production process. Increasing productivity will reduce costs per unit and this will increase **added value** if the customer prices remain unchanged. So efficient operations processes and operations decisions are closely linked to value added.

added value: the difference between the cost of purchasing raw materials and the price the finished goods are sold for

- **Being able to convince consumers to pay more for the good or service than the cost of the inputs.** A good example is the market for luxury ice creams, where the marketing campaigns increase the willingness of consumers to pay far in excess of input costs for the product.

The operations process can involve many stages before physically selling the good or service. These include:

- converting a consumer need into a product that can be produced efficiently
- organising operations so that production is carried out efficiently – for example, ordering stocks to arrive on time
- deciding on suitable production methods
- setting quality standards and checking they are maintained.

Resources

All business operations require resources – 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.

These are both examples of capital inputs to the production process

- **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 – but trained workers will become sought after by other businesses and may leave.
- **Capital** – This refers to the tools, machinery, computers and other equipment that businesses use to produce the goods and services they sell. The term capital can also mean the amount the owners of a business invest to set it up. 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.

Ecological, social and economic sustainability – the role of operations management

'Planet, people, profit' – this is how the commonly held view that businesses have a wider role in the local, national and global communities than just 'making money' is often summarised. It is also known as the 'triple bottom line' – suggesting that business performance should be assessed not just in terms of financial surplus (profit) but also by measuring the impact on the environment and society.

Social enterprises are those which are set up with the specific aim of achieving the 'triple bottom line'. However, other businesses – large multinationals to smaller local businesses – are becoming increasingly focused on satisfying environmental and social goals as well as financial ones. Some cynical observers suggest that they do this because 'it is good for business to be seen to be doing good'.

Ecological sustainability

ecological sustainability: a capacity of ecosystems to maintain their essential functions and processes, and retain their biodiversity in full measure over the long term

Operations management can achieve greater **ecological sustainability** by:

- reducing waste at all levels of the organisation – see lean production and quality management (Chapter 5.3)
- using less energy and sourcing energy from renewable sources where possible
- reducing water use and recycling water
- reducing the use of non-renewable resources in production
- designing products that use recycled materials or allow materials to be recycled at end of useful life
- designing products that use less harmful energy sources, e.g. electric cars.

Social sustainability

social sustainability: the ability of a community to develop processes and structures which not only meet the needs of its current members but also support the ability of future generations to maintain a healthy community

Operations management can achieve greater **social sustainability** by:

- designing production systems that are safe and healthy for employees
- designing work and workplaces to allow for social interaction
- creating jobs in low-income or deprived areas – this may mean relocation of operations facilities
- reducing the negative impact of production on communities – e.g. cutting harmful pollution.

Economic sustainability

Operations management can achieve greater **economic sustainability** by:

- managing and maintaining operational assets – equipment, machinery and buildings – so that they have extended lifespans and do not need to be replaced through damage or unnecessary wear and tear
- increasing the efficiency of the production process to improve business competitiveness – this will usually involve increasing labour and capital productivity; high-productivity businesses tend to have low unit costs and have a better chance of future profitability ('economic sustainability') than businesses with low-productivity rates
- researching and developing products and processes that create customer interest and create value – for example, the future of Apple should be secure if it can continue to develop and launch innovative products that have a clear USP.

You should notice a common theme running through the three definitions given above – the long term. Sustainability means undertaking activities today that do not damage the ability of future generations to undertake the same activities. Clearly, using up the world's supply of fossil fuels is not a sustainable form of energy generation as future generations will not be able to do this. Throwing rubbish into landfill sites is not sustainable as there are fewer and fewer available sites and they can cause damaging polluting side effects. You should be able to think of many more 'unsustainable' business and non-business activities.

economic sustainability: within a business context, economic sustainability involves using the assets of the company efficiently to allow it to continue functioning profitability over time

ACTIVITY 5.1.1

DELL'S OPERATIONS MANAGEMENT – TWO EXAMPLES

DELL CHANGES THE FOCUS OF ITS OPERATIONS

With the initial idea of offering cost-effective, made-to-online-order PCs, Dell has traditionally been known as a pioneer in lean manufacturing. The use of very efficient stock (inventory) control and strong supplier networks allowed the company to operate on a direct-to-consumer model. Because it could produce with incredibly low costs, this created a competitive advantage. However, today, the technology market is more dynamic than ever, and product demand, along with the business models of high-tech companies, is changing rapidly.

Dell is now shifting its strategic focus to providing IT and support services to business customers. It is trying to keep pace with competing businesses such as HP by moving towards a service-based business model, focusing on clients such as large enterprises and governments. By adopting an approach of being a service provider, in addition to selling personal computers, Dell's client-base changes to internal services and large IT organisations. This means that those high-manufacturing processes that enabled direct-to-consumer sales do not make as much sense any more. This change shows that companies need to ensure that manufacturing processes are considered in the context of the firm's financial, marketing and operational objectives, and that these objectives are based on the broader market and competitive pressures.

Source: www.manufacturing.net

DELL INTRODUCES NEW SUSTAINABILITY INCENTIVES

Dell's 'Legacy of Good' plan introduces carbon-negative packaging and closed-loop plastics supply chain.

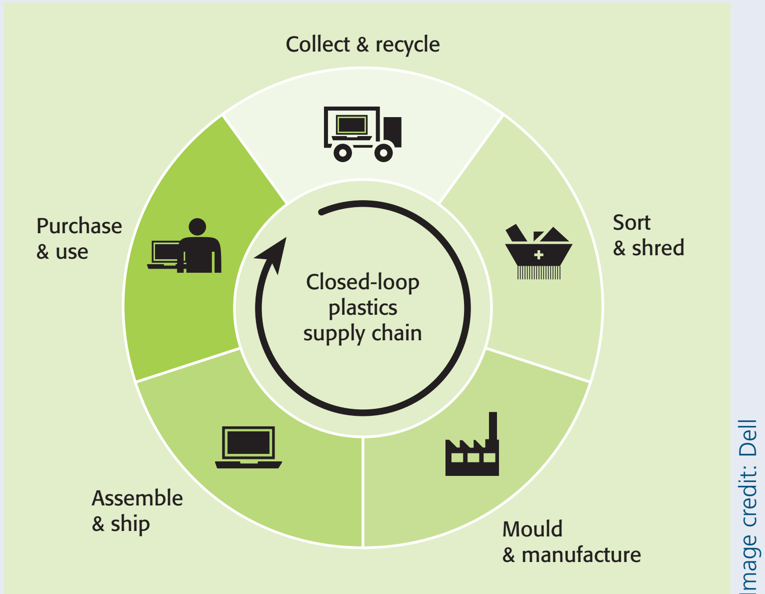


Figure 5.1.2 Dell's Legacy of Good plan promotes sustainability

Dell has announced new sustainability initiatives that CEO Michael Dell called 'the next milestone' in Dell's 2020 Legacy of Good plan.

The electronics giant announced it is the first in the IT industry to introduce carbon-negative AirCarbon™ packaging, through a partnership with Newlight Technologies. Dell's 2020 Legacy of Good plan includes 21 ambitious sustainability and social goals the company is committed to reaching by 2020. The overarching goal is to ensure that the good that comes from Dell's technology will be ten times what it takes to create and use it.

Source: www.sustainablebrands.com

20 marks, 40 minutes

1. Define the term 'operations management'. [2]
2. Suggest **two** resources needed by Dell in its production process. [4]
3. Explain why operations management in a business such as Dell should maintain close relationships with other departments. [4]
4. Evaluate the importance to businesses such as Dell of adopting 'sustainability initiatives'. [10]

THEORY OF KNOWLEDGE

You have started a business that sells a range of sports clothing for the tennis market. You have employed a well-respected designer who has produced a range of shirts, shorts, skirts and tracksuits that will appeal to a niche market of consumers who want to move away from the mainstream brands like Nike and Adidas.

The next stage of the process is securing a business to manufacture the clothing and you are looking at a supplier in Indonesia. The CEO of the Indonesian business has given you a cost for your clothing that will make you competitive in the market for tennis clothing and will earn you a profit that is reasonable but not spectacular for the risk you are taking to start the business.

You know, however, that the pay for the workers who will produce your clothing will be very low, certainly less than you could ever live on. The alternative is to produce your clothing locally at a price which means you will not be competitive and you will make very small profits.

Make an argument to justify a decision to produce the clothing in Indonesia.

To what extent is your argument an ethical one?

ACTIVITY 5.1.2

THE FLIPFLOP RECYCLING COMPANY

Flip-flops are recycled into a range of attractive products

Founded in 2005, the FlipFlop Recycling Company (FFRC) is a social and environmental enterprise based in Kenya which creates artistic products from discarded flip-flops. The FFRC collects discarded flip-flops from around the world which wash up on East African beaches and waterways. The flip-flops are then transformed by local artisans – many of them women, who find it difficult to obtain alternative employment – into craft creations helping poor communities earn an income. The FFRC also provides people in local communities with business skills training and team-building skills. The FFRC aims to use sustainable operations with minimum impact by cleaning up beaches, and thus helping to conserve the wider marine ecosystem. Through this process the FFRC is also able to create greater awareness about the ocean and its inhabitants.

PRODUCTS

The FFRC produces a wide range of products. These are sold – at a profit – to gift shops and tourist centres throughout Kenya. Its products include:

- sculptures (safari animals)
- household goods (bowls, clocks, placemats, etc.)
- interactives (juggling balls, mobiles and toys)
- fashion and accessories (boots, earrings, bracelets, necklaces)
- stationery (pens, notebooks, pen tops)
- gifts (key rings, magnets, house accessories)
- Christmas decorations.

Source: trickleout.net

20 marks, 40 minutes

1. Define the term 'sustainable operation'. [2]
2. Explain why the FFRC could be described as an ecologically sustainable business. [4]
3. Explain why the FFRC could be described as a socially sustainable business. [4]
4. Discuss whether the FFRC is likely to be sustainable in the long term. [10]

OVER TO YOU

Revision checklist

1. Explain what is meant by 'operations management'.
2. Explain **two** examples why, in a hotel business, it is important for operations management to coordinate with other business functions.
3. Explain the 'transformation process' in a manufacturing business that you have studied.
4. Explain the 'transformation process' in a service business that you have studied.
5. SELCO social enterprise provides sustainable energy solutions to low-income households and small businesses. In one scheme, solar-powered lighting was provided by SELCO to a silkworm farmer who depended on dangerous and polluting kerosene lamps. The farmer could not afford the upfront cost, so SELCO helped with the finance too.

   Explain why SELCO could be described as both ecologically sustainable and socially sustainable.

Exam practice question

responsibletravel.com (RT)

Responsibletravel.com (RT) was launched in April 2001, with backing from Anita Roddick (founder of The Body Shop). It is the first and largest business promoting and selling responsible and eco-travel globally. RT likes to get the inside track on places, to discover travel secrets away from the tourist crowds. It has found specialists who know places intimately to run the tours and help you to 'travel like a local'. RT wants to ensure the places its customers travel to remain special and unspoilt by tourism.

RT bases its entire operation on a socially and ecologically sustainable model that aims to help reinvent the tourism industry for the long-term benefit of local people, the environment, travellers and the tourism industry. The entire premise of RT's business is to market and distribute more responsible holidays, thereby creating more jobs for local people, greater income for local people and increased benefits for conservation, whilst at the same time minimising negative impacts on local environments and cultures.

Source: www.responsibletravel.com

20 marks, 40 minutes

1. Define the term 'social sustainability'. [2]
2. Suggest **two** ways responsibletravel.com can manage its operations in a socially sustainable way. [4]
3. Analyse **two** benefits responsibletravel.com might derive from operating in a socially sustainable way. [4]
4. Evaluate responsibletravel.com's socially and ecologically sustainable model as a future growth strategy for the business. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied examine the impact innovation and ethics have on sustainable operations management. [20]

5.2

Production methods

On completing this chapter you should be able to:

Analyse and apply:

The following production methods:

- Job/customised production (AO2)
- Batch production (AO2)
- Mass/flow/process production (AO2)
- Cellular manufacturing (AO2)

Evaluate:

- The most appropriate methods of production for a given situation (AO3)

Setting the scene

CELL MANUFACTURING AT DR. MARTENS

World-famous Dr. Martens footwear is made using cell manufacturing methods. Production workers are divided into individual cells or teams consisting of up to 17 people. Each team is responsible for its own production. Employees work 39 hours a week, but each cell (or pod) can divide that time how they wish. For example, if a cell prefers to work four long days and have a day off, it can do so. For every extra 100 pairs of shoes each cell makes over its target, its members receive extra money. Each cell does everything apart from the cutting and stitching, which still use mass production methods. Each cell is responsible for:

- organising work schedules
- planning output
- meeting order deadlines
- quality.

Everyone in each cell is multi-skilled – they can carry out all the tasks needed to produce the footwear. This has two advantages:

1. Absence of any staff member means production can continue.
2. Doing a variety of tasks – with the increased responsibility that cell manufacturing brings – reduces boredom and increases motivation.

Since introducing the cell-manufacturing system, productivity has improved – yet so has quality.

Points to consider

- Do you think all products could be made using cell manufacturing? Explain your answer.
- What additional costs might there be from introducing cell manufacturing?
- Analyse the potential advantages of cell manufacturing – making reference to motivation theorists.

Key concept link

Business decisions regarding the most appropriate production methods are important strategic choices. Adopting different production methods requires careful management of change – especially the impact on employees. Innovation in production methods is allowing much more flexibility.

Introduction

There are several different ways in which goods and services can be produced. They are usually classified into:

- job/customised production
- batch production
- mass/flow/process production
- cell (cellular) manufacturing.

job production/customised production: producing a one-off item specially designed for each customer

Job/customised production

This is normally used for the production of single, one-off products. These products may be small or large and are often unique. Good examples of **job production** would be a specially designed wedding ring or 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. At any one time, there is only one product being made. New, small firms often use labour-intensive job production before they get the chance to expand and purchase advanced equipment. Job production enables specialised products to be produced and tends to be motivating for workers, because they produce the whole product and can take pride in it.

Job production – every Aston Martin engine is built by hand

However, this production method tends to result in high unit costs, often takes a long time to complete, and is usually labour-intensive. The labour force also needs to be highly skilled and this is not always easy to achieve. 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.

batch production: producing a limited number of identical products – each item in the batch passes through one stage of production before passing on to the next stage

Batch production

Batch production makes products in separate groups and the products in each batch go through the whole production process together. The production process involves a number of distinct stages and the defining feature of batch production is that every unit in the batch must go through an individual production stage before the batch as a whole moves on to the next stage.

A good example of this form of production is a baker making batches of rolls. First, the dough is mixed and kneaded. Then, after being left for a time, the dough is separated into individual amounts, the right size for rolls. After this, the rolls are baked together and then they are left to cool. When they have cooled, they are put on display in the shop and another batch can be prepared. Each roll has gone through the process with the other rolls in the batch and all the rolls have undergone each stage of the process before going on to the next stage.

Batch production allows firms to use division of labour in their production process and it enables 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 students at one school. It also allows each individual batch to be specifically matched to the demand, and the design and composition of batches can be easily altered.

The drawbacks are that batch production tends to have high levels of work-in-progress stocks 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.

Batch production should not be confused with flow production. Some firms produce 'batches' of products using a flow production system. For example, a soft drinks firm may bottle a batch of 20 000 cans of orange drink before resetting the line and producing a 'batch' of another drink. This is flow production rather than batch production because the individual items are free to move through the process without having to wait for others.

Batch production of identical bread rolls

Flow/mass production

These methods are very similar so they will be discussed together. The main difference is that with flow production (sometimes referred to as 'continuous flow production') output is produced 24 hours a day continuously – often with a minimum of labour input. They both produce large quantities of identical products – although see below for 'mass customisation'.

Flow/mass production is structured so that individual products move from stage to stage of the production process as soon as they are ready, without having to wait for any other products. Flow production systems are capable of producing large quantities of output in a relatively short time and so it suits industries where the demand for the product in question is high and consistent. It also suits the production of large numbers of a standardised item that only requires minimal alterations. Flow/mass production usually takes place on a production line – hence the use of the term 'line production'. This production method often involves the assembly of a number of sub-assemblies of individual components. Parts may be bought from other companies. There is usually some automation of tasks (e.g. by using CAM) and this enables a smaller number of workers to produce more products.

flow production: producing items in a continually moving production line – also known as line production. This can be a continuous 24-hours-a-day method

mass production: producing large quantities of a standardised product

An example of flow/mass production would be a Coca-Cola production plant like the one in Ho Chi Minh City, Vietnam. Here, the product is standardised in that it is a can of soft drink of a standard size. The system is flow production because the cans move through the various stages independently. However, the firm can make changes to the contents of the cans and the labelling on them without having to alter the flow production system. They are capable of producing Coke, Sprite and Schweppes Soda Water on the same production line. It is essential that the flow production process is very 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 at the Coca-Cola plant in Ho Chi Minh City, Vietnam

Flow/mass production has a number of advantages over other types of production. Labour costs tend to be relatively low, because much of the process is mechanised and there is little physical handling of the products. The constant output rate should make the planning of inputs relatively simple and this can lead to the minimisation of input stocks through the use of just-in-time (JIT) stock control. Quality tends to be consistent and high and it is easy to check the quality of products at various points throughout the process. The main disadvantage is the high initial set-up cost. By definition, capital-intensive, high-technology production lines are going to cost a great deal of money. In addition, the work involved tends to be boring, demotivating and repetitive.

Process production

process production: producing standardised goods, typically in bulk quantities, by using a continuous input of materials and other resources

The production of goods using this method usually requires inputs for continuous conversion into finished products. These inputs, such as heat, time and pressure, can undergo thermal or chemical conversion in producing finished products – a good example being the continuous flow of crude oil into an oil refinery which uses heat, gases and chemicals to produce a range of industrial products as well as gasoline. The product typically cannot be disassembled to its constituent parts. For example, once it is produced, a tin of paint cannot be broken down into its ingredients. Process manufacturing industries include chemicals, food and beverage, petrol and paint.

The way **process production** systems are designed means that to achieve effective and efficient operation, output must be continuous over a long period of time. Disruptions or accidents can force production to halt and it is expensive and time-consuming to restart production.

Exam tip: It is important to weigh up the advantages and disadvantages of each production method if a question asks you to compare production methods.

Process production methods in an oil refinery can result in thousands of barrels of output daily

Mass customisation

mass customisation: the use of flexible computer-aided production systems to produce items to meet individual customers' requirements at mass production cost levels

The search for production methods that combine the advantages of job production – flexibility and worker satisfaction – with the gains from flow/mass production – low unit costs – has led to the development of **mass customisation**. This method is only possible because of tremendous advances in technology such as computer-aided design (CAD) and computer-aided manufacturing (CAM). These have allowed much quicker developments of new products, designs that feature many common components and robotic machinery that can be switched to making different parts. Developments in the organisation of the production flow lines have also reduced the alienating effects of typical mass production. The emphasis on repetitive, boring tasks has been a major factor in poor worker motivation.

The mass customisation process combines the latest technology with multi-skilled labour forces to use production lines to make a range of varied products. 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 – an essential objective of all operations managers. So, Dell Computers can make a customised computer to suit the customer's specific needs in a matter of hours. By changing just a few of the key components, but keeping the rest the same, low unit costs are maintained with greater product choice.

Exam tip: Although mass customisation is not examined specifically in IB examinations, this important recent production development may be used for comparison purposes.

Cell or cellular manufacturing

Cell manufacturing or production is a form of flow production, but instead of each individual worker performing a single task, the production line is split into several self-contained, mini production units – known as cells. Each individual cell usually produces a complete unit of work, such as a complete washing machine motor rather than just a small part of it. This unit of output can then be used in a number of different products – creating a modular form of construction.

cell manufacturing/production: a lean method of producing similar products using cells, or groups of team members, to facilitate operations by eliminating setup time between operations

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 preset targets. These targets will include output levels, quality and lead times. The unit of output of each cell can often be adapted to be fitted to finished products of slightly different designs and specifications.

Cells are responsible for the quality of their own complete units of work – this links in with total quality management (TQM) (see Chapter 5.3, page 496), job enrichment and team-working (see Chapter 2.4).

The cell manufacturing system has led to:

- significant improvements in worker commitment and motivation because there is teamwork and a sense of 'ownership' of the complete unit of work
- job rotation within the cell
- increased productivity.

Success of cell manufacturing depends on a well-trained and multi-skilled workforce prepared and able to be flexible and accept a more responsible style of working (see Figure 5.2.1).

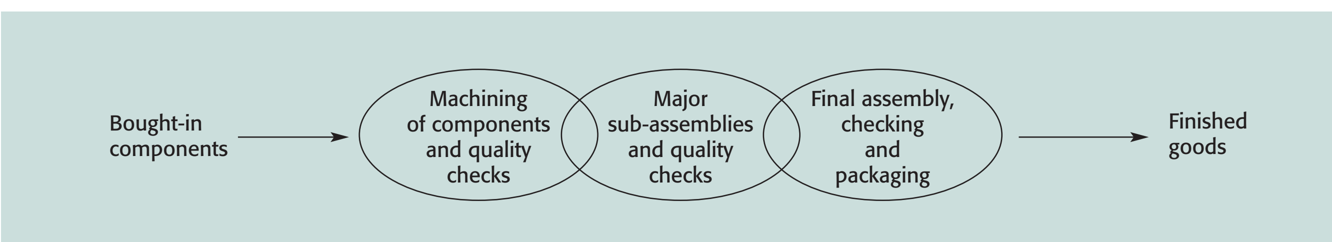


Figure 5.2.1 How cell manufacturing might be organised in an assembly plant

LEARNER PROFILE

Optimax builds the optics that are used in the latest technologies in aerospace, defence and consumer electronics. Optimax's leading technology and 'lean manufacturing' model is a key to its success. It focuses on continuous improvement to deliver precision optics of the highest quality. Optimax focuses on maximising value and minimising waste by adopting lean manufacturing.

Traditional manufacturing, with departmental barriers, has been thrown out the window and lean production cells have taken its place. Optimax has more than 20 different production cells, organised by product group. Each cell is set up to run its optics manufacturing process from start to finish and is worked by highly skilled, cross-trained team members.

Source: www.optimaxsi.com

Discuss the importance of engineers and designers being knowledgeable thinkers as they design sophisticated production systems.

ACTIVITY 5.2.1

SUNBURST BAKERIES

Sunburst Bakeries is a supplier of all kinds of bread and cakes to leading supermarkets. It has a huge factory that makes the entire range of products – no finished items are bought in from other bakers. Production facilities are split into three main areas. Different production methods are used in these three areas. The demand patterns for three of the best-known Sunburst products are very different. Standard loaves are bought by supermarkets every day, all year round. There is some variation in demand through the seasons – but very little. Large, family-sized cakes are mainly bought at weekends – whereas doughnuts are most often bought midweek for children's lunch boxes. Finally, the business is famous for its handmade wedding cakes, each one to a different design. There have been rumours among the workers that one section of the factory that uses batch production might be converted into flow-line production.

20 marks, 40 minutes

1. Define the term 'batch production'. [2]
2. Explain the type of production method Sunburst would use to produce wedding cakes. [4]
3. Analyse **two** factors that affect the type of production method Sunburst chooses for different types of product. [4]
4. Evaluate Sunburst's decision to switch from batch to flow production in one section of its factory. [10]

Production methods – summary

Table 5.2.1 summarises the main features, advantages and limitations of the production methods considered above – that is job, batch, flow/mass (including mass customisation), process, and cell manufacturing.

	Main feature and essential requirements	Main advantages	Main limitations	Main applications
Job production	***Single one-off items, often to customer's specific design or requirements*** • Highly skilled workforce	• Able to undertake specialist projects or jobs, often with high value added • High levels of worker motivation as skills are being fully employed	• High unit production costs as much production will be labour-intensive • Time-consuming – customers will usually have to be prepared to wait for completion of the product • Wide range of tools and equipment needed	Works of art, special fashion dresses, one-off furniture designs and construction projects
Batch production	***Group of identical products pass through each stage together*** • Labour and machines must be flexible to switch to making batches of other designs	• Some economies of scale • Faster production with lower unit costs than job production • Some flexibility in design of product in each batch	• High levels of stocks at each production stage • Unit costs likely to be higher than with flow production	Products with high seasonal demand, e.g. ice creams, or only obtainable seasonally, e.g. freezing of vegetables School uniforms and popular clothing items of most demanded sizes
Flow/mass production	***Mass production of standardised products.*** • Specialised, often expensive, capital equipment – but can be very efficient • High steady demand for standardised products	• Low unit costs due to constant working of machines, high labour productivity and economies of scale	• Inflexible – often very difficult and time-consuming to switch from one type of product to another • Expensive to set up flow-line machinery	Mass-market cars, computers, TVs
Process production	***Continuous input of raw materials and other resources to produce continuous output*** • Design of capital equipment must allow for continuous working; often large capital injections needed to finance operations	• Processes can normally be automated which reduces unit costs • Large quantities can be produced • Ideal for products which have to be of a consistent quality	• Heavy investment required in process design and production equipment/facilities • Difficult and disruptive if the production process has to be stopped • Little opportunity to make different versions of the product	Standardised products in high demand – often produced in large bulk such as chemicals, oil-based products and steel

Table 5.2.1 Summary of the main production methods [*table continues over*]

	Main feature and essential requirements	Main advantages	Main limitations	Main applications
Mass customisation	***Flow production of products with many standardised components but customised differences too*** • Many common components • Flexible and multi-skilled workers • Flexible equipment – often computer-controlled to allow for variations in the product	• Combines low unit costs with flexibility to meet customers' individual requirements	• Expensive product redesign may be needed to allow key components to be switched to allow variety • Expensive flexible capital equipment needed	Products aimed at niche market segments – often at higher prices than standardised products, e.g. special sports shoes, unique paint finishes for cars, mainstream computer programs adapted to needs of one business
Cellular manufacturing	***Team-based production of components or complete products*** • Team members and the equipment needed are placed close to each other • Workers are often multi-skilled to be able to perform all tasks	• Production system is more flexible with multi-skilled workers • Motivation might be high as group work builds team spirit • As all workers in the cell and the equipment they need are placed in close proximity there are very low handling costs – and time is saved during the production process	• Output may not be as high as a traditional 'flow' production system • Different 'cells' may work at different speeds leading to potential tension between them and an imbalance in production of different units of production • The business may need to invest heavily in new machinery and equipment, as each cell will require the same capital items • Employee training costs could be high	Components or sub-assemblies that are used in a variety of different applications which might require slightly different specifications

Table 5.2.1 *Continued*

THEORY OF KNOWLEDGE

Primark makes cheap clothes from cheap labour. Primark was exposed for employing people in sweatshop conditions in Bangladesh, working long hours in hazardous and unhealthy conditions for very low wages. The issue of sweatshop production was heightened when an eight-storey building in Savar, Bangladesh, housing three clothing factories collapsed in April 2013. More than 1100 workers were killed in the wreckage and thousands of people injured. Clothing for sale in Primark's shops were manufactured in this factory.

Source: Adapted from www.telegraph.co.uk

In your class, discuss the ethics of production methods in sweatshop conditions. Should you stop buying cheap clothes that may well have been produced in sweatshops?

Production methods – making the choice

The following factors will influence which production method is appropriate for a particular business/product:

1. **Size of the market** If the market is very small, such as for designer clothes, then job production is likely to be used. Flow production is most efficiently adopted when the market for similar or identical products is very large and consistent throughout the year. If mass production is used in this way, then mass-marketing methods will also have to be adopted to sell the high output levels that can be manufactured. Even in a market for mass-produced items, such as cars, there may be market niches that will allow smaller manufacturers to survive by making one-off products or batches of identical goods before changing the design or style for another model. 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.
2. **The amount of 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.
3. **Availability of other resources** Large-scale flow production often requires a supply of relatively unskilled workers and a large, flat land area. Job production needs skilled craftspeople. If any of these resources are unavailable, or very limited in supply, then the production method may have to be adapted to suit available resources, given the market constraint referred to above.
4. **Market demand exists for products adapted to specific customer 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 or a form of flexible cell manufacturing might be most appropriate. As was seen above, technology is giving businesses increasing flexibility to produce a variety of models from the one basic design and production process.

ACTIVITY 5.2.2

APPROPRIATE PRODUCTION METHODS

Suggest and justify an appropriate production method for each of the following products:

a. children's clothing

b. electric plugs for kitchen appliances

c. ceramic pots to decorate the homes of wealthy customers

d. desktop computers for customers who need slightly different specifications.

Using more than one method

Most firms do not just use *one* production method. It is quite common for many businesses to use more than one production method to gain the benefits that they offer. A French restaurant might have a continuous supply of staple items on the menu – such as frites – but make batches of a dish that can be kept hot for a long time (or even frozen and reheated easily) such as boeuf bourguignon. Specialist dishes that have to be cooked at the table, such as flambés, will use job production. Standard Land Rover models are made on a line production system of mass production. Orders for military versions with special features in common will be made together in one batch. One-off orders, such as a bulletproof, gold-plated model for an oil prince would be hand-assembled and finished.

Final evaluation

The traditional differences between these production methods are becoming much less obvious. Many complex products, such as computers and industrial engines, can be adapted to meet different consumers' requirements. The flexibility offered by technology to large businesses could put at risk the survival of small firms that used to exploit small market niches with hand-built or batch-produced products. However, there is always likely to be a demand from increasingly wealthy consumers for original and specialist products, such as architect-designed, one-off houses, and small firms with non-mass production methods will still thrive in these market segments.

ACTIVITY 5.2.3

IN SEARCH OF QUALITY IN QUANTITY

The spread of mass customisation techniques across industries is starting to spell an end to the old production line. Mass production using flow production, based on standardised parts and processes, was introduced by Henry Ford early in the twentieth century. It greatly cut the costs of making each unit, but the main drawback was that all goods coming off a single production line were identical. In mass customisation the line can be varied to make different products, either individually or in small batches.

Caterpillar, the US supplier of construction and power equipment, says that virtually all of the 11 000 engines it makes each year are different. The variation comes from changes to 10–20% of the 1000 parts that go into each product. Software for the engine controls can also be varied. Cessna makes a wide range of general aviation aircraft from the single-engine piston to business jets on several different production lines. Of the 17 different models produced last year, Cessna produced and delivered over 1200 planes to customers. By producing a variety of models, Cessna is able to market its products to a much wider range of customers, meeting their individual requirements and adding higher value to the components used. Mass customisation needs:

- advanced and flexible capital equipment, e.g. car paint robots can now paint vehicles in 'one-off' colours in between lines of cars in standard colours
- skilled and well-trained workers able to operate this machinery and adapt it to make different products
- product designs that contain as many standardised parts as possible in different versions
- reliable suppliers able to supply slight variations in standard parts or components.

The consultancy Strategic Horizons says mass customisation has increased greatly in the last few years. 'Some time this century mass customisation will be the main form of manufacturing.'

20 marks, 40 minutes

Evaluate whether mass customisation is a production method that should be adopted by all businesses. [20]

OVER TO YOU

Revision checklist

1. Why do many small firms use job production?
2. Explain **one** advantage and **one** disadvantage that batch production has compared to job production.
3. What is meant by a 'flow-line production system'?
4. Why is there a trend towards more customisation in flow production?
5. Under what circumstances would you advise a manufacturer of jeans and T-shirts to switch from batch to flow production?
6. Give an example of a business – other than a restaurant – that might use all three of the main methods of production.
7. Why is process production used in the oil-refining industry?

Exam practice question

PRODUCTION AT BMW

The Mini was one of the few parts of the former Rover group to be retained by BMW following its takeover in 1994. The Mini was seen as a valuable brand by BMW and it continued to develop it with the introduction of a new model in 2001. Production of the car was transferred to the Cowley plant in Oxford and the company spent £230 million on improvements to production facilities. The plant currently produces over 210 000 vehicles a year, but BMW is keen to increase this further.

BMW changed the culture of the organisation by introducing a new system of working at Cowley. It moved away from traditional flow production to a team-based approach. The workforce was reorganised into self-managing teams or cells of between 8 and 15 people. The teams can make production decisions and have job rotation schemes. Responsibility for achieving plant-wide targets are now in the hands of those teams. Each team has more of a stake in the way the business develops rather than a hierarchical system where workers feel alienated from decision-making, stifling initiative and leading to a dependency culture. The organisation also introduced fortnightly team talks where plans, decisions, suggestions and points of view could be aired.

Source: Adapted from www.bized.co.uk

20 marks, 40 minutes

1. Define the term 'flow production'. [2]
2. Analyse **two** disadvantages BMW might have encountered using flow production. [4]
3. Outline **two** characteristics of cell manufacturing. [4]
4. Discuss the advantages and disadvantages to BMW of switching from flow production to cell manufacturing. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, examine the importance of innovation in different production methods. [20]

5.3

H

Lean production and quality management

On completing this chapter you should be able to:

Know and understand:

- Features of lean production: less waste, greater efficiency (AO1)
- Features of quality control and quality assurance (AO1)

Analyse and apply:

- Features of cradle-to-cradle design and manufacturing (AO2)
- The importance of national and international quality standards (AO2)
- Methods of lean production:
  - continuous improvement (kaizen)
  - just-in-time (JIT)
  - kanban
  - andon (all AO2)
- Methods of managing quality:
  - quality circle
  - benchmarking
  - total quality management (TQM) (all AO2)

Evaluate:

- The impact of lean production and TQM on an organisation (AO3)

Setting the scene

THE TRIUMPH OF LEAN PRODUCTION

On the assembly line at Toyota's giant assembly plant in Kentucky, USA, Laura Wilshire is not happy. There is something wrong with the seat-belt fitting on the car she is working on. She pulls a cord (andon cord) – stopping production – and her five fellow workers on that production line crowd round. They soon see that the belt is not screwed in properly and fix the problem. 'I don't like to let something like that go,' she says. 'Quality's really important for people who buy our cars.'

Workers pull the cord 2000 times a week at this car plant. They then become involved in solving quality problems and reducing waste. This is what makes Toyota one of the most reliable and most desired brands in the USA. Using workers to solve work problems is part of Toyota's lean production system. It means that the company can produce cars more cheaply and to a higher quality than its US rivals.

The company's president has said that he did not care if Toyota was the largest carmaker in the world: 'What is important is to be number one for quality.'

Points to consider

- Explain the benefits of involving staff in solving work-related problems.
- What does being 'lean' seem to mean within Toyota?
- Why is it an advantage to be able to develop new products more quickly than competitors? Explain your answer.

Key concept link

Increased globalisation means that businesses that use resources wastefully and inefficiently will become uncompetitive. 'Efficiency and quality' need to be embedded into the culture of a business – as Toyota claims to have done.

Introduction

In competitive global markets, businesses have to focus on improving operational efficiency. Making the most efficient use of scarce resources is the key aim of lean production. Product quality is another important operations management issue that plays a significant part in determining business competitiveness. Low unit costs and low market prices will not improve competitiveness if the consumers receive poor quality and unreliable products. How is quality defined and measured? How can quality standards be met and maintained? These questions are answered in the latter part of this chapter.

Lean production is closely associated with Japanese production methods that are now widely adopted throughout much of the industrialised world. This concept is closely linked with other operations and human resource practices – such as quality circles, empowerment of workers, efficient use of capacity and JIT. It is also linked with the objective of achieving quality output – being lean should involve 'getting it right first time' to reduce wastage of resources.

lean production: producing goods and services efficiently with the minimum of waste resources while maintaining high quality

The overall objective of this production method is to produce quality output with fewer resources – that is, less waste, higher efficiency and elimination of non-added-value activities. Lean means cutting out anything in the production process that adds complexity, cost and time, and does not add value to the customer.

Less waste

The seven main sources of waste in industry have been identified as:

1. excessive transportation of components and products
2. excessive stock-holding
3. too much movement by working people, e.g. to get supplies of components
4. waiting time – delays in the production process
5. overproduction – producing ahead of demand
6. over-processing – making goods that are too complex as they could have been designed more simply
7. defects – products that do not come up to quality standards and have to be rejected or corrected.

Greater efficiency

Business efficiency is measured by comparing the ratio of 'inputs to outputs'.

The most common measure is productivity – labour and capital – which measures output per unit of labour or capital input.

Productivity is not the same as the level of production and the two should not be confused. 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

Efficiency and productivity can be increased by:

- improving employees' skill levels
- improving workers' motivation
- purchasing more technologically advanced equipment
- more effective management of labour and other resources.

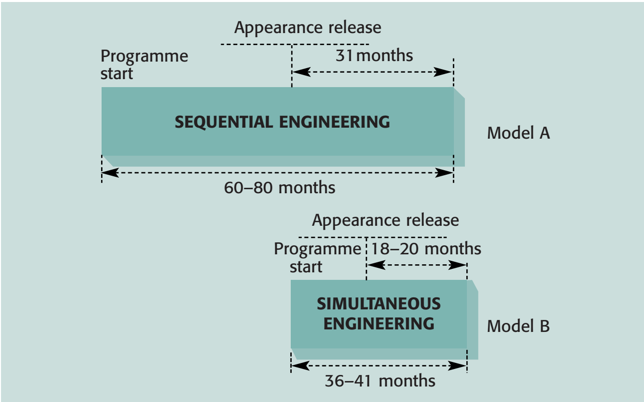


Figure 5.3.1 The benefits of simultaneous engineering

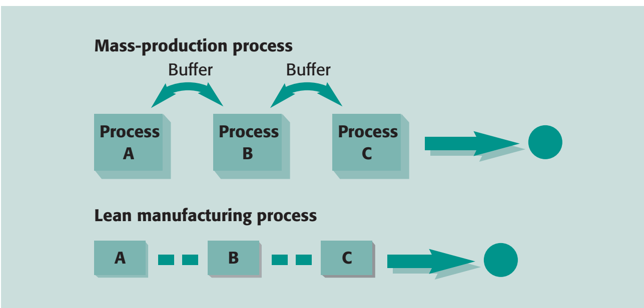


Figure 5.3.2 Eliminating buffers, reducing transfer distance and streamlining processes will mean products will be delivered to customers more quickly and will be of a higher quality

Methods of lean production

Simultaneous engineering

This is a method of developing new products by ensuring that essential design, market research, costing and engineering tasks are done at the same time as each other (simultaneously) – not one after the other (sequentially). 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 5.3.1 for new car models.

Flexible specialisms

Lean production recognises that both technological advances and changing consumer tastes can lead to very short production runs – such as mobile phones or computer games consoles. Changing from one design of product to another requires flexible working in three main areas:

- flexible employment contracts that allow non-core workers to be called in or not employed as demand conditions change
- flexible and adaptable machinery – often computer-controlled – that can be quickly switched from one design to another
- flexible and multi-skilled workers able to perform different jobs on different product ranges.

This flexible approach leads to quicker responses to consumer demand changes, wider ranges of products offered to customers, reduced stock-holdings as goods can be made to order, and higher productivity.

Continuous improvement (kaizen)

kaizen: Japanese term meaning 'continuous improvement'

The philosophy behind **kaizen** is that all workers have something to contribute to improve the way their business operates and the way the product is made. Traditional styles of management never give workers the opportunity to suggest improvements to the way things are done because the assumption is that trained managers 'know best'. The objective of managers adopting this autocratic approach is to keep production up to the mark and then look for one-off improvements in the form of inventions or to make investments in machines to increase productivity.

The continuous improvement philosophy suggests that, in many cases, workers actually know more than managers about how a job should be done or how productivity might be improved. Someone who works at a task every day is actually much more likely to know how to change it to improve either quality or productivity than a manager with, perhaps, no hands-on experience of production at all. Another key feature of this idea is that improvements in productivity do not just result from massive one-off investments in new technology. A series of small improvements, suggested by staff teams, can, over time, amount to as big an improvement in efficiency as a major new investment. This idea is illustrated in Figure 5.3.3.

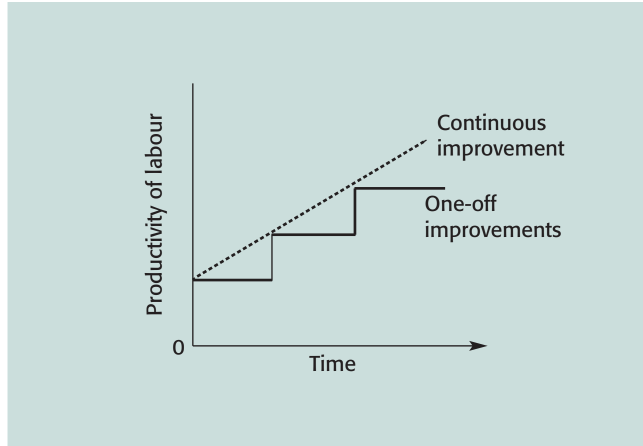


Figure 5.3.3 Continuous improvement (kaizen) compared to 'one-off' changes

Conditions necessary for continuous improvement and kaizen groups to operate:

1. Management culture must be directed towards involving staff and giving their views and ideas importance – managers must accept that, in many areas of the business, work experience will count for as much as theoretical knowledge.
2. Team-working – suggesting and discussing new ideas to improve quality or productivity is best done in groups. These kaizen groups are likely to be drawn from the work team – or cell – operating in the place of work. Kaizen groups should meet regularly to discuss problems that they have identified. This requires management to provide the time and necessary training. Recommendations for change could then be put forward to managers, or each group may be empowered to put their own ideas into practice.
3. Empowerment – giving each kaizen group the power to take decisions regarding workplace improvements allows speedier introduction of new ideas and motivates employees to come up with even more ideas. This suggestion is linked with the work of Herzberg and the concept of job enrichment.
4. All employees should be involved.

Many firms now use the continuous improvement approach, but it needs to be adopted throughout an organisation – indeed problems can occur if some work groups within the business do not make small improvements in this way. The continuous improvement process has a knock-on effect and improvements in one part of the production system will require improvements further down the line. For example, if 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 on to the support struts, then 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 an increase in work in progress. There would be no overall increase in production levels. This example highlights the need for all workers to be involved in a continuous improvement programme, if the firm is to fully benefit from its success.

Exam tip: In an examination answer, it would be good analysis to link the continuous improvement principle to the work of Herzberg on job enrichment (see Chapter 2.4).

Continuous improvement (kaizen) – an evaluation

Although now a widely used practice, there are some limitations to the kaizen approach:

1. Some changes cannot be introduced gradually and may need a radical and expensive solution, e.g. the need for Kodak to invest heavily in the manufacture of digital cameras rather than 'paper-film'-based cameras when the new technology was introduced.
2. There may be very real resistance from senior managers to such a programme due to their existing culture. Kaizen will only work effectively if there is genuine empowerment of the groups involved – authoritarian managers would find this impossible to accept.
3. At least in the short term there may be tangible costs to the business of such a scheme, such as staff training to organise meetings and lost output as a result of meeting time.

ACTIVITY 5.3.1

CONTINUOUS IMPROVEMENT THINKING FIRES PRODUCTIVITY

Mike Brookes is founder and co-owner of Ambi-Rad. His Midlands, UK-based engineering company is a European leader in warm air-heating systems. 'We used to be a top-down company with all the new ideas coming from the directors,' explains Mr Brookes.

At Ambi-Rad, Mr Brookes decided two years ago that it was time for change. He introduced continuous improvement thinking, under which employees throughout the company hierarchy are given more control over decisions and encouraged to come up with suggestions for quality and efficiency improvements. The 150 workers at Ambi-Rad's main plant in the UK are divided into eight groups which are each responsible for specific aspects of making the company's heaters. Team leaders encourage new ideas and act as a link between the shop floor and senior managers. One recent idea came from Jean Cox, an assembly worker at Ambi-Rad. She suggested punching holes in a piece of metal in a different place so as to shorten the overall production process. The proposal was implemented, leading to a small but worthwhile productivity improvement. 'I feel I am much more involved,' says Ms Cox. 'As a problem occurs, rather than carry on regardless, we are now encouraged to think of a way round it.'

Suggestions from people like Ms Cox have taken £600 000 a year off the company's costs. The continuous improvement scheme has enabled Ambi-Rad to maintain profits at a time of severe difficulties in the engineering business. In the past two years, many comparable UK companies have seen sales and profits hit by the economic recession.

'Because of the new manufacturing ideas we have kept pre-tax profits at 10% of sales, which is really excellent by the standards of other engineering companies,' Mr Brookes says. Mr Brookes wants savings from kaizen-based ideas to reach £1 million annually over the next few years. From a combination of improved competitiveness resulting from this thinking, new products and a stronger export effort, Ambi-Rad plans to increase sales 25% in the next three years, while keeping the profit ratio roughly similar.

20 marks, 40 minutes

1. Define the term 'productivity'. [2]
2. Explain the key features of continuous improvement (kaizen). [4]
3. Explain how team-working has led to a rise in productivity at Ambi-Rad. [4]
4. Evaluate the possible problems to Ambi-Rad of introducing lean production methods like continuous improvement (kaizen). [10]

Just-in-time (JIT) – stock control

just-in-time (JIT): this stock-control method aims to avoid holding stocks by requiring supplies to arrive just as they are needed in production and completed products are produced to order

Originating in Japan, this approach to stock control is now influencing stock-holding decisions in businesses all over the world. **Just-in-time (JIT)** requires that no buffer stocks are held, components arrive just as they are needed on the production line and finished goods are delivered to customers as soon as they are completed. The principle is easy to understand, but much less easy to put into practice.

For JIT to work effectively these conditions must be met:

1. **Relationships with suppliers have to be excellent.** Suppliers must be prepared and able to supply at very short notice – short lead time. Suppliers have to see that being reliable and consistent is of great long-term benefit to them as well as the business adopting JIT. This often means that a firm will have only one, or at most two, suppliers for each component, so that a relationship of mutual benefit can be built up.
2. **Production staff must be multi-skilled and prepared to change jobs at short notice.** There is no point in a worker continuing to produce the same item all the time if this leads to stocks building up. Each worker 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.
3. **Equipment and machinery must be flexible.** Old-fashioned manufacturing equipment tended to be designed to produce one range of very similar products. It might have taken days to adapt it to making other types of products. This equipment would be most unsuitable for JIT-based systems. The machinery would have to produce large batches of one type of component before being converted to making another item. Stocks of each item produced would be needed to cope with demand while it was producing other goods. Modern, computer-controlled equipment is much more flexible and adaptable – often able to be changed with no more than a different software program. In this way, very small batches of each item can be produced, which keeps stock levels to an absolute minimum. However, such equipment is expensive and, as a result, JIT may not be so appropriate for small or under-financed firms.
4. **Accurate demand forecasts will make JIT a much more successful policy.** If it is very difficult for a firm to predict likely future sales levels, then keeping zero stocks of materials, parts and finished goods could be a very risky strategy. Demand forecasts can be converted into production schedules that allow calculation of the precise number of components of each type needed over a certain time period.
5. **The latest IT equipment will allow JIT to be more successful.** Accurate data-based records of sales, sales trends, reorder levels and so on will allow very low or zero stocks to be held. Similarly, if contact with suppliers can be set up with the latest electronic data exchanges, then automatic and immediate ordering can take place, when it is recorded that more components will shortly be required.
6. **Excellent employer–employee relationships are essential for JIT to operate smoothly.** 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.
7. **Quality must be everyone's priority.** As there are no spare stocks 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. The advantages and disadvantages of JIT are summarised in Table 5.3.1.

Exam tip: Any question about JIT that involves discussing how appropriate it is in different business cases should lead to an answer that considers the potential drawbacks of the approach as well as its more obvious benefits.

Advantages	Disadvantages
• Capital invested in stock is reduced and the opportunity cost of stock-holding is reduced. • Costs of storage and stock-holding are reduced. Space released from holding of stocks can be used for a more productive purpose. • There is much less chance of stock becoming outdated or obsolescent. Having fewer goods held in storage also reduces the risk of damage or wastage. • The greater flexibility that the system demands 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 from 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 supplying firms.

Table 5.3.1 The advantages and disadvantages of JIT stock (inventory) control

Exam tip: When possible, try to make this link: efficient management of stock can help to reduce waste levels and this can create added value for a business.

JIT evaluation

JIT may not be suitable for all firms at all times:

- There may be limits to the application of JIT if the costs resulting from production being halted when supplies do not arrive far exceed the costs of holding buffer stocks of key components.
- Small firms could argue that the expensive IT systems needed to operate JIT effectively cannot be justified by the potential cost savings.
- In addition, rising global inflation makes holding stocks of raw materials more beneficial as it may be cheaper to buy a large quantity now than smaller quantities in the future when prices have risen. Similarly, higher oil prices will make frequent and small deliveries of materials and components more expensive.

ACTIVITY 5.3.2

TOYOTA'S PRODUCTION IS HALTED

A fire at a major supplier of parts to Toyota's Japanese factories has brought all car production to a stop. Toyota's JIT production system relies on suppliers delivering only the necessary volume of vehicle parts to the assembly line at precisely the point in the manufacturing process at which they are required. The problem is that when things go wrong at just one supplier – Aisin Seiki's fire, for example – the lack of spare parts (stock) can lead to serious problems. Toyota always relies on one supplier for all major parts, because it believes that this brings huge economies of scale. These suppliers not only have to agree to be 100% reliable – excluding events such as fires or earthquakes – but also accept that they must design parts for Toyota's cars themselves. This special relationship with suppliers has helped Toyota reduce its costs by $820 million in each of the past three years.

NISSAN CUTS STOCK TO ALMOST ZERO

Nissan's car factories now operate on an average of just 1.6 days' worth of component and raw-material stocks. This is one of the lowest in the entire motor industry. Computer links with suppliers, which are often located in the same area as the Nissan factories, allow special coded messages to be sent from the Nissan production line.

These contain details of the models and colours of cars being assembled. The supplier, for example of car carpets, then knows that it must supply particular colours of carpets directly to the factory. In fact, some suppliers will make up to 120 deliveries in a day. The parts are taken straight to the assembly line – they do not pass through a traditional warehouse first. Nissan production control directors claim that this method brings huge savings in stock-holding and internal stock-handling as well as great space-saving advantages.

20 marks, 40 minutes

1. Define the term 'JIT stock control'. [2]
2. Outline **two** key features of the JIT stock control system. [4]
3. Analyse **two** problems for businesses using a single supplier for their components. [4]
4. Examine the advantages and disadvantages for Nissan and Toyota of using the JIT stock control system. [10]

Kanban

kanban: Japanese manufacturing system in which the supply of components is regulated through the use of an instruction card sent along the production line

A **kanban** system is a means of achieving just-in-time (JIT) production. It works on the basis that each process on a production line pulls through just the number and type of components the process requires, at just the right time. The method used is a kanban card. This is usually a physical card but other devices can be used. Two kinds of kanban cards are mainly used – a withdrawal kanban and a production-ordering kanban.

Kanbans on a production line

Each process or cell production area on the production line has two kanban 'post-boxes' – one for withdrawal and one for production-ordering kanbans. At regular intervals a worker takes withdrawal kanbans that have accumulated in his process post-box, and any empty pallets, to the location where finished parts from the preceding process are stored. Each full pallet has attached to it one or more production-ordering kanbans which he removes and puts in the appropriate post-box belonging to the process that produced the parts. The worker now attaches a withdrawal kanban to the pallet and takes it back to his own process area. When this new pallet begins to be used, its withdrawal kanban is put back into the withdrawal post-box. At each process on the line, production-ordering kanbans are periodically removed from their post-box and used to determine what parts and quantities to produce next.

When and how kanbans are effective

1. Kanbans help simplify planning and match production to meet changing customer demand.
2. The system requires planned monthly and weekly production schedules.
3. Kanban cards simplify day-to-day flexibility, and changes to the production schedule need only to be given to the final assembly process and will then automatically work their way back up the line.
4. Kanban systems can be made more 'lean' by removing cards or by reducing the number of parts on a pallet. The effect will be to speed the flow through the process and hence reduce lead times. However, it also makes the system more vulnerable to breakdowns and other causes of dislocation. By identifying the areas within the line that are causing delay, efforts can be focused to improve them. The overall efficiency of the line is raised by overcoming these problem areas.

Andon

andon: a manufacturing term referring to a system to notify management, maintenance, and other workers of a quality or process problem

Andon is derived from a Japanese term for a type of paper lantern. In manufacturing, andon systems provide visual feedback to the supervisors on the factory floor. Typically, andon systems indicate 'line status' – showing when assistance is needed (e.g. from a supervisor or when maintenance is required), and empowering employees to stop the production process when they believe that there is a quality issue (see the Toyota Setting the scene case study).

The first andons in manufacturing were simple lights that enabled operators to signal line status based on colour: green for normal operation; yellow when assistance was needed; and red when the line was stopped because a quality problem had arisen. More sophisticated visual displays are often used for andons in modern factories, but their purpose, to provide efficient, immediate communication of the status of the production line, remains the same.

Benefits of andon systems

1. Immediate attention to manufacturing problems is raised.
2. The system provides a simple and consistent mechanism for communicating information in the factory.
3. Andons can lead to immediate reaction to quality, down time and safety problems.
4. Andon systems increase employees' accountability and empower them to take action when problems occur.
5. Andons improve the ability of supervisors to quickly identify and resolve manufacturing issues.

ACTIVITY 5.3.3

LEAN PRODUCTION IS FOR SERVICE BUSINESSES TOO

Yukai Resort in the famous Gero Onsen hot spring area of Japan is part of a luxury Japanese hotel chain which performs lean hotel operations. Lean production helps the hotel offer great value to its customers, reduce cost and remain competitive in the competitive hospitality industry. The standard hotel rate in the Gero Onsen hot spring area is US$180 per person per night including all meals. At Yukai Resort, the price for the same offering is US$91 – every day of the year, regardless of high/low season.

What's the secret?

All hotel duties are shared by all employees. They are all trained to be multi-skilled. This has allowed the resort to operate with minimal staff and reduce costs overall while maintaining high quality. For instance, the receptionists, in their free time, will go to areas needing assistance; perhaps the kitchen or laundry. Dinner and breakfast are buffet style, which reduces staffing requirements. Employees are also active in lean management or lean kaizen efforts. The manager leads weekly kaizen circles.

Employee engagement is the key. Cost minimisation is an obvious benefit. For workers, this system allows them to gain experience in all aspects of hotel operations and gives them direct input in improvement activities. It is not only empowering and motivating but also excellent in terms of career development.

Source: www.process-improvement-japan.com

20 marks, 40 minutes

1. Define the term 'lean production'. [2]
2. Outline **two** ways the Yukai Resort has applied lean production within its hotel. [4]
3. Explain how the application of lean production has allowed Yukai Resort to keep its price at $91 per room. [4]
4. Evaluate the difficulties for Yukai Resort of using lean production in its hotel. [10]

Cradle to cradle

This term was invented by Walter R. Stahel in the 1970s and popularised by William McDonough and Michael Braungart in their 2002 book of the same name. In **cradle-to-cradle** manufacturing all material inputs and outputs are seen either as technical or biological resources. Technical resources – such as scrap steel – can be recycled or reused with no loss of quality. Biological resources – such as waste products from food processing – can be composted and reused in an environmentally friendly way.

cradle to cradle (C2C): a manufacturing principle that seeks to create production techniques that are not just efficient but are essentially waste-free and truly sustainable.

In contrast the expression 'cradle to grave' refers to a business taking responsibility for the disposal of goods it has produced – for example, by safe disposal of waste or unwanted products – but not putting the products' constituent components back into the production process.

ACTIVITY 5.3.4

CRADLE TO CRADLE (C2C) – FULLY SUSTAINABLE PRODUCTION?

Examples of C2C processes exist in many industries. Onion farms on the California coast turn waste into energy. The office furniture company Herman Miller uses materials that can be recycled or composted. Even Rungis, Paris's largest wholesale market, avoids sending waste to landfill and uses it to fuel its operations and part of the energy needs of Orly airport. Many companies have found success from implementing cradle-to-cradle systems with plastic and paper materials. A true 'closed-loop' system in which materials are reused indefinitely is not yet a reality, but could be within a few years.

One cradle-to-cradle leader is DSM, the Dutch plastic giant. It has developed cradle-to-cradle systems since 2008, actively working with McDonough Braungart Design Chemistry (MBDC), the consultancy that awards cradle-to-cradle certifications to businesses. DSM received these certifications for several of its products, including Arnitel and Akulon, plastics that can be used for moulding various products – from automobile components to engineering devices. These plastics can be fully recycled without impairing the quality of the new finished products that are made from them.

10 marks, 20 minutes

1. Define the term 'cradle-to-cradle manufacturing'. [2]
2. Outline **two** benefits to a business of using cradle-to-cradle manufacturing. [4]
3. Explain how using cradle-to-cradle manufacturing might increase business cost. [4]

THEORY OF KNOWLEDGE

Toyota's Motomachi plant

Rows upon rows of giant robot arms weave in and out of a tightly packed assembly line of unpainted car skeletons. There are no humans in sight – just huge machines working in jerks and spasms, but quickly, each massive arm doing something different. Some spew sparks and fire, some brush, some drill.

Ninety-six percent of the production at Motomachi is completed by robots. Thirty workers take care of the robots which have an average life of 10 to 12 years. This giant factory is full of giant robots; it produces cars for the world's best-selling automaker. Toyota sold 9.98 million vehicles in 2013.

Studied at universities and schools around the world, the Toyota Production System is considered by many to be the most well-run and efficient self-correcting production system in the world.

'Toyota's approach to production may have made it one of the most efficient factories in the world but the price paid by workers replaced by robots is a high one.'

Source: Adapted from edition.cnn.com

To what extent do you agree with this statement?

Managing quality

What is meant by 'quality'?

A quality product does not necessarily have to be the 'best possible'.

Consumer expectations will be very different for goods and services sold at different prices. So we have to make clear from the outset that a **quality product** does not *have* to be made with the highest-quality materials to the most exacting standards – but it must meet consumer requirements.

quality product: a good or service that meets customers' expectations and is therefore 'fit for purpose'

In certain cases, a product must meet the highest quality standards and the high cost of it becomes almost insignificant. Internal parts for a jet engine used on a passenger plane will be expected to have a failure rate of less than one in one million. However, if fashion clothing was made to the same exacting standards – with regards to stitching, buttons, zips and so on – how much would a pair of jeans cost then? 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 have still met consumer expectations and have been of the required quality. So a highly priced good may still be of low quality if it fails to come up to consumer requirements. A cheap good can be considered of good quality if it performs as expected. It should now be clear that quality is a relative concept and not an absolute one – it depends on the product's price and the expectations of consumers.

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. However, quality is a crucial issue for service providers too. For example, the quality of service offered by UK banks is claimed to be inferior to those in other countries in terms of:

quality standards: the expectations of customers expressed in terms of the minimum acceptable production or service standards

- time taken to answer the telephone
- no indication of waiting time on the telephone

- queuing time in branches
- contact with the same person on each occasion
- number of accounts errors made
- quality of financial advice given.

The advantages of producing quality products and services are:

- easier to create customer loyalty
- saves on the costs associated with customer complaints – for example, compensation, replacing defective products and loss of consumer goodwill
- longer life cycles
- less advertising may be necessary as the brand will establish a quality image through the performance of the products
- a higher price – a price premium – could be charged for such goods and services. Quality can, therefore, be profitable.

Exam tip: Quality is often viewed by students as an absolute concept and not a relative one. Quality must be explained in reference to the expectations of the target market consumers. The level of quality selected by any business must be based on the resources available to it, the needs of the target market and the quality standards of competitors.

Features of quality control and quality assurance

There are two distinct approaches that a business can take when attempting to achieve quality output. In practice, this distinction can become blurred as elements of both principles can often be adopted. The two approaches are called quality control and quality assurance.

What are the differences between quality control and quality assurance?

These two terms are used to classify two very different approaches to managing and achieving quality in any business.

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.

quality control: this is 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

Examples

- An iPod player being tested at the end of the production line for battery-charging capability.
- A telephone-banking adviser having a call to a customer listened to by a supervisor and recorded.

Quality-control techniques

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 follows 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 – but it has high costs and these could be reduced by 'zero-defect' manufacturing which is the aim of total quality management.
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.

Inspecting for quality

Traditionally, quality has been checked by inspecting products at the end of the production process. Some checking might take place at different stages of the process, but the emphasis was on the quality of the finished article. Quality inspection is expensive – qualified engineers have to be used – and such checks can involve damaging the product – for example, dropping computers to see if they still work. As a result, a sampling process must 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.

Weaknesses of inspecting for quality

The key point about inspected quality is that it involves a group of quality-control inspectors who check the work of workers. There are several problems with this approach:

1. It is looking for problems and is, therefore, negative in its culture. It can cause resentment among workers, as inspectors believe that they have been 'successful' when they find faults. In addition the workers are likely to look upon the inspectors as management employees who are there just to check on output and to find problems with the work. Workers may consider it satisfying to get a faulty product passed by the team of inspectors.
2. The job of inspection can be tedious, so inspectors become demotivated and may not carry out their tasks efficiently.
3. If checking takes place only at specific points in the production process, then faulty products may pass through several production stages before being picked up. This could lead to a lot of time being spent finding the source of the fault between the quality checkpoints.
4. The main drawback is that it removes from workers the responsibility for quality. The inspectors have full authority for checking products so 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. Ultimately, this lack of responsibility is demotivating and will result in lower-quality output.

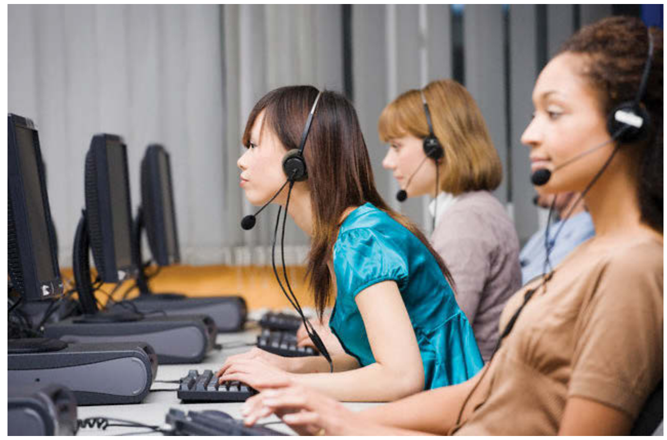
Quality assurance

Quality assurance is based on setting agreed quality standards at all stages in the production of a good or service in order to ensure that customers' satisfaction is achieved. It does not just focus on the finished product. This approach often involves self-checking by workers of their own output against these agreed quality standards. The key differences between the two methods are that quality assurance:

- puts much more emphasis on prevention of poor quality by designing products for easy fault-free manufacture, rather than inspecting for poor-quality products – 'getting it right the first time'
- stresses the need for workers to get it right the first time and reduces the chances of faulty products occurring or expensive reworking of faulty goods
- establishes quality standards and targets for each stage of the production process – for both goods and services
- checks components, materials and services bought into the business at the point of arrival or delivery – not at the end of the production process, by which stage much time and many resources may have been wasted.

The quality assurance department will need to consider all areas of the firm. Agreed standards must be established at all stages of the process from initial product idea to it finally reaching the consumer. These stages include:

- **Product design** – Will the product meet the expectations of consumers?
- **Quality of inputs** – Quality must not be let down by bought-in components. Suppliers will have to accept and keep to strict quality standards.
- **Production quality** – This can be assured by total quality management (TQM) and emphasising with workers that quality levels must not drop below preset standards.
- **Delivery systems** – Customers need goods and services delivered at times convenient to them. The punctuality and reliability of delivery systems must be monitored.
- **Customer service including after-sales service** – Continued customer satisfaction will depend on the quality of contact with consumers after purchase.



Some retail companies record staff telephone conversations with customers to help with after-sales training and customer-care quality assurance

Examples

- Nissan car factories have predetermined quality standards set and checked at each stage of the assembly of vehicles – by the workers accountable for them.
- First Direct, a European telephone-banking organisation, sets limits on waiting times for calls to be answered, average times to be taken for meeting each customer's requests and assurance standards to monitor that customer requests have been acted on correctly.

Quality assurance has the following claimed advantages over quality-control systems based on final inspection:

- It makes everyone responsible for quality – this can be a form of job enrichment.
- Self-checking and making efforts to improve quality increase motivation.
- The system can be used to 'trace back' quality problems to the stage of the production process where a problem might have been occurring.
- It reduces the need for expensive final inspection and correction or reworking of faulty products.

Exam tip: Quality is not just an issue for large businesses. Small and medium-sized firms also need to give consideration to this vital operations-management area. They must ensure that the quality level selected and the quality-assurance methods used are within their resources. In fact, by using quality assurance with the emphasis on reducing wasted faulty products and on staff self-checking quality levels, these businesses can save money in the long term.

LEARNER PROFILE

Principled

Food safety and food quality are our top priorities. Our goal is to serve food that consistently meets the highest quality and safety standards – from the time it is grown, harvested or caught, to when it is put into a sub or salad in our stores.

We have stringent audit processes that we enforce throughout our supply chain. We also require that all our suppliers' employment practices meet our Vendor Code of Conduct. We begin with setting detailed product specifications followed by inspection of samples pulled from the supply chain to ensure that our requirements are being met. All approved facilities that supply food to Subway stores undergo a third-party audit for food safety that includes HACCP (Hazard Analysis and Critical Control Points) on at least an annual basis, if not more frequently.

Source: www.subway.co.uk

This statement from Subway suggests its products are produced to the highest standards.

As a principled business how important is it for a business to communicate quality assurance effectively to its different stakeholders?

ACTIVITY 5.3.5

QUALITY ASSURANCE AT THE HAIRDRESSER'S

The Kuala Lumpur branch of FatBoy Trims had the worst record of all of the company's branches for customer satisfaction. The number of complaints received at head office about this branch and the quality of its haircutting and styling services had been much greater than for any other location. Revenue is low and the number of repeat customers had fallen to 15% of total customers. A rival business nearby, which charged at least 30% more, was always full. The revenue per customer was also low as high-value services – such as colouring and tinting – were avoided by customers. A new manager had just been appointed to the branch and she immediately set about establishing quality targets for each stage of the 'customer experience'. These included:

- maximum time for phone to ring
- maximum waiting time for appointment
- maximum waiting time between hair wash and when cutting begins
- all customers to be offered refreshments
- minimum time spent by stylists with each customer
- feedback forms completed by 20% of clients; stylists to discuss answers with client.

Each employee was given responsibility for at least one of these targets. A record had to be kept of the branch's success at meeting these targets. At first, branch costs increased as an additional worker was recruited to help meet the quality standards. After two months, the number of repeat clients had reached 36% and the branch was able to reduce its advertising expenditure. After four months, revenue had risen by 38%. The branch reached third place in the company league table for customer satisfaction.

10 marks, 20 minutes

1. Define what is meant by the term 'quality assurance'. [2]
2. Outline how FatBoy Trims has tried to improve the quality of its product. [4]
3. Analyse **two** ways how improving the quality of its product can increase FatBoy Trims' revenue. [4]

ACTIVITY 5.3.6

TRINIDAD TRACTOR FACTORY LTD (TTF) – QUALITY BECOMES AN ISSUE

The last meeting between the marketing and operations directors of TTF was very heated. They each blamed the other for the disappointing rise in customer complaints and the fall in unit sales. The marketing director had complained that 'The number of faulty tractors leaving our factory has increased. Our reputation is being damaged by these faults and many former customers are now buying imported tractors. We have just lost a government order for 15 tractors as our competitor was able to boast about their ISO 9000 certificate.' The operations director had replied by saying that customers were becoming much more demanding and it was up to the marketing department to provide good after-sales service. 'I have increased the number of quality-control engineers from five to eight and we are correcting more faults in finished products than ever before.'

	TTF customer complaints	TTF sales in units
2012	53	2345
2013	78	2124

18 marks, 36 minutes

1. Describe **two** problems TTF experiences because of low-quality products. [4]
2. Explain the difference between quality control and quality assurance. [4]
3. Evaluate TTF's decision to increase the number of quality-control inspectors to improve the quality of its tractors. [10]

Methods of managing quality

Benchmarking

The full title for **benchmarking** is 'best practice benchmarking'.

benchmarking: involves management identifying the best firms in the industry and then comparing the performance standards – including quality – of these businesses with those of their own business

This comparison will identify areas of the business that need to be improved to meet the standards of quality and productivity of the best firms.

Stages in the benchmarking process:

1. **Identify the aspects 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 reliability of the product, speed of delivery and after-sales service.
2. **Measure performance in these areas** – for example, reliability records, delivery records and the number of customer complaints.
3. **Identify the firms in the industry that are considered to be the best** – this process might be assessed by management consultants or by benchmarking schemes operated by government or industry organisations.
4. **Use comparative data from the best firms to establish the main weaknesses in the business** – this data might be obtained from firms by mutual agreement, from published accounts, specialist industry publications and contact with customers/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, but more substantial changes may be necessary.
7. **Re-measurement** – 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 to achieve long-term improvements in productivity and quality.

Benchmarking – an evaluation

Benefits	Limitations
Benchmarking is a faster and cheaper way of solving problems than firms attempting to solve production or quality problems without external comparisons. • The areas of greatest significance for customers are identified and action can be directed to improving these. • It is a process that can assist the firm to increase international competitiveness. • Comparisons between firms in different industries, for example customer service departments in a retailer compared with a bank, can encourage a useful crossover of ideas. If the workforce participates in the comparison exercise this can result in: • better ideas for improvement and increased motivation.	The process depends on obtaining relevant and up-to-date information from other firms in the industry. If this is difficult to obtain, then the benchmarking exercise will be limited. • Merely copying the ideas and practices of other firms may discourage initiative and original ideas. • The costs of the comparison exercise may not be recovered by the improvements obtained from benchmarking.

Table 5.3.2 Benefits and limitations of benchmarking

quality circles: groups of employees who meet regularly to discuss ways of resolving problems and improving production and quality in their department/organisation

Quality circles

This is a Japanese-originated approach to quality. It is based on employee involvement in improving quality, using small groups of employees to discuss quality issues. Using team-working and participation can – as well as leading to quality improvements – result in greatly increased worker participation. The overall aim of the groups is to investigate quality problems and present solutions to management – or, if a group is fully empowered, to put the improvements into effect itself.

Main benefits	Main conditions determining success
• Improves quality through joint discussion of ideas and solutions • Improves motivation through participation • Makes full use of the knowledge and experience of the staff	• Circle members must be committed to improving quality • Training given in holding meetings and problem-solving • Full support from management • The team should be empowered to implement the recommendations

Table 5.3.3 Quality circles – main benefits and necessary conditions

Total quality management (TQM)

This approach to quality requires the involvement of all employees in an organisation. It 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 the quality-improvement process

internal customers: people within the organisation who depend upon the quality of work being done by others

Total quality management (TQM) often involves a significant change in the culture of an organisation. Employees can no longer think that quality is someone else's responsibility – instead, the search for quality must affect the attitudes and actions of every employee. When adopting this concept, every worker should think about the quality of the work they are performing because another employee is, in effect, their **internal customer**. Every department is obliged to meet the standards expected by its 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:

- 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 delivered.
- A computer assembly team is the internal customer of the teams producing the individual components – a fault with any of these means the assembled computer will not meet quality standards.

The TQM concept has revolutionised the way all workers are asked to consider quality. To be effective the concept must be fully explained and training given to all staff. TQM is not a technique; it is a philosophy of quality being everyone's responsibility. The aim is to make all workers at all levels accept that the quality of the work they perform is important. In addition, they 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. TQM should almost eliminate the need for a separate quality-control department with inspectors divorced from the production line itself.

TQM aims to cut the costs of faulty or defective products by encouraging all staff to 'get it right first time' and to achieve '**zero defects**'. This is in contrast to traditional inspected quality methods that considered quality control as being a cost centre of the business. Under TQM, if quality is improved and guaranteed, then reject costs should fall and the demand for the products rises over time. However, TQM will only work effectively if everyone in the firm is committed to the idea. It cannot just 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, as TQM will not operate well in a rigid and authoritarian structure.

zero defects: the aim of achieving perfect products every time

The impact of lean production and TQM on an organisation

The impact of lean production methods can help to transform the competitiveness of both manufacturing and service-based businesses. They cannot be introduced overnight, however, and, as with any major business change, will have to be introduced with an understanding of their impact on different functions within a business. This section considers these impacts – but firstly, here is a summary of the potential benefits of lean production and an evaluation of the main methods used:

Main advantages of lean production

- Waste of time and resources is substantially reduced or eliminated.
- Unit costs are reduced, leading to higher profits.
- Working area is less crowded and easier to operate in.
- There is less risk of damage to stocks and equipment.
- New products are launched more quickly.

Impact of lean production on business functions

Finance

The purchase of new and advanced capital equipment is expensive. Without machinery that can be quickly adapted to different products, lean production will be impossible.

Small production runs and fast switch-over times are essential to make waste and stock reduction a real possibility. This technology does not come cheaply and some firms – particularly smaller manufacturers with limited resources – may decide not to take up this option. By specialising in niche-market products, which are less price sensitive, firms may still be able to maintain competitiveness without adopting lean production. In addition, the retraining of staff in the multi-skills needed to produce a range of different products will be expensive.

Human resources

If lean production is being introduced into a traditional business, then the existing workforce and management team will need to be prepared to accept the necessary changes in working conditions and levels of empowerment. The new culture will need to accept much more worker involvement – for example, through kaizen groups and more worker empowerment. Staff need to realise the crucial importance of their reliability and dedication – as so few stocks are held and no 'buffers' exist, the commitment of the workers to the success of lean production is essential. Real lean production depends just as much upon flexible and cooperative employees as it does upon machines.

Lean production is not always the 'solution'

Lean production might not be suitable when:

- businesses have real difficulty in forecasting demand and so are running on virtually zero stocks. This would be a major problem if demand rose unexpectedly.
- production processes are very expensive to start up after a break in production. For example, if a steel works ran out of stocks of coke or iron ore, the resulting cool-down in the blast furnace could lead to a huge repair bill because cooling causes cracking of the internal linings.
- firms use lean production as a device for making extensive redundancies. Lean production can result in job losses – this is one aspect of increased efficiency. However, a faltering business that attempts to adopt lean production merely as an attempt to cut job numbers will be unlikely to gain the much-needed support of the workforce.
- businesses depend on customer service as their USP. In these situations, a less 'lean' approach might give customers more choice of finished product and more certain delivery dates.
- the costs of new technology and retraining are so substantial that some businesses might have to survive on making existing systems more efficient rather than fully embracing lean production principles.

Impact of TQM

Quality is not an 'option'. It is a fundamental aspect of all successful businesses. Quality is an issue for all firms, not just those in the secondary sector or service-sector firms, such as those in tourism and insurance, for whom it is important to put the quality of their 'products' and customer service at the top of their priorities 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 either. Satisfying customers will give clear advantages when seeking further sales. Involving all employees in quality-improvement programmes can lead to a more motivated workforce. Improving quality needs to be the driving force throughout an organisation – it is not just an issue for the factory floor or the bank clerk. At the same time, 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 and that will encourage them to return in the future.

National and international quality standards

Quality standards aim to give stakeholders a form of assessing the product quality, performance or behaviour of businesses. Each country has its own standards organisations but increasingly international standards are becoming more significant as they aim to achieve consistency between national standards. The most important international standards body is the ISO.

ISO (International Organisation for Standardisation) is the world's largest developer of voluntary International Standards. International Standards give state-of-the-art specifications for products, services and good practice, helping to make industry more efficient and effective. These standards have been developed through global agreement and they help to break down barriers to international trade.

Founded in 1947, the ISO has published more than 19 500 International Standards covering almost all aspects of technology and business. From food safety to computers, and agriculture to healthcare, ISO International Standards impact on business activity and customer satisfaction.

ISO 9000

This award is given to firms that can demonstrate that they have a quality-assurance system in place that allows for quality to be regularly measured and for corrective action to be taken if quality falls below these levels. This award does not prove that every good produced or service provided by the business is of good quality. It is an indication that a business has a system of quality in place that has relevant targets set and activities ready to deal with a quality problem.

To obtain the **ISO 9000** certificate the firm has to demonstrate that it has:

- staff training and appraisal methods
- methods for checking on suppliers
- quality standards in all areas of the business
- procedures for dealing with defective products and quality failures
- after-sales service.

The benefits for a firm of being forced to establish a quality-assurance framework and to have this externally monitored are clear. There are, however, drawbacks such as costs of preparing for inspection and bureaucratic form-filling to gain the certificate.

IS0 9000 is one of a series of international guidelines for quality assurance. **ISO 9000** relates specifically to the criteria that need to be met during the manufacturing process. It is not a *guarantee* of good quality, however.

ISO 9000: this is an internationally recognised certificate that acknowledges the existence of a quality procedure that meets certain conditions

OVER TO YOU

Revision checklist

1. Why does 'cutting waste' help increase business efficiency?
2. How does lean production help reduce opportunity costs?
3. Explain **two** problems that a flower retailer would have to deal with by changing to JIT stock management.
4. Explain the difference between 'kanban' and 'andon'.
5. Explain how lean production can help a business to become more competitive.
6. Why is cradle to cradle said to be an ultimate version of 'sustainable production'?
7. Explain why 'quality' does not always mean 'making the best product possible'.

8. Explain **three** benefits to a business from producing quality products.
9. Why might 'designed-in' quality be better than 'inspected quality'?
10. Explain **two** drawbacks of inspected quality.
11. Outline the key features of total quality management.
12. Are the following statements true or false? Briefly explain your decision in each case.
    a. An expensive product is always of higher quality than a cheaper one.
    b. Insisting on higher quality standards always costs a business more.
    c. ISO 9000 ensures products are of a high quality.
    d. Quality-assurance systems can result in lower total costs for a business.
13. Explain why improving quality is important in an increasingly competitive market.
14. Use the example of a small manufacturer of fashion clothing to explain how quality assurance could be adopted.
15. Distinguish between quality control and quality assurance.
16. What are the problems often associated with effective benchmarking?
17. Explain how a service-based business could benefit from adopting benchmarking.
18. Examine **two** conditions that are necessary for a kaizen programme to operate successfully.
19. Explain the impact of lean production methods on any two functional departments in a computer-manufacturing business.
20. Explain the term 'quality circle'.

Exam practice question

HAISHO ELECTRONICS: IS LEAN PRODUCTION THE ANSWER?

Haisho specialises in equipment for construction firms. It has established a reputation for good-quality, reliable products. Sales have not risen for several years due to increased competition from cheaper imports. Many of these imports are low quality, but one Japanese manufacturer sells high-quality products at prices below those of Haisho. A recent board meeting at Haisho discussed this problem.

'What surprises me is how quickly they put new ideas into production. They only announced the remote-controlled crane project last year, but it is already in full production. Our last new idea took us three years to develop for sale,' said the marketing director. The finance director agreed and added, 'The Japanese firm operates on stock levels around 10% of ours, yet they are always able to supply their customers' needs.'

'We have a real problem here – I know what the solution is but it will not be cheap or painless,' said the operations director. 'Our equipment is old-fashioned but would cost millions to update. It takes my workers 24 hours to change tools to make a different component, yet the latest computer-controlled machines can do the same job in five minutes. Our employees have no way of informing supervisors if there is a production-line problem and they are not involved in resolving quality problems. The employees spend too much time getting stocks from the warehouse. Time is wasted and too much stock held. JIT is going to be essential for us. We need to look at applying lean production and a TQM approach to our whole operation.' The finance director immediately said that the business could not afford new equipment. The human resources manager defended the workers by saying that they were working hard and were all trained in their own specialist area. The operations director was unimpressed: 'Either we take steps now to cut out waste and reduce stock levels and new product launch times or our employees won't have any jobs in a few months' time!'

20 marks, 40 minutes

1. Define the term 'total quality management'. [2]
2. Analyse **two** ways in which investment in new machinery would improve Haisho Electronics' efficiency. [4]
3. Analyse **two** reasons why this business might be losing competitiveness to its rivals. [4]
4. Evaluate whether the adoption of lean production methods would help this business become more competitive. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, compare and contrast the importance of innovation and globalisation in operations management. [20]

5.4

Location

On completing this chapter you should be able to:

Analyse and apply:

- The reasons for a specific location of production (AO2)

Evaluate:

- Ways of reorganising production, nationally and internationally:
  - Outsourcing/subcontracting
  - Offshoring
  - Insourcing (All AO3)

Setting the scene

LOCATING IN TRINIDAD AND TOBAGO

Photo © TriniGourmet.com

Two multinational food companies have located in Trinidad for similar reasons. P. R. Trinidad Ltd is a subsidiary of French drinks group Pernod Ricard. The 100-employee company extracts anise oil, which is used as flavouring, from the leaves of anise bushes planted on land leased at a low rent from the government. Before deciding on Trinidad as the best location, the company 'looked first at the economic and political stability of the country,' reported the operations manager. 'Trinidad also enjoys the right climate for anise production and we found a large area of flat land suitable for its production,' he added. Other reasons given for this location decision were the well-trained workforce with a good supply of qualified technicians from the local university. The company is planning some joint ventures with other local businesses – so the existence of other businesses in the drinks industry was an important factor in moving to Trinidad too.

Coca-Cola recently opened a bottling plant in Trinidad and employs 350 staff there. The flow production method is used with much automated machinery. The demand for soft drinks in the Caribbean is high all year round. The general manager Bob Ramchand believes that 'the government is in favour of private sector industry and supports it. Many of the qualified young professionals in the Caribbean come from the University of West Indies and this was important to us.' Trinidad is a member of the regional free-trade area known as CARICOM. Membership allows free trade between members for goods manufactured on the island. Many of the other countries in the region are too small to have the resources needed for a large operation such as Coca-Cola. 'I believe that in the long term the decision will prove to be an even better one as the CARICOM area opens up more and more and Trinidad is well located to supply all of its members,' added Mr Ramchand.

5.4 Operations management

Points to consider

- List and explain **six** reasons for these companies locating in Trinidad.
- Coca-Cola could have exported its product to Trinidad from the USA. Why did the company not do this?
- Do you think that the location decision is a very important one for all businesses? Explain your answer by referring to soft drink manufacturers, hotels and hairdressing businesses.

Key concept link

Location decisions are some of the most important strategic choices that management make. They can involve issues of globalisation and different national cultures. They can have an ethical dimension too – is it right to close factories and make workers redundant in high- wage economies to relocate in low-wage economies?

Introduction

optimal location: a business location that gives the best combination of quantitative and qualitative factors

Deciding on the **'optimal' location** for a new business – or for relocation of an existing one – is often crucial to its success. Location decisions – choosing new sites for expansion or relocation of the business – are some of the most important decisions made by management teams. Selecting the best site will have a significant effect on many departments of the business and, ultimately, on the profitability and chances of success of the whole firm. Location decisions have three key characteristics:

1. They are strategic in nature – as they are long term and have an impact on the whole business.
2. They are difficult to reverse if an error of judgement is made – due to the costs of relocation.
3. They are taken at the highest management levels and are not delegated to subordinates.

Exam tip: Do not assume that the 'best' location for a business will never change – cost and other factors can change over a period of time and this accounts for many firms 'relocating' to new sites – but this can be expensive.

An optimal location decision is one that selects the best site for expansion of the business or for its relocation, given current information. This best site should maximise the long-term profits of the business. The optimal site is nearly always a compromise between conflicting benefits and drawbacks. For example:

- 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.
- A factory location which is cheap to purchase because of its distance from major towns might have problems recruiting staff due to lack of a large and trained working population.

An optimal location is likely to be a compromise that balances:

- high fixed costs of the site and buildings with convenience for customers and potential sales revenue
- the low costs of a remote site with limited supply of suitably qualified labour
- **quantitative factors** with qualitative ones
- the opportunities of receiving government grants in areas of high unemployment with the risks of low sales as average incomes in the area may be low.

quantitative factors: these are measurable in financial terms and will have a direct impact on either the costs of a site or the revenues from it and its profitability

Factors influencing location decisions

Quantitative factors

Problem	Disadvantages to business
High fixed site costs	• High break-even level of production • Low profits – or even losses • If operating at low-capacity utilisation, unit fixed costs will be high
High variable costs, e.g. labour	• Low contribution per unit produced or sold • Low profits – or even losses • High unit variable costs reduce competitiveness
Low unemployment rate	• Problems with recruiting suitable staff • Staff turnover likely to be a problem • Pay levels may have to be raised to attract and retain staff
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 just-in-time (JIT) stock management system due to unreliable deliveries

Table 5.4.1 Disadvantages to a business of non-optimal location decisions

Site and other capital costs such as building or shop-fitting costs

These vary greatly from region to region within a country and between countries. 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 previously 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. An insurance company call centre will need many employees, but 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 in other countries – for example, bank and insurance company call centres.

Transport costs

Businesses that use heavy and bulky raw materials – such as steel making – will incur high transport costs if suppliers are at a great distance from the steel plant. Goods that increase in bulk during production will, traditionally, 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 will be of less significance.

Market potential

The level of sales made by a business can depend directly on location. Confectionery shops and convenience stores have to be just that – convenient to potential customers. In addition to this, certain locations can add status and image to a business and this may allow value to be added to the product in the eyes of the consumers. 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 an address in New York's Wall Street.

Government grants

Governments across the world are very keen to attract 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 financial assistance to retain existing jobs or attract new employment to deprived areas of high unemployment.

ACTIVITY 5.4.1

GOVERNMENT SUPPORT

Senior management at Nissan were initially reluctant to build the new Qashqai at their Sunderland factory. However, a UK government grant of £3.26 million helped to clinch the decision to invest a total of £95 million into the new production facilities at this factory in the north of England. It secured 250 jobs in this area of high unemployment.

16 marks, 32 minutes

1. Outline **two** benefits the regional economy would gain from Nissan's location in Sunderland. [6]
2. Evaluate Nissan's decision to locate in Sunderland because of the UK government grant. [10]

Once these quantitative factors have been identified and costs and revenues estimated, the following techniques can be used to assist in the location decision:

1. Profit estimates

By comparing the estimated revenues and costs of each location, the site with the highest annual potential profit may be identified.

ACTIVITY 5.4.2

PROFITS IN DIFFERENT LOCATIONS

12 marks, 24 minutes

1. Calculate the estimated annual profit from these two possible locations for a mobile-phone shop: [6]

	Site A – city centre location	Site B – shopping arcade out of the city
Estimated annual costs (including rent and labour costs)	$975 000	$498 000
Expected annual sales (units)	25 000	17 000
Forecast selling price per unit	$50	$45

2. Analyse **one** reason why a change in location may lead to a rise in future profits. [6]

2. 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. The simplest of these, the payback method, can be used to estimate the location most likely to return the original investment most quickly. This could be of particular benefit to a business with a capital shortage or in times of economic uncertainty. Calculating the annual profit as a percentage of the original cost of each location is another useful measure.

ACTIVITY 5.4.3

DISCUSS WHICH SITE YOU THINK MAKES THE BEST INVESTMENT

TLC Cosmetics is planning to open a new branch of its shops selling upmarket cosmetics. The company has expanded rapidly and it has substantial loans. Some economists are predicting an increase in interest rates by the Bank of England.

10 marks, 20 minutes

On the basis of the information for TLC Cosmetics in the table below, recommend which site it should choose for its new branch. [10]

	Site X – capital cost £2 million	Site Y – capital cost £3 million
Length of time to repay initial capital cost (payback period)	2.5 years	3.8 years
Annual profit (ARR) made as % of initial cost	12%	14%

3. Break-even analysis

This is a straightforward method of comparing two or more possible locations. The lower the break-even level of output the better the site is, other things being equal. This information might be particularly important for businesses that face high levels of fixed costs and which may benefit from a location with lower overheads.

ACTIVITY 5.4.4

WHICH SITE COVERS ITS COSTS AT A LOWER OUTPUT LEVEL?

ICT Chemicals Ltd plans to open a new paint factory with a maximum capacity of ten million litres per year. It has narrowed the choice of sites down to:

- Site C in the UK, located eight kilometres from a large city. There have been some protests from local residents and environmental groups about this location.
- Site D in a less economically developed country with very low labour wage rates and few health and safety controls. There are, however, concerns about political instability in the region and some employees may be reluctant to work at this site.

The figures in the table exclude transport costs.

	Site C	Site D
Level of output needed to cover all costs (break-even output)	4 million litres	2 million litres

10 marks, 20 minutes

On the basis of the information available to ICT Chemicals, recommend which location it should choose. [10]

qualitative factors: non-measurable factors that may influence business decisions

Qualitative factors

There are other important factors that cannot be measured in financial terms. These are called **qualitative factors**.

Safety

To avoid potential risk to the public and damage to the company's reputation as a consequence of an accident that risked public safety, some industrial plants will be located in remote areas, even though these may increase transport and other costs.

Room 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 room for further expansion of the business, 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 plc, this is unlikely to be a factor, as earning profits and increasing returns to shareholders will be key objectives that will take priority in location decisions.

Labour supply

Apart from the cost of labour, the availability or non-availability of workers with appropriate skills will be an important factor for most business location decisions.

Ethical considerations

A business deciding to relocate is likely to make workers redundant. This will cause bad publicity and could also be contrary to the ethical code of the business and may be viewed by stakeholders as being immoral. In addition, if the relocation is to a country with much weaker controls over worker welfare and the environment, there could be further claims that the business is acting unethically.

Environmental concerns

A business might be reluctant to set up in an area that is particularly sensitive from an environmental viewpoint, as this 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. Singapore's huge port facilities have encouraged many of the world's largest shipping firms to set up a base there. The quality of IT infrastructure varies considerably around the world and this is an important consideration for companies that need quick communication with their different sites or customers, for example call centres or selling via the internet. The growing popularity of online shopping in developed countries may lead to some retailers opening fewer high-street stores and more 'warehouse' operations to supply consumers.

ACTIVITY 5.4.5

ROLLS-ROYCE GOES FOR A QUALITY LOCATION

Choosing the lowest-cost location for the Rolls-Royce factory was not a priority. When BMW moved production from the industrial northern town of Crewe, it chose one of the most crowded and expensive parts of the country – the south-east of England. The Goodwood factory has many advantages but low cost is not one of them. One of its main benefits is its proximity to a small airport where the helicopters and executive jets of intending purchasers of Rolls-Royce cars can arrive in style. Potential buyers are identified by the company and invited to visit the factory and attend events held at the nearby exclusive marina and horse-race and motor-race courses. The area has been termed a 'playground for the wealthy' and future customers often spend a day or two at the races or a morning at the marina before browsing the cars – and more often than not, signing an order form.

Source: Adapted from http://business.timesonline

6 marks, 12 minutes

Analyse the importance of **one** qualitative factor affecting Rolls-Royce's decision to locate in Goodwood. [6]

Low cost was not a priority when locating the Rolls-Royce factory

Other locational issues

The pull of the market

This is less important with the development of transport and communication industries and with the world becoming a single market. The internet can achieve a massive amount in terms of rendering location of a retailing business less important, but the market is still very important for the service industries and the power of the car has taken many of these out of the convenient centres of towns and on to the ring roads. The cinema is a good example. Once the centrepiece of a town, it is found regenerated on the ring roads. Superstores and other retail stores have relocated in a similar fashion.

Planning restrictions

Local authorities have a duty to serve the interests of their populations. On the one hand, they want business and industry because they provide employment. On the other hand, they 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 has set up industrial estates and business parks that both businesses and consumers find very attractive.

External economies of scale

These are cost reductions that can benefit a business as the industry 'clusters' and grows in one region. It is common for firms in the same industry to be clustered in the same region – Silicon Valley in the USA and Bangalore in India have very high concentrations of IT-focused businesses. All IT firms in these regions will benefit from the attraction of a pool of qualified labour to the area, local college courses focused on IT and a network of suppliers whose own scale economies should offer lower component costs. In addition, it will be easier to arrange cooperation and joint ventures when the businesses are located close to each other.

Multi-site locations

See Table 5.4.2 for the advantages and disadvantages of multi-site locations.

Advantages	Disadvantages
• Greater convenience for consumers, e.g. McDonald's restaurants in every town • Lower transport costs, e.g. breweries can supply large cities from regional breweries rather than transport from one national brewery • Production-based companies reduce the risk of supply disruption if there are technical or industrial relations problems in one factory • Opportunities for delegation of authority to regional managers from head office – help to develop staff skills and improve motivation • Cost advantages of multi-sites in different countries	• Coordination problems between the locations – excellent two-way communication systems will be essential • Potential lack of control and direction from senior management based at head office • Different cultural standards and legal systems in different countries – the business must adapt to these differences • If sites are too close to each other, there may be a danger of 'cannibalism' where one restaurant or store takes sales away from another owned by the same business

Table 5.4.2 Multi-site locations – advantages and disadvantages

ACTIVITY 5.4.6

ONE COMPANY, MANY FACTORIES

Toyota is one of the best examples of a multi-site business with 52 manufacturing facilities in 26 different countries. In a typical recent 12-month period, it opened its first factory in Mexico and opened its 13th manufacturing facility in the USA – in Mississippi. Recently concern has been expressed by the company that its production capacity in the USA was starting to outstrip demand for vehicles, so this could be the last new factory the company builds there for some time.

Source: Adapted from www.reuters.com

10 marks, 20 minutes

Evaluate Toyota's decision to locate operating factories in so many different countries. [10]

LEARNER PROFILE

Knowledgeable

McDonald's has more than 34 000 stores in 118 countries, some of which don't serve burgers but all of them serve fries. The American giant has nine restaurants in Azerbaijan. Located at the crossroads of western Asia and Eastern Europe it is bordered by Russia to the north, Georgia to the north-west, Armenia to the west and Iran to the south. With a population of nine million and a GDP per capita of $10 000 it represents a significant opportunity for multinational businesses like McDonald's.

Setting up a business in a country like Azerbaijan requires knowledge.

Source: tbs-abroad.org

Brainstorm in your class all the things a business like McDonald's would want to know to successfully open a restaurant in Azerbaijan.

Discuss how McDonald's can improve its knowledge of Azerbaijan.

Ways of reorganising production – nationally and internationally outsourcing

If a business receives orders that it cannot easily fulfil because of lack of capacity it is common to contract another business to undertake some or all of the additional work. However, the growth of **outsourcing** and **subcontracting** in recent years by many businesses is not necessarily driven by shortage of capacity. These are the other major reasons for outsourcing:

outsourcing: using another business (a 'third party') to undertake a part of the production process rather than doing it within the business using the firm's own employees

subcontracting: the practice of assigning to another business (the subcontractor) part of a contract – for example, a specialist activity that makes up part of a construction contract

- **Reduction and control of operating costs** Instead of employing expensive specialists that might not be fully used at all times by the business it could be cheaper to 'buy in' specialist services as and when needed. These specialist firms may be cheaper because they benefit from economies of scale, as they may provide similar services to a large number of other businesses. Much outsourcing involves offshoring – buying in services, components or completed products from low-wage economies.
- **Increased flexibility** By removing departments from the staff payroll and buying in services when needed, fixed costs are converted into variable costs. Additional capacity can be obtained from outsourcing only when needed and if demand falls contracts can be cancelled much more quickly than closing down whole factories owned by the business. The advantages of using subcontractors to 'take the strain' during periods of full capacity removes the need for expensive long-term capacity expansion projects.
- **Improved company focus** By outsourcing 'peripheral' activities, the management of a business can concentrate on the main aims 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.
- **Freed-up internal resources** for use in other areas. If the Human Resource (HR) department of an insurance company is closed and the functions bought in, then the office space and computer facilities could be made available to improve customer service.

There are potential drawbacks to outsourcing and subcontracting too:

- **Loss of jobs within the business** This can have a negative impact on staff motivation. Workers who remain directly employed by the organisation 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** Internal processes will be monitored by the firm's own quality-assurance system. This will not be so easy when outside contractors are performing important functions. A clear contract with minimum service-level agreements will be needed. The company contracting out the functions may have to send quality-assurance staff out to the business undertaking the tasks to ensure that product quality and customer-service standards are being met.
- **Customer resistance** This could take several forms. Overseas telephone call centres have led to criticism about inability to understand foreign operators. Customers may object to dealing with overseas outsourced operations. Bought-in components and functions may raise doubts in the customers' minds over 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?

Exam tip: You may be asked for your advice on outsourcing an activity. Generally, the more important an activity is to the overall aims and reputation of the business, the less likely it is that outsourcing will be appropriate.

Outsourcing evaluation

The trend towards outsourcing will continue as firms seek further ways of improving operational effectiveness and as more opportunities arise due to globalisation. The process is not without its risks, however. Before any substantial **business-process outsourcing** 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 reestablish it if it was found that the outsourcing had failed.

business-process outsourcing (BPO): a form of outsourcing that uses a third party to take responsibility for complete business functions, such as HR and finance

One of the key factors in any business decision on outsourcing is to decide what is a truly core activity that is so important that it must be kept within the direct control of the business. The nature of these core activities will vary from business to business.

ACTIVITY 5.4.7

WORLD'S AIRLINES INCREASE OUTSOURCING

There is one area where major national airlines and their cut-price competitors agree – aircraft maintenance is a lot cheaper when it's performed by low-paid mechanics working for outsourcing companies. JetBlue, Southwest, Qantas, America West and United are among the big airlines which outsource all major maintenance of their aircraft to contractors in other countries. JetBlue's A320 Airbus planes are sent to El Salvador for maintenance, for example. US Airways recently cut 2000 skilled mechanics' jobs as it outsourced most of its maintenance and repair work.

Aircraft mechanics in El Salvador – should aircraft maintenance be outsourced?

It wasn't long ago that all global airlines employed their own teams of highly qualified and highly paid aircraft engineers. They were all licensed by their own country's civil aviation authority and could earn at least $100 an hour. Mechanics working for outsourcers do not have to be licensed – only their supervisors must be fully qualified. In El Salvador the mechanics earn between $10 and $20 an hour.

Most airlines have also outsourced customer-enquiry call centres, ticketing, baggage handling and inflight catering and merchandising. Malaysia Airlines recently denied rumours that it was about to outsource its inflight retail operation called Golden Boutique. The airline has made clear its desire to 'mutually separate' non-core operations. The company described its inflight business as 'non-core but good value', so it may want to remain in complete control of this with its own employees.

20 marks, 40 minutes

1. Define the term 'outsourcing'. [2]
2. Explain **two** potential advantages to an airline of outsourcing inflight catering. [8]
3. Evaluate the decision of an airline to outsource the maintenance of its aircraft. [10]

Offshoring

The arguments for and against offshoring are very similar to those for outsourcing within the same country. However, there are some additional factors to consider:

1. Low-cost countries offer substantial benefits. This is undoubtedly the major reason explaining most business **offshoring** decisions.
2. The potential for higher profits will benefit the finance department despite the high setup costs of overseas operations or the transport and communication costs of using subcontractors in overseas locations.
3. With labour wage rates in India, Malaysia, China and Eastern Europe being a fraction of those in Western Europe and the USA, it is not surprising that **multinationals** that wish to remain competitive have to seriously consider offshoring to low-wage economies. Examples include:

Norwich Union Insurance call centres	India
Panasonic TV production	Czech Republic
General Motors (car components)	China
Hornby Toy Trains	China
Dyson vacuum cleaners	Malaysia.

4. In developing countries, because of the shortage of jobs, the subcontracting businesses will find it easy to recruit unskilled or semi-skilled workers. Many of these workers are well educated with good English-language skills.

Look at the data in Table 5.4.3 for labour costs in different countries compared with UK labour costs, which are some of the highest in the world. It is now easy to see what cost advantages subcontractor companies have when they operate in countries such as Bulgaria, Hungary, India and China.

offshoring: the relocation of a business process done in one country to the same or another company in another country

multinational: a business with operations or production bases in more than one country

Exam tip: Do not confuse **offshoring** with outsourcing, although they may be linked. Outsourcing is transferring a business function, such as human resources, to another company. It is only offshoring if this company is based in another country.

Exam tip: Do your own research during the Business and Management course on major location decisions, both at home and abroad, of businesses based in your country.

Country	Average hourly pay in euros	Compared with United Kingdom (=100)
India	0.83	4
China	1.73	8
Bulgaria	3.7	17
Hungary	7.8	35
Sweden	39	180

Table 5.4.3 Average hourly wage rates in different countries compared with UK in 2013

THEORY OF KNOWLEDGE

Ethics

'Globalisation, as defined by rich people like us, is a very nice thing . . . you are talking about the internet, you are talking about cell (mobile) phones, you are talking about computers. This doesn't affect two-thirds of the people of the world.' Jimmy Carter, former US president.

The unequal distribution of the benefits of globalisation, according to former US president Jimmy Carter, favour the richest people in more developed countries.

Consider the question:

To what extent do people in more developed countries have an ethical responsibility to redistribute the benefits of globalisation to those in less developed countries.

ACTIVITY 5.4.8

TRG'S EXCELLENT EXPERIENCE IN PAKISTAN

TRG is a company listed on the Karachi Stock Exchange. The business takes controlling stakes in firms offering services to other businesses – such as web- and phone-based customer service centres – and prepares them for rapid expansion. It has operations in Lahore, Karachi, the Philippines and Morocco. The company's decision to base its head office in Lahore, Pakistan was based on a number of factors:

- large pool of English-proficient graduates
- well-organised capital market giving opportunities to raise the finance needed
- land costs 30% less than India or the Philippines
- wages 60% less than the USA
- government willing to offer incentives, a 15-year tax 'holiday' and willing to invest in IT infrastructure.

There were some initial problems:

- cultural differences
- lack of general management experience among the graduates – they had to be trained in this
- lack of support organisations, such as specialist personnel recruitment firms or training institutes, as TRG were one of the first businesses in this industry in the country.

Source: www.sourcingmag.com

24 marks, 48 minutes

1. Define the term 'offshoring'. [2]
2. Explain how TRG's location in Pakistan could have increased its profits. [4]
3. Analyse two ways a 'large pool of English-proficient graduates' in Pakistan might be a benefit to TRG. [8]
4. Examine **three** of the problems TRG has faced locating in Pakistan. [10]

Potential limitations of offshoring

International locations can also add to the number of drawbacks that might result from an inappropriate location decision. Here are some of the major additional issues that need to be weighed up carefully before going offshore.

1. Language and other communication barriers

Distance is often a problem for effective communication. This human resources problem is made worse when company employees, suppliers or customers use another language altogether. This is one of the reasons for India's success in attracting offshoring companies – English is one of the official languages.

2. Cultural differences

These are important for the marketing department if products are being sold in the country concerned – consumer tastes and religious factors will play a significant role in determining what goods should be stocked. Cultural differences also exist in the workplace and impact on human resource management. Toyota found that the typical Mexican worker is self-reliant and independent, yet the Toyota manufacturing system depends greatly on team work and cooperation. Effective staff training may be necessary to ensure that cultural differences do not prevent successful overseas expansion. For example, Oscar Rodriguez was only 20 when he was employed by Toyota's new Tijuana factory. 'I was self-reliant and I would conceal production problems and try and fix them myself,' he said. 'But I was taught how to communicate and I have learned that there is never a stupid question. The company supervisors teach us well and they are patient.'

Source: www.detnews.com

3. Level of service concerns

This operations management issue applies particularly to the offshoring of call centres, technical support centres and functions such as accounting. Some consumer groups 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.

4. Supply-chain concerns

The operations management department will also be concerned about the loss of control over quality and reliability of delivery with overseas manufacturing plants. This reason is always cited by Zara, the clothing company, for its decision not to offshore clothing production to cheaper countries as 'fast fashion' requires very close contact with suppliers. Using just-in-time (JIT) manufacturing may become much riskier if important supplies have to be shipped thousands of miles to an assembly plant.

Exam tip: Remember, the lowest-cost location may not always be the optimal location – if quality suffers or if there is negative public reaction to products being made by low-wage workers, then low costs may be outweighed by even lower revenue!

5. Ethical considerations

There may be a loss of jobs when a company locates all or some of its operations abroad and this may, as in the case of Burberry clothing, led to a consumer boycott as there were claims that the company's decision to close its Welsh factory was not 'the right thing to do'. In addition, there are several reports of high-street clothing retailers sourcing supplies from Asian factories using child labour and very low-wage labour. Could this negative publicity cancel out the competitive advantage of low-cost supplies? Will the marketing department experience lost sales from negative publicity and will human resources find it more difficult to recruit well-qualified staff if the business is viewed as being unethical?

Is it right to sell clothing in European shops that has been made by low-wage labour in Asian countries?

insourcing: the reverse of outsourcing as it is undertaking a business function or process within the business rather than contracting it to another business

inshoring: ending offshoring contracts with overseas suppliers and returning functions or processes to business operations in the home country

Insourcing

In the last five years there has been an increasing number of businesses that have reversed the outsourcing and offshoring process. A prime example of **insourcing** is that of General Motors (GM) in the USA which has switched from being 90% dependent on offshoring of its IT services to just 10%. The process of manufacturing is also **inshoring** or 'returning home' in many businesses. These are some of the reasons why:

- the cost savings with China have halved since 2000, as Chinese labour costs rise
- quality control issues have cost some companies more than they were saving

- companies had to fill a whole shipping container to get the per unit cost down, and then had to put goods waiting for transport in expensive warehouses
- working conditions in many Chinese and Bangladeshi factories break the strict ethical codes of Western businesses so production is being scaled back
- US shale gas production is cutting manufacturing energy costs in US factories by up to 40%.

It is claimed that an estimated half a million jobs could return to the USA if companies evaluate the problems, and full costs, of outsourcing to China.

ACTIVITY 5.4.9

BURBERRY STOPS HANDBAG PRODUCTION IN CHINESE FACTORY IN ETHICS ROW

Workers at a factory in Guangdong province have complained about low pay and aggressive and verbally abusive behaviour from managers. British-owned luxury goods manufacturer Burberry has pulled production of its bags from a factory in the Guangdong province of China.

The move follows concerns that working hours and conditions at the factory, operated by the Korean company Simone Accessories Collection, were in possible violation of Burberry's ethical guidelines. The China-based factory makes handbags for several Western clothing and accessory brands.

Source: The Associated Press.

GM BETS ON INSOURCING, BRINGS BACK 10 000 IT JOBS

There's a big potential upside to GM's insourcing effort – if managed correctly. 'Higher productivity, lower management burden, reduced travel costs, improved quality, reduced 'rework', increased convenience of shared working hours and better cultural fit are all tangible benefits experienced by organisations that have repatriated roles,' says F. B. Mack, director of operations for outsourcing advisory Sylvan Advisory.

Source: www.cio.com

10 marks, 20 minutes

Discuss GM's and Burberry's decisions to insource more of their operations. [10]

OVER TO YOU

Revision checklist

1. What would be meant by the term 'optimal location' for a new Walmart supermarket?
2. Outline possible reasons why Tesco chose the USA as a country in which to expand.
3. Analyse **two** ways in which the location of a retail shop could affect its competitiveness.
4. Examine the quantitative factors that a hairdressing business might take into account when deciding whether to relocate.
5. What is meant by 'clustering' of similar firms in an industry and why might this be of significance in the location decision for a new car factory?
6. Why do governments often award grants to firms setting up in certain areas of the country?
7. Explain why the location of a new clothes retailer is of strategic importance to the business.

8. Outline **two** examples of qualitative factors that might be considered by an insurance company planning to relocate its offices to a cheaper region, far away from its existing operations.
9. How might the increasing use of internet shopping have an impact on the location decisions of businesses that sell to final consumers?
10. Why might a high-technology business decide to locate in Germany, despite the huge labour cost advantages that some developing countries have?

Exam practice question

GERMAN EFFICIENCY IN AN EGYPTIAN LOCATION

Two large banners hanging from the ceiling – 'Zero defect is perfection' and '0.01 of a millimetre makes a difference' – remind the staff of their employer's quality standards. Welcome to the Egyptian German Automotive company, an oasis of German efficiency 30 kilometres south-west of the busy streets of Cairo. Almost every one of the 1600 Mercedes sold in Egypt comes from this plant, a joint venture set up in 1996 by Mercedes and a group of Egyptian entrepreneurs.

The company had no choice other than to set up its own operations in order to serve this market, where some 65 000 cars are sold a year. Very high import duties, imposed by the government to safeguard local industries and jobs, force manufacturers to charge exorbitant prices for imported cars. 'Egypt is a local assembly market because the average import duty on a car is 230%. If you want to sell in this market, you have to be here,' says Roland Sabais, managing director of Mercedes Egypt.

Once set up, foreign companies have to deal with many rules and regulations designed to help local producers. A recent example was the government's decision to increase the percentage of local parts in the car from 40% to 45% virtually overnight. Despite these hurdles the operations are profitable and have met the targets set by head office. One of the reasons why the company is profitable, despite the 'non-tariff trade barriers', is that labour is cheap and productivity is high. The 400 workers in the Cairo Mercedes plant are paid on average 80% less than their counterparts in Germany, even though they are trained and perform to similar standards. Infrastructure costs are also low. The factory cost Daimler-Benz Egyptian pounds (E£)150 million ($38.5 million), but its revenues are tax-free for ten years because it is located in one of the government-sponsored industrial zones.

20 marks, 40 minutes

1. Define the term 'joint venture'. [2]
2. Explain **one** qualitative factor Mercedes might take into account when choosing to locate in Cairo. [4]
3. Analyse **one** reason why Mercedes chose to use a joint venture when entering the Egyptian economy. [4]
4. Discuss the advantages and disadvantages to Mercedes of its decision to increase its offshoring operations in Egypt. [10]

Key concept question

20 marks, 40 minutes

Using a case example of a business you have studied, examine the extent to which a business's stakeholders benefit from its increased use of offshoring and outsourcing. [20]

5.5

H

Production planning

On completing this chapter you should be able to:

Analyse and apply:

- The supply chain process (AO2)
- The difference between JIT and just-in-case (JIC) (AO2)

Analyse and apply, construct and calculate:

- Stock control charts based on the following:
  - lead time
  - buffer stock
  - re-order level
  - re-order quantity (all AO2 and AO4)
- Capacity utilisation rate (AO2 and AO4)
- Productivity rate (AO2 and AO4)
- Cost to buy (CTB) (AO2 and AO4)
- Cost to make (CTM) (AO2 and AO4)

Setting the scene

THE SHOCKING COST OF HOLDING STOCKS

It is commonly accepted that the cost to a business of holding stock is between 4% and 10% of the stock's value. So, if an average stock level is $1 million, the annual cost of actually keeping and looking after the stocks could be up to $100 000. Recent research has shown that the figure could be as high as 40%. These costs include:

- storage costs
- stock-handling costs
- loss and damage of stocks
- obsolescence
- opportunity cost of capital.

But how to cut down on these costs? Could businesses manage their operations with lower stocks – or even no stocks at all? The experience of a Scottish supermarket group suggests that it is possible to move away from holding large stocks 'just in case' there is a demand for the products. The managers of Scotmid decided on an IT-driven stock-ordering system that re-ordered goods from suppliers automatically as remaining goods on the shelves were purchased by customers. 'We now have much tighter control of stock, wastage and improved cash flow. Stock-holding has reduced dramatically with huge benefits throughout the supermarket group,' said Robin Kilpatrick, IT manager, Scotmid.

Points to consider

- Give examples of stocks held by: (a) a supermarket, (b) a house builder and (c) an insurance company.
- Explain as many reasons as you can why businesses hold stocks.
- Could a business manage with 'zero' stocks? Explain your answer.

5.5 Operations management

Key concept link

Changes in the approach to stock management have been true innovations in business. The development and adoption of IT programs to allow the use of JIT and more effective management of the supply chain have brought about radical improvements in operations planning. Innovation is not just about new products – it is also about new business processes that reduce costs, cut waste and improve competitiveness.

Introduction

Managing the supply chain and stock (inventory) levels are important operations management responsibilities. The two main conflicting elements are:

- cost minimisation – to remain competitive
- consistent and reliable supply of products – to satisfy customer demand.

Cutting costs – by reducing excess capacity or by reducing stock levels – can, at times, lead to increased risks of supply bottlenecks and disappointed customers. This chapter analyses these important issues and the main concepts of production planning.

The supply chain process

supply chain: every business that comes into contact with a particular product – for example, the supply chain for most products will be all the businesses manufacturing parts for the product, assembling it, delivering it and selling it

The **supply chain** encompasses all the steps it takes to get a good or service from the supplier to the customer. Supply chain management is an important process for most businesses, especially with the increasing trend towards outsourcing/offshoring. Businesses will strive to have the most optimised supply chain because it usually translates into lower costs for the company.

Supply chains need to be managed to reduce costs, minimise transportation, eliminate bottlenecks and maximise customer value. According to the Council of Supply Chain Management Professionals (CSCMP), supply chain management encompasses the planning and management of all activities involved in sourcing, procurement, stock and logistics management.

Managing supply chains requires IT links with all suppliers and distribution companies and the constant monitoring of deliveries and dispatches of parts/components/finished goods.

Exam tip: Do not confuse the term 'logistics' with 'supply chain'. Logistics refers to the physical distribution process of parts/components and finished goods whereas the supply chain includes relationships and trading terms with multiple companies such as suppliers, manufacturers and the retailers.

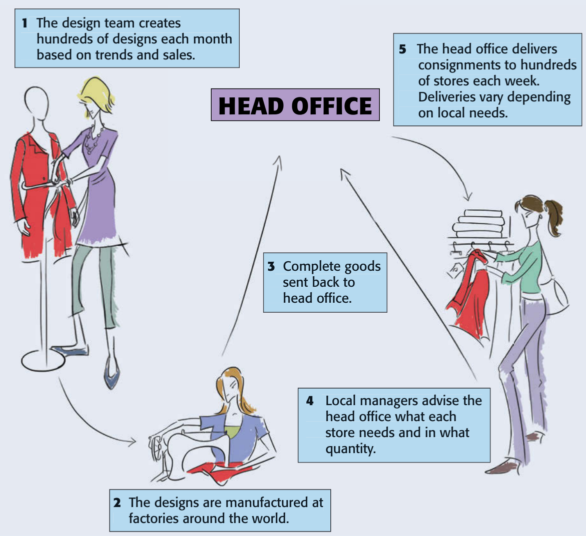
ACTIVITY 5.5.1

THE QUICK CHANGE ARTIST

Zara's ability to quickly bring the latest designs to its stores rests on its unique business model.

The headquarters of Zara, the company that introduced the idea of fast fashion two decades ago, operates a highly centralised design, manufacturing and distribution system. The building is officially known as 'the Cube'. It is central command for a fashion business built on an unconventional idea: speed and responsiveness are just as important as cost. Zara is famous for its ability to deliver newly designed clothes to stores quickly and in small batches. Twice a week, at precise times, store managers order clothes, and twice a week, on schedule, new garments arrive. For Zara, its supply chain is its competitive advantage.

Zara's factories in Spain and those it uses in Portugal, Morocco and Turkey produce its trendiest clothes. The relative proximity to northern Spain, where Zara is based, means transportation is quick and low cost – important for 'fast fashion'. Zara executives have invested in high-tech equipment and extra capacity that allows their factories to accommodate sudden production increases or changes in styles – something few Asian manufacturers would be able to do.



Just outside the Cube is the company's 465 000-square-metre main distribution centre. The company produces about 450 million items a year for its 1770 stores in 86 countries. Some 150 million garments pass through the centre to be inspected and sorted. Whether a shirt is made in Portugal, Morocco or Turkey it still goes to Spain before being shipped to a store. Beyond the distribution centre are the 11 Zara-owned factories. Every shirt, sweater and dress made there is sent directly to the distribution centre via an automated underground monorail. There are 200 kilometres of track. Across the surrounding Galicia region are many subcontractors, some of which have worked for Zara since it was founded in 1975.

Source: BloombergBusinessweek.com, Bloomberg L.P.

10 marks, 20 minutes

1. Define the term 'supply chain'. [2]
2. Describe Zara's supply chain. [4]
3. Explain **two** reasons why Zara's supply chain might give it a competitive advantage. [4]

Stock (inventory) control – the difference between JIT and JIC

The meaning and aims of JIT – the just-in-time stock control principle – were explained in Chapter 5.3. Traditionally, businesses tended to rely on the JIC principle of stock control – 'just-in-case'. Failure to hold a high enough level of stocks of parts and components could result in production being halted when stocks run out. Failure to hold a high enough level of stocks of finished goods could mean customer dissatisfaction if demands cannot be met immediately or in the short term.

All businesses hold stocks of some kind. Banks and insurance companies will hold stocks of stationery, and retailers have stocks of goods on display and in their warehouses. Manufacturing businesses will hold stocks in three distinct forms:

1. **Raw materials and components**. These will have been purchased from outside suppliers. They will be held in stock until they are used in the production process.

stock (inventory): materials and goods required to allow for the production and supply of products to the customer

JIT – just-in-time stock control: this stock-control method aims to avoid holding stocks by requiring supplies to arrive just as they are needed in production and completed products are produced to order

JIC – just-in-case stock control: the stock management strategy that businesses use when they hold a high level of stocks because there is a risk of 'stock-out'

2. **Work in progress**. At any one time the production process will be converting raw materials and components into finished goods and these are 'work in progress'. For some firms, such as construction businesses, this will be the main form of stocks held. Batch production tends to have high work-in-progress levels.
3. **Finished goods**. Having been through the complete production process goods may then be held in stock until sold and despatched to the customer.

Exam tip: Any question about JIT that involves discussing how appropriate it is in different business cases should lead to an answer that considers the potential drawbacks of the approach as well as its more obvious benefits.

Read Chapter 5.3 again to understand the important principles on which JIT is based and the requirements for it to operate effectively. These requirements – such as very close relationships with suppliers and excellent transport links – are less important with JIC and these are some of the differences between the two systems. However, the essential difference between the JIT and JIC strategies is that with JIT stocks are minimised or, if possible, eliminated whereas in JIC, stocks are held at a sufficient level to act as a buffer if component part delivery delays or production problems occur. The operation of JIC is usually represented by the stock control graphs which are analysed below.

Tables 5.5.1 and 5.5.2 summarise the advantages and disadvantages of the just-in-case and just-in-time management approaches. For more information on the JIT approach, see Chapter 5.3.

Advantages	Disadvantages
• Stocks of raw materials can be used to allow the firm to meet increases in demand by increasing the rate of production quickly. • Raw-material supply hold-ups will not lead to production stopping. • Economies of scale from bulk discounts will reduce average costs. • Stocks of finished goods can be displayed to customers and increase the chances of sales. • Stocks of finished goods can be used to meet sudden, unpredicted increases in demand – customers can be satisfied without delay. • Firms can stockpile completed goods to meet anticipated increases in demand as with seasonal goods or products such as toys at festival times.	• There are high opportunity costs of working capital tied up in stock. • There are high storage costs. • There is a risk of goods being damaged or becoming outdated. • 'Getting it right first time' – a key component of lean production – matters less than with JIT as other supplies are kept in stock to replace defective items. • Space used to store stock cannot be used for productive purposes.

Table 5.5.1 Just-in-case stock management approach – advantages and disadvantages

Advantages	Disadvantages
• Capital invested in stock is reduced and the opportunity cost of stock-holding is reduced. • Costs of storage and stock-holding are reduced. • Space released from holding of stocks can be used for a more productive purpose. • Much less chance of stock becoming outdated or obsolescent. Less stock held also reduces the risk of damage or wastage. • The greater flexibility that the system demands 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 from 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 supplying firms.

Table 5.5.2 Just-in-time stock control – advantages and disadvantages

THEORY OF KNOWLEDGE

Taiichi Ohno (1912–1990) was an icon of Japan's manufacturing resurgence after the Second World War. Born in Dalian, in eastern China, he joined Toyota Automatic Loom Works between the wars.

Ohno worked as a production engineer for Toyota towards the end of the Second World War, at a time when its productivity was way below that of America's mighty Detroit industry. Toyota's management wanted to catch and overtake America's in just three years.

The just-in-time stock management system was to be a central feature of Ohno's work and drive efficiency in Japanese car plants. But JIT is more than just a business system – it is a Japanese management philosophy. Ohno is cited as a great example of his country's perseverance, of not accepting something until it really works for the business.

In groups discuss how a nation's culture and beliefs affect the way its businesses make decisions.

Exam tip: Remember to apply your answer to the business in the question of the case study when writing about stocks and stock-handling systems – for example, if the business sells toys, it is likely to hold high stocks of toys at festival times.

LEARNER PROFILE

Open-minded

The emergence of Japan as an industrial power in the 1970s and 80s had managers in the rest of the world running around looking at their methods that delivered such business efficiency. The just-in-time approach to stock management was a key feature of the Japanese production approach and major businesses around the world wanted to adopt it.

Research how one country's business ideas have influenced organisations in other countries.

Stock-holding costs

There are three costs associated with stock-holding:

1. **Opportunity cost**. Working capital tied up in stocks could be put to another best alternative use. The capital might be used to pay off loans, buy new equipment or pay off suppliers, or could be left in the bank to earn interest.
2. **Storage costs**. Stocks have to be held in secure warehouses. They often require special conditions, such as refrigeration. Staff will be needed to guard and transport the stocks, which should be insured against fire or theft.
3. **Risk of wastage and obsolescence**. If stocks are not used or sold as rapidly as expected, then there is an increasing danger of goods deteriorating or becoming outdated. This will lower the value of such stocks. Goods often become damaged while held in storage – they can then only be sold for a much lower price.

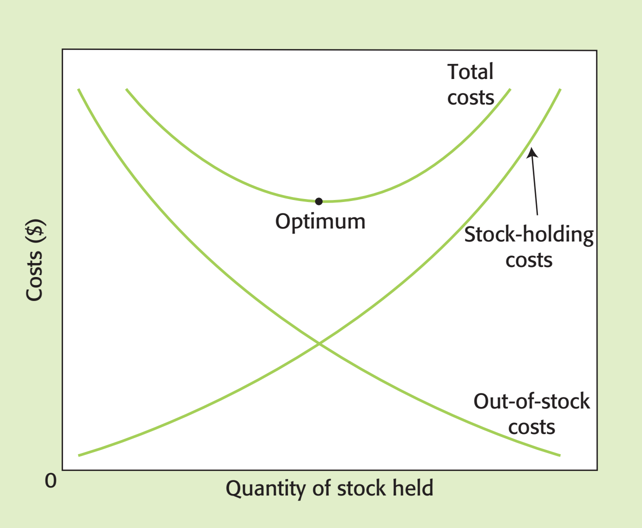


Figure 5.5.1 Total stock-holding costs

Costs of not holding enough stocks

There are risks to holding very low stock levels and these risks may have financial costs for the firm. These costs are often called 'stock-out' costs:

1. **Lost sales**. If a firm is unable to supply customers 'from stock', then sales could be lost to firms that hold higher stock levels. This might lead to future lost orders too. In purchasing contracts between businesses, it is common for there to be a penalty payment clause requiring the supplier to pay compensation if delivery dates cannot be met on time.
2. **Idle production resources**. If stocks 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.
3. **Special orders could be expensive**. If an urgent order is given to a supplier to deliver additional stock due to shortages, then extra costs might be incurred in administration of the order and in special delivery charges.
4. **Small order quantities**. Keeping low stock levels may mean only ordering goods and supplies in small quantities. The larger the size of each delivery, the higher will be the average stock level held. By ordering in small quantities, the firm may lose out on an important economy of scale such as discounts for large orders.

economic order quantity (EOQ): the optimum or least-cost quantity of stock to re-order taking into account delivery costs and stock-holding costs

Exam tip: You will not be asked to calculate the optimum order size, but it is advised that you remember the costs of stock-holding and the costs of being out of stocks – and apply these to the business in the question.

The optimum stock level will be at the lowest point of the total stock cost graph (see Figure 5.5.1).

Optimum order size

Purchasing managers might be tempted to order huge quantities of stocks in order to gain economies of scale and to ensure that the firm never runs out. 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.

However, stock-holding costs will be higher as the large orders will have to be stored until they are needed. Opportunity costs will be higher due to more capital being tied up. The danger of stock becoming obsolete and out of date is increased. What, then, is the optimum order size? It will differ for every firm and every kind of stock. The **economic order quantity** (EOQ) can be calculated for each product, but for the IB examinations it is sufficient just to know the forces that influence the size of this optimum order size. These are summarised in Figure 5.5.2.

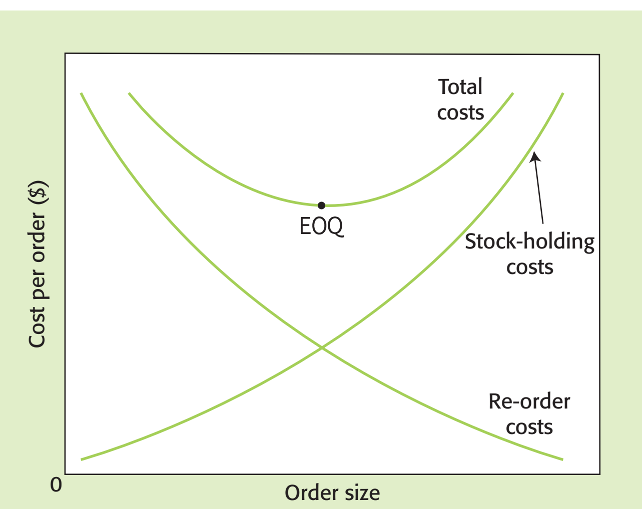


Figure 5.5.2 Factors influencing the economic order quantity

Stock control charts

Stock control charts or graphs are widely used by businesses adopting the JIC strategy to monitor stock levels. These charts record stock levels, stock deliveries, buffer stocks and maximum stock levels over time. They aid a stock manager in determining the appropriate order time and order quantity (see Figure 5.5.3).

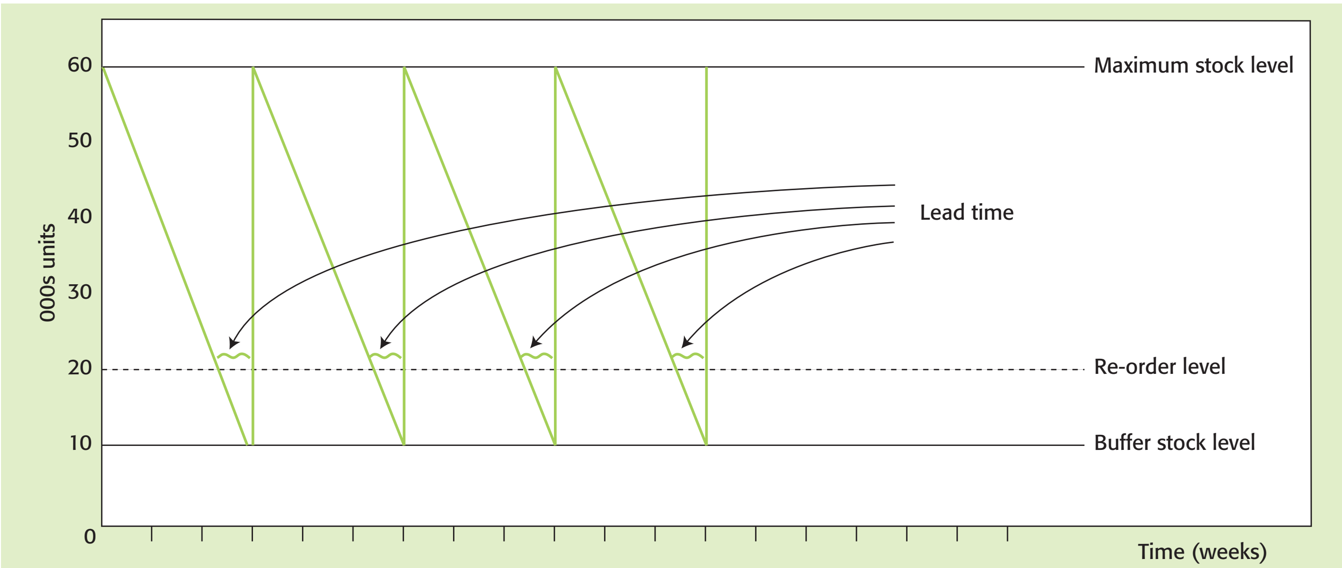


Figure 5.5.3 A typical stock control chart

Figure 5.5.3 has certain key features:

1. **Buffer stocks.** The more uncertainty there is about delivery times or production levels, the higher the buffer stock 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 stocks.
2. **Maximum stock level.** This may be limited by space or by the financial costs of holding even higher stock levels. One way to calculate this maximum level is to add the EOQ of each component to the buffer stock level for that item.
3. **Re-order quantity.** This will be influenced by the economic order quantity concept referred to above.
4. **Lead time.** The longer this period of time, then the higher will have to be the re-order stock level. The less reliable suppliers are, the greater the buffer stock level might have to be.
5. **Re-order stock level.** It is now very common for computers to be used 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 and it can then re-order automatically from the supplier when stocks fall to the re-order stock level. The stock control chart can also be prepared by the computer. Figure 5.5.4 shows the sale of Popsquash soft drinks from one retailer over a ten-week period.

As can be seen from Figure 5.5.4, the stock level does not always follow the regular and consistent pattern of the previous chart. The sales have been affected by two important factors, shown by the more steeply sloping lines, and deliveries were delayed one week. This is a more realistic situation and helps to illustrate the usefulness of this type of chart for future decision-making regarding stocks.

buffer stocks: the minimum stocks that should be held to ensure that production could still take place should a delay in delivery occur or production rates increase

re-order quantity: the number of units ordered each time

lead time: the normal time taken between ordering new stocks and their delivery

re-order stock level: the level of stocks that will trigger a new order to be sent to the supplier

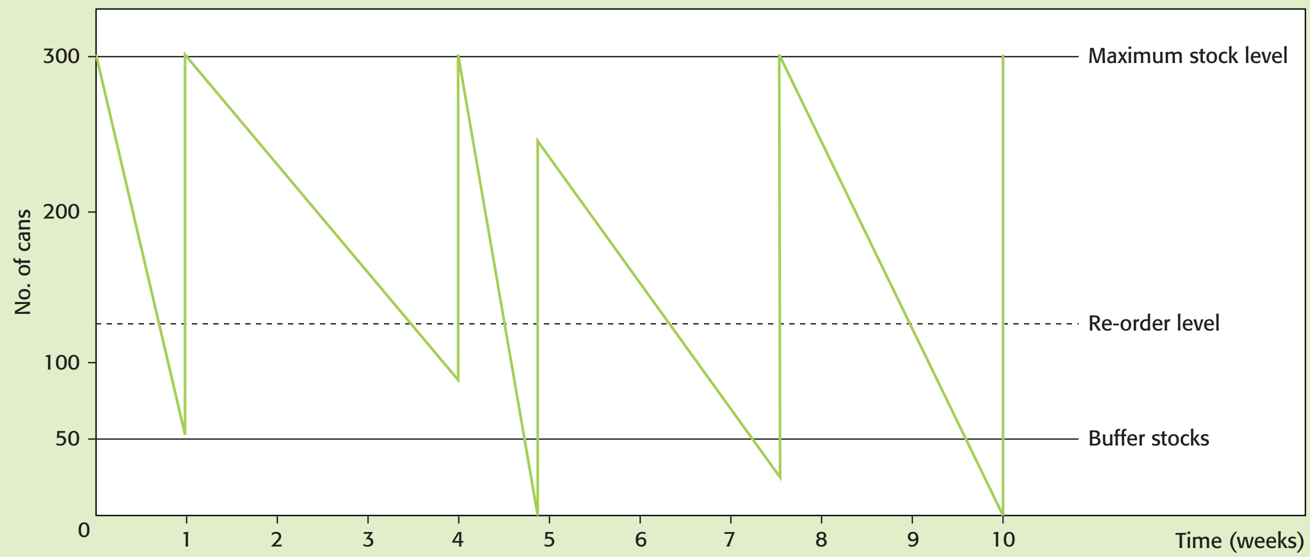
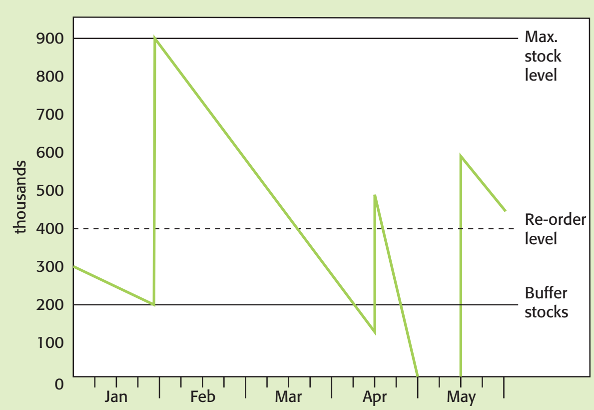


Figure 5.5.4 Stock control chart for 'Popsquash' soft drinks

ACTIVITY 5.5.2

STOCK CONTROL AT SAIKO



Stock control chart for Saiko Trading Ltd

20 marks, 40 minutes

1. Define the term 'buffer stock'. [2]

2. Referring to the chart above, state the:

- **a.** size of the order Saiko received at the end of January [2]
- **b.** lead time in weeks for Saiko between ordering goods in March and receiving them. [2]

3. Outline **two** factors that might determine the maximum stock level held by Saiko. [4]

4. Evaluate the advantages and disadvantages of using the just-in-case method of stock control. [10]

Capacity utilisation

Capacity utilisation is calculated by the formula:

$$\frac{\text{current output level}}{\text{maximum output level}} \times 100 = \text{rate of capacity utilisation}$$

Maximum capacity is the total level of output that a business can achieve in a certain time period. So, for a hotel, monthly total capacity will be the number of 'room nights' available during this period. For a factory, it will be the total level of output that all of the existing resources can produce. If a firm is working 'flat out' at **full capacity**, it is achieving 100% capacity utilisation with no spare capacity.

capacity utilisation: the proportion of maximum output capacity currently being achieved

full capacity: when a business produces at maximum output

Impact on average fixed costs

When capacity utilisation is at a high rate, average fixed costs will be spread out over a large number of units – unit fixed costs will be relatively low. When utilisation is low, fixed costs will have to be borne by fewer units and unit fixed costs will rise (see Table 5.5.3).

100-bed hotel	All bedrooms occupied (100% of capacity)	50 bedrooms occupied (50% of capacity)
Hotel fixed costs per day, e.g. rent and salaries	\$2500	\$2500
Average fixed costs per room per day	\$25	\$50

Table 5.5.3 How unit fixed costs for a hotel vary with capacity utilisation

Do all firms aim to produce at 100% capacity at all times? In theory, the cost advantages of this would appear to be great. Unit fixed costs will be at their lowest possible level and this should help to lift 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 not have any unsold seats. Employees will have a sense of job security too.

There are also potential drawbacks to operating at full capacity for a long period of time:

- Staff 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 flat out and there may be insufficient time for maintenance and preventative repairs and this could lead to increased unreliability in the future.

So many firms attempt to maintain a very high level of capacity utilisation, but to keep some spare capacity for unforeseen eventualities.

Excess capacity

excess capacity: exists when the current levels of demand are less than the full capacity output of a business – also known as spare capacity

Full-capacity working

The potential problems connected with operating at full capacity have been referred to. When a business is operating close to or at full capacity, then other decisions have to be taken:

- Should the firm increase its scale of operation by acquiring more production resources?
- Should it keep existing capacity but outsource or subcontract more work to other firms?

- Could the quality of products obtained from subcontractors be assured?
- Should it keep working at full capacity and not expand, perhaps because of the danger that demand might fall in the near future?

Exam tip: When making decisions about how to deal with excess capacity it is important to consider both the length of time that the spare capacity might exist for and the causes of the problem.

ACTIVITY 5.5.3

HOTELS' EXCESS CAPACITY

The following data applies to the hotel industry. Capacity utilisation in the hotel industry is often referred to as 'room occupancy rates'.

	2013	2014
London hotels – capacity utilisation	85%	75%
Average room price	$135	$145
Istanbul hotels – capacity utilisation	70%	80%
Average room price	$90	$95

10 marks, 20 minutes

1. Define the term 'capacity utilisation'. [2]
2. Explain **two** factors that could account for falling rates of capacity utilisation in London hotels. [4]
3. Analyse **two** possible consequences of rising capacity utilisation in Istanbul's hotels. [4]

Capacity shortage

What options is a firm faced with if the demand for its products exceeds current output capacity? It is essential to analyse the cause of the excess demand and how long it is likely to last. If it results from a reduction in output caused by a faulty machine that will be repaired next month, then drastic action to raise capacity is unlikely. If, however, the firm has been producing at 100% capacity for some time and there seems to be no sign of demand falling, then two options need to be weighed up (see Table 5.5.4).

Long-term capacity shortage		
	Advantages	**Disadvantages**
Option 1: Use subcontractors or outsourcing of supplies, components or even finished goods	• No major capital investment is required • Should be quite quick to arrange • Offers much greater flexibility than expansion of facilities – if demand falls back, then the contracts with other firms can be ended	• Less control over quality of output may add to administration and transport costs • 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
Option 2: Capital investment into expansion of production facilities	• Long-term increase in capacity • Firm is in control of quality and final delivery times • New facilities should be able to use latest equipment and methods • Other economies of scale should be possible too	• Capital cost may be high • Problems with raising capital • Increases total capacity, but problems could occur if demand should fall for a long period • Takes time to build and equip a new facility – customers may not wait

Table 5.5.4 How to overcome long-term capacity shortage problems

ACTIVITY 5.5.4

IMPROVING EFFICIENCY AT NASSAU TEXTILE MANUFACTURING

The problems at NTM began several years ago when the previous chief executive took the decision to double production capacity. He could not have foreseen the worldwide recession and how this would reduce the demand for the textiles made in the factory. The following figures tell their own story and the cost impact on the business is now serious:

	2012	2013	2014
Maximum capacity (million metres)	5	5	5
Actual annual output (million metres)	4.0	3.7	3.0
Selling price per metre	$3	$3	$2.7
Annual fixed costs	$3m	$3m	$3m
Variable costs per metre	$2	$2	$2.2

20 marks, 40 minutes

1. Calculate the capacity utilisation rates for Nassau in each of the three years. [3]
2. Calculate the profits made by Nassau in each of the three years. [3]
3. Describe the relationship between Nassau's profits and capacity utilisation over the three years. [4]
4. Discuss the advantages and disadvantages of Nassau's capacity utilisation rate. [10]

Productivity

Productivity is not the same as the **level of production** and the two should not be confused. 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. The most common measures of productivity are:

$$\text{labour productivity (number of units per worker)} = \frac{\text{total output in a given time period}}{\text{total workers employed}}$$

$$\text{capital productivity} = \frac{\text{output}}{\text{capital employed}}$$

Nearly all firms are trying at all times to increase productivity, even if total production is not increasing. A business can do this by employing fewer but better-skilled workers and by using fewer but more technologically advanced machines. Improvements in productivity usually lead to a reduction in the unit costs of production. If the costs of labour and capital inputs do not change, then any increase in output per worker or output per machine will lead to a fall in unit costs. In competitive markets, this could give firms a crucial advantage.

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

Table 5.5.5 shows the annual output and employment levels in two companies producing kitchen cupboards.

	Number of units produced	Number of workers employed	Labour productivity = output/workers	Annual pay per worker	Labour cost per unit
Company A	5000	10	500	$2000	$4
Company B	12 000	20	600	$2000	$3.33

Table 5.5.5 The higher the level of labour productivity, the lower the labour cost per unit produced – assuming the pay per worker is the same

Raising productivity levels

There are *four* main ways in which productivity levels could be increased:

1. **Improve the training of employees to raise skill levels**. Employees with higher and more flexible skill levels should be more productive. As well as being able to perform tasks more efficiently, they could become more interested in work due to their ability to do different jobs. However, training can be expensive and time-consuming and highly qualified staff could leave to join another, perhaps rival, business.
2. **Improve worker motivation**. Many different views on the most appropriate ways to do this exist. Increasing pay, as identified by Herzberg and as explained in Chapter 2.4, is unlikely to have a permanent impact on productivity. There may be little point in raising pay by 10% if labour productivity only rises by 5%. After all, it is unit costs that firms want to drive down. Most businesses now put the emphasis on non-financial methods of motivation. These include involvement in decision-making, kaizen groups, delegation and quality circles. If these increase productivity without an increase in labour pay, unit costs will fall.
3. **Purchase more technologically advanced equipment**. Modern machinery – from office computers to robot-controlled production machines – should allow increased output with fewer staff. Such expensive investment will only be worthwhile, though, if high output levels can be maintained. In addition to the capital cost, staff may need to be retrained and there may be genuine fear amongst the workers about lost jobs and reduced security of employment.
4. **More efficient management**. There are many ways in which ineffective management can reduce the overall productivity of a business. Failure to purchase the correct materials, poor maintenance schedules for machines or heavy-handed management of staff are just some of these. More efficient operations and people management could go a long way to improve productivity levels.

ACTIVITY 5.5.5

WHY PRODUCTIVITY IS IMPORTANT

In one town there are three take-away pizza stores. Rapid Pizza is losing sales to the other two businesses because its prices are higher. 'We must change these prices to cover our costs,' said the manager at Rapid Pizza. He asked for advice from a business consultant who was able to obtain the following information:

	Number of pizzas produced each week	Number of workers employed	Weekly pay per worker
Rapid Pizza	3000	15	$60
Pizza to Go	3960	18	$60
Pizza4U	6600	25	$66

20 marks, 40 minutes

1. Define the term 'labour productivity'. [2]
2. Calculate the rate of labour productivity in all three businesses. [3]
3. State which business is the most efficient based on labour productivity. [1]

4. Outline **two** possible reasons for the different rates of labour productivity between the businesses. [4]
5. Evaluate the importance of labour productivity for the long-term performance of firms in the pizza industry. [10]

It is possible for a business to achieve an increase in labour productivity but to reduce total output too. If demand for the product is falling, it might be necessary to reduce the size of the workforce – but by a greater proportion than the reduction in output.

ACTIVITY 5.5.6

WESTLIFE JEANS LTD

The operations manager at Westlife Jeans Ltd is concerned about the declining rate of productivity in the factory. He has collected the following data from factory records. Each worker is paid $3000 per year and this has not changed for three years. New workers have been employed and put into the production department with little training. The additional machines were purchased second-hand and some of them have proven to be unreliable. The operations manager has been told to increase productivity within six months, as it is believed that the labour costs of Westlife Jeans' main competitor are 20% lower. Although the marketing department admits that the higher quality of Westlife's jeans allows higher prices to be charged, the lack of cost competitiveness is cutting into profits. Falling profitability may make it difficult to raise the capital needed for any technological improvements in the factory – but, without these, profits could fall even further.

	2012	2013	2014
Total output of jeans	50 000	55 000	60 000
Workers employed	20	24	30
Number of machines used	10	12	15

20 marks, 40 minutes

1. For each year calculate the labour productivity and capital productivity for the Westlife factory. [4]
2. Describe the trends in labour productivity and capital productivity over the three years. [4]
3. Explain **two** possible reasons for the change in labour productivity over the three years. [4]
4. Explain **two** consequences for the change in capital productivity over the three years. [4]
5. Analyse **two** methods Westlife could use to increase labour productivity. [4]

Make-or-buy decisions

The potential benefits and limitations of outsourcing were analysed in Chapter 5.4. One of the key factors for operations managers to consider when making the 'make ourselves or buy-in' decision is the relative costs of these two options. In quantitative terms, if it can be shown that the long-term costs of outsourcing (buying-in) a component or product are less than the cost of making that component or product then outsourcing might be the better option. Qualitative factors should also be considered however – such as impact on worker morale of redundancies, social responsibility objectives and quality issues.

When dealing with a make-versus-buy decision, there are four figures that operations managers should consider:

1. expected volume (V)
2. the fixed or overhead costs directly associated with making the product (FC)
3. the unit direct costs of making the product (UDC)
4. the unit cost from an external supplier – including transport costs (UCS).

This data can then be inserted into the following formulae:

$$\text{Cost to buy (CTB)} = \text{V} \times \text{UCS}$$

and

$$\text{Cost to make (CTM)} = \text{FC} + (\text{UDC} \times \text{V})$$

If CTM exceeds CTB, then it is more financially advantageous to buy-in or outsource. If CTB exceeds CTM, the opposite is true and the business will benefit financially from making the product 'in-house'. The unit cost from suppliers of a component or service can be obtained from estimates given by potential suppliers. The cost to make should use contribution costing, that is only the *additional costs* of making a product or component or providing a service should be considered. Overhead costs that would still have to be paid if the outsourcing option were used should *not* be included in the cost-to-make calculation.

An example can be used to demonstrate the two formulae:

Cost to buy: An operations manager of a computer assembly firm has obtained an estimate from a specialist supplier of keyboards: 'To supply 10 000 (V) keyboards each month at \$3 (UCS) each = total cost, including transport, of \$30 000' (CTB).

Cost to make: The manager has estimated the internal direct costs of making keyboards in-house at \$2.50 (UDC) each. The fixed costs that can be directly allocated to the production of these keyboards amount to \$6000 per month (FC). Total cost of making the products is [\$6000 + (\$2.50 × 10 000)] = \$31 000 (CTM).

Obtaining 10 000 keyboards from an outsourcing company would save the computer business \$1000 per month. The cost to buy is less than the cost to make – assuming the expenditure on the fixed costs can be stopped immediately when production ceases.

Make-or-buy decisions are not just about numbers. Other questions an operations manager should ask include:

- Is this the organisation's core competency – and would the business be losing key skills by outsourcing?
- Could the business risk losing a competitive advantage by disclosing detailed information about production designs and methods to an outsourcing business?
- What will the impact on quality or delivery be?
- What additional risks would we be facing?
- How irreversible is the decision? Could the business return to making the product if a supplier let them down completely?

ACTIVITY 5.5.7

SHOULD PRODUCTS X AND Y BE BOUGHT-IN?

An electrical assembly business, located in Europe, produces several products. The following data (in US$) are available for two of its key components, X and Y:

Products	*X*	*Y*
Direct labour costs per unit	$5	$7
Direct material costs per unit	$4	$12
Fixed factory costs directly allocated to each product (monthly)	$2000	$3000
Business overhead costs (administration and marketing) allocated to each product (monthly)	$6000	$8000
Current monthly output (units)	500	1000
Unit cost of product if bought-in from supplier (including transport costs from Asia)	$11	$24

20 marks, 40 minutes

1. Calculate the unit direct cost of making product X and product Y. [4]
2. Calculate the cost to make 500 units of product X per month (tip: ignore the allocated business overhead costs as these will still have to be paid if production ceases). [2]
3. Calculate the cost to make 1000 units of product Y per month (tip: ignore the allocated business overhead costs as these will still have to be paid if production ceases). [2]
4. Calculate the total cost to buy product X and product Y. [2]
5. Examine whether the business should make or buy product X or product Y. [10]

Exam tip: For make-or-buy decisions remember to consider: Will the supplier increase prices once the firm has closed down its own production capability? Will the quality be as good? Is the supplier reliable?

OVER TO YOU

Revision checklist

1. Explain the following terms:
   a. buffer stock level
   b. stock re-order size
   c. lead time.
2. From the diagram below, identify:
   a. buffer stock level
   b. order size
   c. lead time.
3. State **three** types of stocks that are likely to be held by a chocolate manufacturer.
4. Explain why most manufacturers will hold stocks in the form of 'work in progress'.
5. Explain **two** factors that would determine the maximum stock level held by a food-processing business.
6. Explain **two** conditions that must exist for JIT stock control to work effectively.
7. Explain **two** risks to a business from operating a JIT system.
8. If a business currently has an annual production capacity of 50 000 units, what will be its rate of capacity utilisation if its annual production is:
   a. 20 000 units
   b. 30 000 units
   c. 45 000 units
   d. 50 000 units?

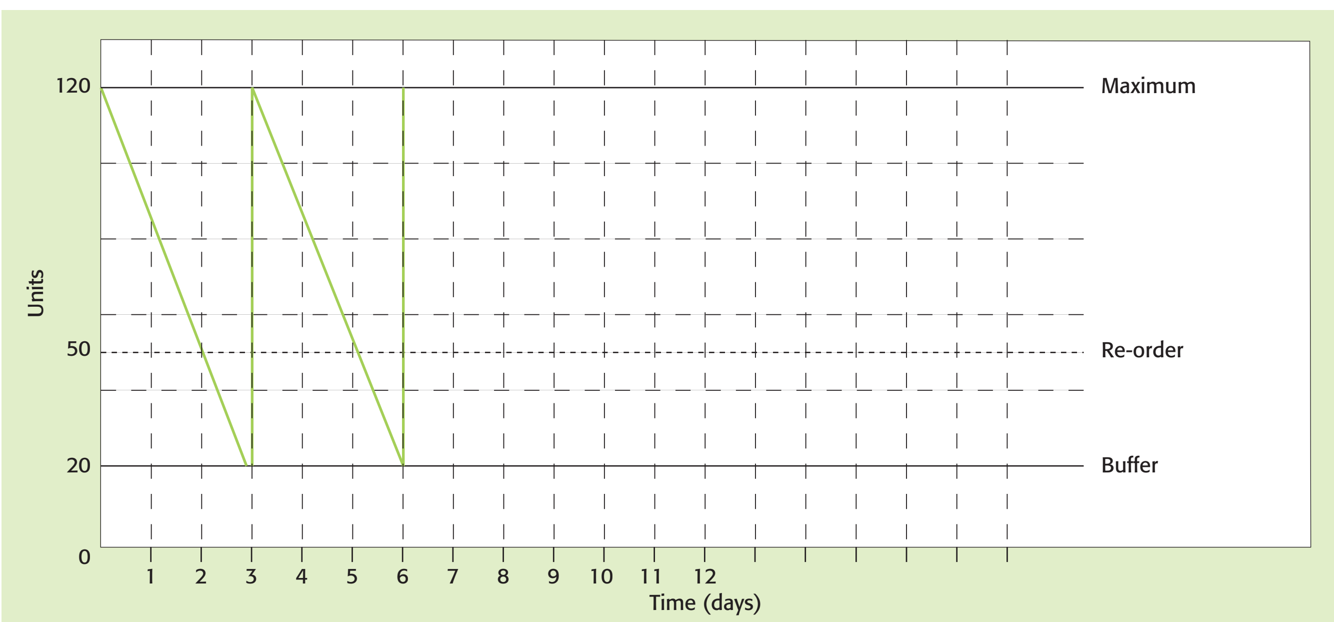
   Show your working.
9. What is meant by 'full-capacity working'?
10. Explain **two** reasons why firms may not wish to operate at 100% capacity.
11. Refer to the table below:
    a. Calculate the capacity utilisation rates in each of the three years.
    b. Calculate the average fixed costs in each of the three years.

    Comment on your results.

	2012	2013	2014
Maximum capacity (units)	5 million	5 million	5 million
Actual annual output (units)	4 million	3.7 million	3 million
Annual fixed costs	$3 million	$3 million	$3 million

12. Calculate the labour productivity for Saisho Electronics for the 3 years shown:

	2012	2013	2014
Employees	2000	2100	2050
Annual output	1.5 m	1.8 m	1.6 m



13. A furniture-making business produces a range of designs including computer desks. The operations manager is considering stopping production of these. Calculate the 'cost to make' and the 'cost to buy' of 100 computer desks per month:

Computer desks	
Direct labour cost per unit	$25
Direct materials cost per unit	$30
Fixed costs directly related to this product per month	$3000
Estimated supplier's unit cost including transport	$75

Exam practice question

MFLEX TO EXPAND OPERATIONS IN MALAYSIA

MFLEX, the leading global maker of high-quality advanced circuit boards to the electronics industry, has leased a 35 000-square-metre factory in Johor Darul Takzim, Malaysia. It has purchased new manufacturing equipment for the plant and employed 125 workers, which will mean a considerable increase in capacity and scale of operation for the company. Directors hope that, within two years, the rate of capacity utilisation of the new factory will be 90%. This expansion follows a decision by the directors to make more components rather than buy them in from external suppliers.

The factory will allow the business to respond more rapidly and flexibly to just-in-time demands from its customers. MFLEX will also expect its suppliers to be able to deliver materials and components on a JIT basis and it has signed exclusive deals with certain suppliers and is connected to them by computer link to speed up ordering.

Rapid inflation in Malaysia, as in other countries, is forcing some businesses to rethink their use of JIT manufacturing systems. With rising costs of industrial materials and components and much higher charges for transport, some operations managers are looking again at whether the 'no buffer stock' policy of the JIT method with frequent small orders being delivered is actually costing more than a large stock-order policy.

Source: Adapted from http://biz.yahoo.com

20 marks, 40 minutes

1. Define the term 'capacity utilisation of 90%'. [2]
2. Explain the difference between stock-holding costs and the costs of not holding enough stock. [4]
3. Outline **two** criteria MFLEX needs to meet in order to use JIT stock management successfully. [4]
4. Evaluate MFLEX's decision to use JIT stock management. [10]

Key concept question

20 marks, 40 minutes

'JIT is something of an exception. The cultural differences between countries are so strong that it is impossible for the management techniques of one country to be used effectively in another.'

Using a case study you have studied, discuss the validity of this statement. [20]

5.6

H

Research and development

On completing this chapter you should be able to:

Analyse and apply:

- The importance of developing goods and services that address customers' unmet needs (AO2)
- Distinctions between product, process, positioning and paradigm innovations (AO2)
- The difference between adaptive creativity and innovative creativity (AO2)

Evaluate:

- The importance of research and development for a business (AO3)
- How different factors influence the research and development strategies in an organisation (AO3)

Setting the scene

APPLE'S INNOVATIVE CULTURE

Apple's non-stop programme of innovative products seems set to continue. The year 2014 was a typical year with launches of a new Apple TV, iPhone 6, iOS8 and the presentation of the iWatch. These products generated great consumer interest and helped to restore Apple's profitability. The new features on these products and the increasing number of apps available, keeps the company ahead of most of its competitors and seals the company's reputation as being innovative and 'different'. The pace of change in the markets Apple operates in is accelerating as rivals – such as Samsung – spend increasing amounts on research and development in an effort to invent and develop the next 'big idea'.

Points to consider

- How do innovative products benefit consumers?
- What benefits does Apple appear to gain from launching innovative products?
- Are all innovative products necessarily a marketing success?

Key concept link

Innovation in business refers to the generation and application of new ideas for products, services or business processes. Significant innovations can change an industry – when was the last time you used a landline telephone kiosk? – but incremental innovations are also important as they can be an effective way for a business to gain or maintain competitive advantage. Adopting a strategy of research and development can be expensive and result in benefits only in the long term – but these benefits can be substantial.

Introduction

In most industries, change is the only constant. Change can result in new products or new ways of making existing products. Some industries are more likely to undergo substantial changes brought about by new technologies and new adaptations of existing technologies. The IT, computer and mobile-phone markets are experiencing more **innovation** than most. How do businesses benefit from introducing radical new products and what factors influence the range and pace of innovation? These are the main issues explained in this chapter.

innovation: the practical application of new inventions into marketable products

The importance of research and development

Spending on **research and development** (R&D) is growing globally and in most industrial sectors. The benefits to a country of encouraging R&D spending include:

- creation of high-tech jobs which increase average income levels
- creation of high-added-value products that may then be manufactured in that country
- prestige – a country being linked to scientific and technological breakthroughs and **inventions**
- attracting investment by multinational corporations, keen to locate close to innovative businesses – for example, suppliers.

research and development (R&D): the scientific research and technical development of new products and processes

invention: the formulation or discovery of new ideas for products or processes

The importance of research and development to business

The benefits of successful R&D spending to business include:

- **competitive advantage** over competitors – Dyson has become one of the world's leading vacuum-cleaner manufacturers in 20 years as a result of its 'dual cyclone' technology
- it can create **intellectual property rights** for a business – see Research and development – advantages section below
- **customer loyalty** – Microsoft's continuous development and improvement programme for its computer-operating systems help to keep customers loyal to the brand even though competitors are growing in number
- **high, premium prices** – being first into a market with an innovative product can allow high prices to be charged, e.g. the tiny but expensive Smart Car was marketed not as a low-cost form of transport but an eco-friendly vehicle, worth paying 'extra' for
- **publicity** – Apple receives free worldwide publicity for each new innovative product it releases – senior managers invite the world's media to huge launch events
- **lower costs** – Pilkington, the glass maker, revolutionised float-glass making and slashed the cost of making glass to give it substantial cost advantages.

THEORY OF KNOWLEDGE

Over three decades ago James Dyson set out to create the ultimate vacuum cleaner. Thousands of failed prototypes later, he finally developed a product the world wanted to buy: the 'bagless' vacuum cleaner. His product was a sensation and it turned Dyson into a billion-dollar business and made him a household name for his innovative approach to developing new products.

Consider how reason, emotion and sense perception might have influenced Dyson when he was developing his 'bagless' vacuum cleaner.

Which way of knowing do you think would have been most important in Dyson's case?

Research and development – advantages

So, the benefits gained from successful R&D spending can be considerable. Why else would Volkswagen claim to be spending over $1.1 million an hour on developing new products and processes? The companies with the largest R&D budgets in 2013 are shown in Table 5.6.1 (source: Booz & Company). Despite the global downturn between 2008 and 2011, 90% of the respondents to Booz & Company's survey said that innovation was critical in preparing for the economic upturn. Barry Jaruzelski, a partner at Booz & Company, said, 'Reducing efforts on innovation would be similar to unilateral disarmament in wartime. Now is the opportune time to build advantage over competitors with R&D spending, especially weaker ones that may have to skimp on R&D for financial reasons.' One example of lack of finance limiting R&D spending was General Motors. It used to be the world's largest R&D spender but was so badly hit by the economic downturn that in 2010 it slipped to being the 50th largest spender on R&D. In 2013 it had climbed back to 11th place.

Company	R&D spending, 2013 (US$ billion)	As percentage of revenue
Volkswagen (cars – Germany)	11.4	4.8
Samsung (computing and electronics – South Korea)	10.6	5.8
Roche (health – Switzerland)	10.2	21
Intel (computing and electronics – USA)	10.2	19
Microsoft (IT – USA)	9.8	13.3
Toyota (cars – Japan)	9.8	3.7
Novartis (health – Europe)	9.3	16.5
Merck (health – USA)	8.2	17.3
Pfizer (health – USA)	7.9	13.3
Johnson & Johnson (health/beauty – USA)	7.7	11.4

Table 5.6.1 The largest corporate R&D budgets, 2013

Source: Booz & Company

ACTIVITY 5.6.1

10 marks, 20 minutes

These questions are based on Table 5.6.1.

1. Define the term 'research and development'. [2]
2. Calculate the total 2013 revenue for:
   a. Toyota [2]
   b. Volkswagen. [2]
3. Explain **two** possible reasons why the industries in the table spend such large sums on research and development. [4]

Research and development – limitations

Although R&D spending has the potential to yield a competitive advantage it may also have limitations:

- R&D **does not always lead to an invention or discovery**. Billions of dollars have been spent by pharmaceutical companies to develop a cure for the common cold – so far they have all failed.
- R&D is **expensive and has an opportunity cost**. Would the money spent on R&D be more wisely invested in marketing existing products more intensively?
- Inventions **do not always lead to successful innovative products**. Examples of product failures after extensive R&D spending include the Sinclair C5 battery-powered vehicle, yoghurt shampoo, New Coke and disposable paper clothing.
- **Competitors' R&D spending** may result in even more successful products. Toshiba lost millions of dollars that it had invested in HD-DVD technology when it was knocked out of the market by Sony's Blu-ray system.
- **Ethical issues** can sometimes outweigh the potential commercial benefits. Many consumers still reject genetically modified (GM) food crops and there is no certainty that big GM R&D spenders such as Monsanto will receive a return on their investments.

Exam tip: Never confuse research and development (scientific research and technical development) with market research.

THEORY OF KNOWLEDGE

Agriculture and food: the genetically modified crop marches on

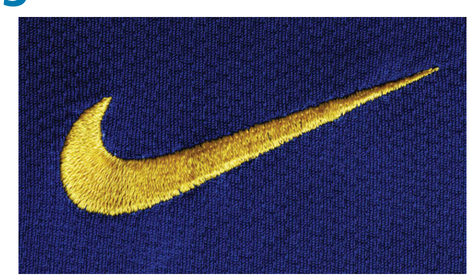
In agricultural biotechnology, the big theme is still the march of genetically modified crops across the world's farmland. The most authoritative annual survey of GM planting, carried out by the International Service for the Acquisition of Agri-biotech Applications, showed a 7% annual increase last year in the area covered to 134 million hectares (330 million acres) in 25 countries.

Source: Clive Cookson, FT.com, 4 May 2010

In the light of growth of the market for GM crops, how do you know whether society benefits from R&D into different types of products?

Intellectual property rights

As a type of property, **intellectual property** is intangible, a creation of the mind, with no physical existence. With a tangible object – such as a computer – property rights cease when the object is destroyed. With intellectual property, since there is nothing physical, **property rights** only exist for as long as the law says they do.



This does not mean that property rights – the rights to possess, use, license, sell and financially benefit from property – are not worth anything. Far from it, as they can:

- set a business apart from its competitors and encourage increased sales as a result of this distinctiveness

intellectual property: refers to creations of the mind such as inventions, literary and artistic works and symbols, names, images and designs used in business

intellectual property rights: legal property rights over the possession and use of intellectual property

- be sold or licensed to provide an important revenue stream
- form a key part of the branding process and assist in the marketing of the firm's products
- be given a financial value on a business balance sheet which increases its net assets.

There may be problems protecting intellectual property. Copying without permission of the **copyright** holder has always been a problem, but the ability to download digital versions of music, film and other material, which has led to illegal downloading, has made the task of protecting revenue earned by the intellectual property even more difficult. In addition, brand names and **trademarks** can be damaged by bad publicity and this can 'write off' a great deal of value from a balance sheet or the value of the business.

copyright: legal right to protect and be the sole beneficiary from artistic and literary works

trademark: a distinctive name, symbol, motto or design that identifies a business or its products – can be legally registered and cannot be copied

Unmet needs

Customers have needs that are unmet from the existing goods and services available on the market. Businesses can find out about these unmet needs by using market research. If research established that some consumers would like to be able to purchase tablet computers with larger screens, then manufacturers could respond to this unmet need by developing new products – probably adapting existing tablets, in this case.

Some innovations are so 'different' (see **innovative creativity**, page 540) that customers may not even be able to perceive that they could exist before they are marketed. If they prove to be sales successes, then these customers were not even aware of these unmet needs! Light-emitting diode (LED) lighting was a radical product development – these lights use less power and last longer, even when compared to 'low-energy' bulbs. But consumers may not have been aware of their needs for such lighting before they were released on the market. The sales success of LED lights suggest that this product innovation is effectively meeting needs that were previously not being satisfied.

Not all innovations satisfy unmet needs – in which case they will be marketing failures.

Razor phone

A phone with an electric shaver built in was developed and manufactured by Tondemoketai in China. The company believed that this was a viable product and it was launched in 2009. The phone featured an electric shaver head at the bottom, hidden away under a plastic cover, and was able to power a 'full shave' when the battery was fully charged. It was not successful because it failed to satisfy an unmet consumer need.

Source: www.brandwatch.com

Possibly a better system for Tondemoketai to have adopted would have been one driven by marketing and putting the customers' needs first. Producing innovative goods that are, according to market research, likely to sell is a more effective strategy. R&D is usually directed towards developing products that market research indicates will meet an unmet need – unless consumers are unaware of their future needs!

Types of innovation

The following distinctions are now often made when discussing the process of innovation by businesses. It is called the 4Ps Innovation Model.

Product innovation: new, marketable products such as hybrid/electric cars or developing and improving existing products such as the Apple iPad Air. These products are trying to satisfy consumers' unmet needs – even if they are not aware of them!

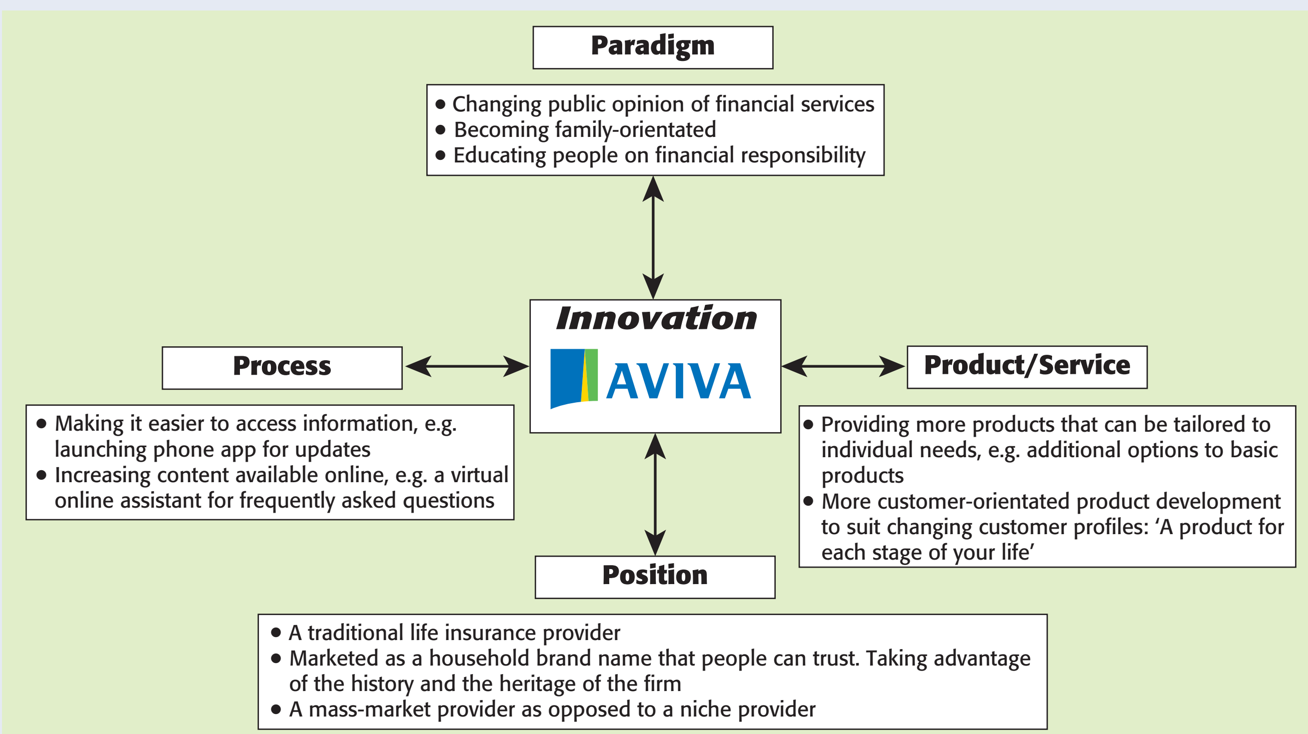
Process innovation: new methods of manufacturing a product or providing a service that offer benefits to the business/customer – for example, Pilkington's float glass process that cut the cost of making glass. In digital publishing and selling, books can now be instantly purchased and downloaded with such processes as 'one-click' buying on Amazon, which then automatically downloads the title to the user's Kindle.

Positioning innovation: this involves 'relocation' of the customer's perception about a certain product. Today, in the global marketplace, position is everything. What makes the organisation profitable is not necessarily how good its products or services are, but what their customers perceive about them. For example, an old established product in the UK is Lucozade – originally developed as a glucose-based drink to help children and invalids during convalescence. This link with illness was abandoned by the brand owners, GlaxoSmithKline, when they relaunched the product as a health drink aimed at the growing fitness market. It is now presented as a performance-enhancing aid to healthy exercise. This shift is a good example of position innovation. Mobile phones used to be marketed as devices used by business managers – only later did these products become perceived as being essential gadgets for teenagers who would often look upon them as a fashion accessory as well as a communication device.

Paradigm innovation: a distinctive change in what a business does or in the nature of goods/services available. The creation of social media sites has been described as paradigm innovation. Replacing existing publishing businesses with 'online self-publishing' would be another paradigm innovation. The use of mobile phone apps to make financial transactions is having a huge impact on how banks provide services and relate with customers.

ACTIVITY 5.6.2

Aviva is a large European-based insurance and pension business. Using the 4Ps innovation model above:



1. Explain **one** possible innovation for this business which would be classified as a 'process' change.
2. Explain **one** possible innovation for this business which would be classified as a 'product' change.
3. Explain **one** possible innovation for this business which would be classified as a 'position' change.
4. Explain **one** possible innovation for this business which would be classified as a 'paradigm' change.

Adaptive creativity and innovative creativity

The 4Ps distinction is one way of analysing innovative change. A second dimension to innovation is the degree of change involved. Updating the styling on a model of car is not the same as coming up with a completely new concept car which has an electric engine and is made of new carbon fibre materials and not steel and glass. Similarly increasing the speed and accuracy of a welding machine is not the same thing as replacing it with a computer-controlled welding robot. There are degrees of novelty in these, running from minor incremental or adaptive improvements right through to radical changes involving innovative creativity which transform the products and services available.

Adaptive creativity examples	Innovative creativity examples
Cameras in mobile phones	VoIP (e.g. Skype)
ATMs	Online banking and insurance
iPad mini	iTunes
Airbus A380	Jet airliners
Flat beds in business class	Low-cost airlines

Table 5.6.2 Examples of adaptive creativity and innovative creativity

ACTIVITY 5.6.3

This activity refers to Table 5.6.2.

1. Select **one** example of adaptive creativity and explain why it is not 'innovatively creative'.
2. Select **one** example of 'innovative creativity' and explain why it was such a significant development.
3. Identify **one** further example of adaptive creativity and explain its importance to the business that developed it.

Factors affecting R&D practices and strategies in an organisation

patent: legal right to be the sole producer and seller of an invention for a certain period of time

Businesses may adopt a range of R&D strategies. Business strategies towards R&D include:

- minimal R&D spending and focus on traditional products using traditional processes
- minimal R&D spending and 'acquire' **patents** and innovative ideas through takeover and merger
- high R&D spending to compete with and gain a competitive advantage.

Several factors may influence the R&D strategy and the level of R&D spending of 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 firms. Other businesses, such as hotels and hairdressing, would need to spend much less as the scope for innovation is more limited.
- **The R&D and innovation spending plans of competitors** In most markets, it is essential to innovate as much as or more than competitors if market share and technical leadership are to be maintained. However, a monopoly may limit R&D spending if it believes that the risk of a more technically advanced competitor entering the market is limited. On the other hand, profits from a monopoly could be used to finance research into innovative products if the risk of competitor entry into the industry is high.
- **Business expectations** If business managers are optimistic about the future state of the economy and the rate of economic growth and consumer demand, then they are more likely to agree to substantial budgets for R&D and aim to introduce more innovative products.
- **The risk profile or culture of the business** The attitude of the management to risk and whether shareholders are prepared to invest for the long term will have a significant effect on the sums that businesses can inject into R&D programmes. 'Short-termism' is an accusation made towards many major UK financial institutions and the need to satisfy these investors could discourage managers from investing in R&D.
- Government policy towards grants to businesses and universities for R&D programmes and the range and scope of tax allowances for such expenditure will influence decisions by businesses.
- **Finance is needed for effective R&D** In many firms this may be limited and will restrict the number of new innovations that could be made. General Motors (see page 536) cut R&D spending greatly when it was short of cash following the 2008/9 financial crisis but has started to increase it again now that it has returned to profitability.
- **Ethical considerations** If the culture of the business is focused on corporate social responsibility then R&D spending might be focused on products that will benefit society as well as yield a return. Organic pesticides are expensive to research and develop yet both Bayer and DuPont have invested in these.

LEARNER PROFILE

In 1999 Google's founders Larry Page and Sergey Brin approached George Bell, the CEO of the search engine business Excite, to sell their search engine which was supported by the innovative Google algorithm. The offer price for Google was $1 million. Excite said no. Page and Brin reduced their selling price to $250 000. Excite refused the offer for a second time. Google is now worth $348 billion.

Source: Adapted from www.businessinsurance.org

There are lots of examples of business people making decisions that involved missed opportunities.

How important do you think it is for business people to be open-minded when they are making decisions about new innovations?

Prepare a presentation on this topic to give to your class.

ACTIVITY 5.6.4

GILLETTE: MANAGING PRODUCT INNOVATION

Gillette believes that continuous new product development resulting from extensive R&D is necessary to differentiate itself from competitors. True to its corporate slogan of 'innovation is Gillette', the company has introduced some of the most successful and widely acclaimed innovative products in the consumer products industry. Its product range, protected by trademarks, includes brands such as Sensor, SensorExcel, Mach3 and Gillette for Women Venus.

The company's oblective is to generate 40% of its sales from products launched within the last five years. One reason for Gillette's strong focus on new product development is due to competition successfully learning to copy its products very quickly. For example, Schick (part of Warner-Lambert, later taken over by Pfizer but known as Wilkinson Sword in many parts of the world) had imitated Gillette's Trac II twin-blade razor within five months of the product's launch.

New product launches have added to the brand value of Gillette. It has succeeded, in some markets, in making razors less of a commodity product – which consumers just buy on price and convenience considerations – but a differentiated branded consumer product that customers will pay a premium price for.

Source: Adapted from www.icmrindia.org

20 marks, 40 minutes

1. Define the term 'trademark'. [2]
2. Explain how the use of innovative products can add to the value of a company such as Gillette. [4]
3. Analyse **two** reasons why Gillette continues to spend large sums on R&D even in a global downturn. [4]
4. Evaluate the factors that determine the level of innovation in an industry. [10]

OVER TO YOU

Revision checklist

1. Explain, with examples, the difference between invention and innovation.
2. Outline **two** potential benefits to a pharmaceutical company such as Pfizer of being able to patent a new drug following extensive research and development.
3. Why might an innovative product allow a business to successfully charge high prices for it? Illustrate your answer with an example.
4. Explain **two** reasons why high R&D spending might not lead to increased sales and profits for the business.
5. Explain why R&D spending accounts for a higher proportion of spending for some businesses than others. Use business examples in your answer.
6. Using business examples, differentiate between product innovation and process innovation.
7. Using business examples, differentiate between adaptive creativity and innovative creativity.

Exam practice question

DEVELOPMENTS IN TWO INDUSTRIES

Volkswagen's engineers are about to release more details of the latest range of petrol engines to be used in a large range of VW and Audi models. These engines will incorporate some of the new ideas that have been researched at VW's German engineering base. They include 'variable compression ratios'; electric turbochargers and cylinder deactivation – where two cylinders in a four-cylinder engine shut down at low loadings to save fuel. These innovations, together with the 'coasting' functions being built into VW transmissions, mean that all new models will meet the most stringent legal demands for efficiency and low-pollution levels.

Amazon has announced that it is developing a scheme to deliver parcels by airborne drones. These unmanned flying machines – called Octocopters – will be able to deliver parcels up to 3kg in weight within 30 minutes of online orders being received. This development is likely to transform distribution just as online retailing transformed shopping. Amazon is still working on technological and safety issues related to the innovation. It is confident, as one spokesperson said, 'in a few years drone vehicles will be as common as trucks on the road'.

20 marks, 40 minutes

1. Define the term 'innovation'. [2]
2. Describe the difference between adaptive creativity and innovative creativity. [4]
3. Analyse **two** factors that might have affected the R&D strategies used by Amazon and Volkswagen. [4]
4. Discuss the advantages and disadvantages to Amazon and Volkswagen of spending large amounts of money on R&D. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, evaluate how business strategy affects research and development. [20]

5.7

H

Crisis management and contingency planning

On completing this chapter you should be able to:

Analyse and apply:

- The difference between crisis management and contingency planning (AO2)
- Factors that affect effective crisis management (AO2)
- Advantages and disadvantages of contingency planning (AO2)

Setting the scene

FLIGHT MH370: HOW DO YOU PREPARE FOR THE UNPRECEDENTED?

The public relations team at Malaysia Airlines was strongly criticised for the way in which the airline disaster was managed and communicated. One airline analyst described the actions of the airline and the Malaysian government as a ‘masterclass in how not to deal with a crisis’. But is it possible to prepare a business for a disaster that is completely unprecedented? There was, as a journalist put it, ‘no previous case study to refer to in the crisis management manual’.

The theory of crisis management planning is to consider the likely and less likely (Titanic-type) scenarios and build a response communication programme that fits in neatly with the operational actions that the business should be taking.

Malaysia Airlines were accused of:

- taking too long to release news of the plane’s disappearance and appearing to be withholding information
- being defensive and allowing speculation and rumour to spread
- communicating inappropriately with the passengers’ families – the airline used text/SMS messages to report that the plane was finally confirmed as having crashed with no survivors.

Points to consider

- Is there any point in preparing for disasters when completely unique risks can occur?
- Why is effective communication important when dealing with a crisis such as this?
- Do you think all businesses should consider what to do in the event of a major disaster?

Key concept link

Responding to crises and unforeseen events requires careful planning. Attempting to ‘cover up’ a disaster because the organisation is in no way prepared to handle it can lead to claims of unethical behaviour. Accidents happen and stakeholders will respond more positively to organisations that are prepared for their consequences than those that adopt a culture of ‘hope for the best’ and claim ‘it was so unexpected’.

Introduction – the difference between crisis management and contingency planning

Contingency planning is also known as 'business continuity planning' or 'disaster-recovery planning', which perhaps gives a better idea of what it is for. Unplanned events can have a devastating effect on businesses of any size. Crises such as fire, floods, damage to stock, illness of key staff, IT system failure or accidents on the business's premises or involving its vehicles could all make it difficult or impossible to continue operating. At worst, important customers could be lost to competitors. Contingency planning helps with **crisis management** – by being prepared with a series of procedures to be put into effect if an emergency occurs, the organisation will be better able to manage most negative situations when they occur.

Contingency planning and crisis management are not conflicting ideas but instead work in tandem. Contingency planning is the process of preparing for potential emergencies, while crisis management is the overall management of emergencies when they do occur. Smart and diligent contingency planning is an important aspect of crisis management because it ensures that individuals and organisations make the necessary preparations to be ready when serious problems arise.

contingency planning: preparing the immediate steps to be taken by an organisation in the event of a crisis or emergency

crisis management: steps taken by an organisation to limit the damage from a significant, damaging event by handling, containing and resolving it

Effective crisis management

A crisis is something which poses a genuine threat to the reputation or even survival of the organisation. This could be anything from an employee who has behaved inappropriately, to an accident closing the business down temporarily. It might be that a customer is unhappy with how the organisation has behaved – and told their story to the local press. Very often, it is when a bad news story about an organisation becomes public that it constitutes a real crisis.

THEORY OF KNOWLEDGE

In October 2013 the USA finally saw the launch of the new public health system – the Affordable Care Act, or 'Obamacare'. The new law that promised to make healthcare available to even the poorest Americans had a disastrous launch when the computer system which facilitated online registration for Obamacare crashed. Bewildered users just couldn't log on and if they could the process was so painful they just gave up.

Obama's critics had a field day launching into one of the central parts of his administration's most important policies. Experts say the major problems with the Obamacare website cannot reasonably be solved quickly, and the best fix would be to start over from scratch.

After assessing the website, Dave Kennedy, the CEO of information-security company TrustedSec, estimates that about 20% of HealthCare.gov needs to be rewritten. With a huge 500 million lines of code, according to a recent *New York Times* report, Kennedy believes fixing the site would probably take six months to a year.

Source: Adapted from the *Wall Street Journal*, 14 October 2013

In your class discuss the knowledge issues associated with the IT problems of the launch of Obamacare.

The power of the media, particularly online social media, means that news spreads quickly – especially bad news. Whatever the crisis, managing it effectively is crucial to minimising damage to the organisation.

1. Transparency

This means being honest and open about the crisis, its causes and consequences – and what the organisation intends to do in response to it. Keeping back any information or trying to twist it to the benefit of the business will almost always backfire and lead to an even more negative reaction than if the truth was communicated in the first instance.

2. Communication

The way the organisation communicates during a crisis can make the difference between the crisis escalating out of control and it being a minor setback. It is important to gain control of communications in a crisis by being proactive. If there is public interest in the crisis, then information needs to be given clearly, fully and promptly. If this is not the case, the media will write their own stories and rumours will spread, especially through social media. The aim of successful crisis communications is to show that the organisation is:

- going about its normal work
- controlling and responding to the crisis
- retaining the support of the media, employees and customers, who matter most.

Mishandling crisis communications can make the whole situation very much worse. If the message or media used is wrong, or the organisation appears to be in chaos, this reflects badly on the organisation and it makes another negative story for the media.

3. Speed

It is sometimes called the golden hour. This refers to how much time there is to respond to a crisis or incident breaking in the media. Time is being telescoped by digital and social media. Eyewitness accounts of events or rumours about incidents appear on Twitter at a speed once unimaginable.

The advice from Jane Jordan-Meier, author of *The Four Stages of Highly Effective Crisis Management: How to Manage the Media in the Digital Age* is: crisis management and communication plans are irresponsible or worse unless they include digital and social media. News used to be released by radio scanners, which pick up police and other emergency services messages. Twitter is now the 'scanner' of the 21st century. Twitter breaks the news and adds instant updates.

Jordan-Meier says the impact of Twitter, Facebook and LinkedIn cannot be overstated. A share price can drop quickly thanks to Twitter, which not only breaks news and gives updates but is also full of rumours and misconceptions. The share price in Qantas plummeted when it was thought an airliner had crashed in Indonesia. Once the airline communicated the facts about an engine failure, however, its share price recovered. Speedy and careful monitoring can stop a hot issue in its tracks before it explodes into a crisis. Such rumour management is critical and can be established through something as simple as a Google Alert. Establishing listening posts to monitor social media messages also helps knowing the whereabouts of likely friends and potential enemies.

Jordan-Meier says, for every \$1 spent on this work before a crisis, \$9 is saved in the response.

4. Control

Keeping control of the crisis and not being swept along by events helps to present an image of calm and confidence. This will help to restore the image of the organisation once the crisis has passed. The chance of keeping control of a crisis situation will be helped greatly by having prepared a contingency plan and using this in 'rehearsals' of potential crisis situations.

One aspect of 'control' is for the organisation to start a media log. This should have details of all the newspapers and other media that have contacted the organisation, what information was sent and when they are expected to get back to you. If there is more than one individual on the crisis coordination team it should be clear who the media should contact and who has responsibility for each aspect of managing the crisis. Dealing with a crisis should be the responsibility of the most senior manager available. This is not a task that should be delegated.

Finally, perhaps the crisis management advice of Lanny Davis, an adviser to former US president Bill Clinton, is relevant to all senior managers when faced with a disaster situation:

'Tell it Early, Tell it All, Tell it Yourself.'

Key steps in contingency planning

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. The key steps to take in developing contingency plans are:

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.
2. **Assess the likelihood of these occurring.** Some incidents are more likely to occur than others and the degree of impact on business operations varies too. It seems obvious to plan for the most 'common' disasters, but the most unlikely occurrences can have the greatest total risk to a business's future. These issues need to be balanced carefully by managers when choosing which disaster events to prepare for most thoroughly.
3. **Minimise the potential impact of crises.** Effective planning can sometimes remove 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, as far as possible. This is often best achieved by the publicity department telling the truth, indicating the causes when known and giving full details of how to contact the business and the actions being taken to minimise the impact on the public. Staff training and practice drills with mock incidents are often the most effective ways of preparing to minimise negative impact.
4. **Plan for continued operations of the business.** As in Activity 5.7.1 below, prior planning can help with alternative accommodation and IT data – the sooner the business can begin trading again, the less the impact is likely to be on customer relationships.

LEARNER PROFILE

Thinkers

Thinkers 'exercise initiative in applying thinking skills critically and creatively to recognise and approach complex problems, and make reasoned, ethical decisions.' – IB learner profile

In your class consider a crisis that your school or college has faced (it could also be a crisis faced by another school). Under the following headings consider how you would have dealt with the crisis:

- Exercise initiative
- Apply thinking skills critically
- Apply thinking skills creatively
- Make a reasoned decision
- Make an ethical decision.

ACTIVITY 5.7.1

PLANNING FOR THE WORST PAYS OFF

When arsonists destroyed the head office of marketing agency FDS Group, chairman Alison Williams ensured her 75 employees were relocated and the business fully operational within three working days. 'Having a disaster recovery plan as part of our corporate plan helped to rehouse the entire business in days and sent out a strong positive signal to our customers,' said Alison. 'Our contingency planning routines meant that our data were backed up off site. We made use of our contacts in the local business community and had two temporary offices to view within 24 hours. The company secretary made sure the insurance company's loss adjuster was on site by noon of the day after the fire. I've never been so proud of my staff, and suppliers fell over themselves to help us too. There was no time to dwell on the situation – most of our customers are blue-chip businesses and they wanted the reassurance that we could be operational again as soon as possible. Senior managers communicated with all major suppliers and customers within six hours of the fire being reported.'

Managers from FDS held several informal meetings with customers within days of the fire to reassure them that it was 'business as usual'. This was also part of the firm's contingency plan. This demonstration of the firm's commitment to its customers paid off as it showed that customers' needs were valued above everything else.

Source: Adapted from www.businesslink.gov.uk

20 marks, 40 minutes

1. Define the term 'contingency planning'. [2]
2. Explain **two** advantages to FDS of undertaking contingency planning. [4]
3. Describe **two** examples of effective crisis management in FDS's case. [4]
4. Evaluate the possible disadvantages of contingency planning to FDS. [10]

Table 5.7.1 analyses the advantages and disadvantages of contingency planning.

Advantages	Disadvantages
• **Reassures** employees, customers and local residents that concerns for safety are a priority • **Minimises negative impact** on customers and suppliers in the event of a major disaster • **Promotes a culture of safety** within the organisation and **reduces the risk** of accidents causing serious damage or injuries • **Public relations response** is much more likely to be speedy, transparent and appropriate, especially if senior managers are used to communicate what the company intends to do, by when and how	• **Costly and time-consuming:** the planning process, the need to train employees and undertake practice drills of what to do in the event of a range of crises occurring, all cost time and money – these considerations may lead small businesses in particular not to commit resources to contingency planning • Needs to be **constantly updated** as the number and range of potential disasters can change over time • **Employee training** needs to be increased if labour turnover is high or if the nature of potential risks changes • **Avoiding disasters** is still better than planning for what to do if they occur

Table 5.7.1 Contingency planning – advantages and disadvantages

ACTIVITY 5.7.2

CADBURY HAD A PLAN READY

The risk of salmonella contaminating millions of chocolate bars put Cadbury's corporate plan in doubt. The problem was caused by a leaking pipe in one of Cadbury's UK factories but the company's contingency plan swung into action. Over a million chocolate bars were recalled by the company, they were disposed of in a completely safe way and the Food Standards Agency was informed. Retailers were fully compensated for stock that was destroyed. Cadbury apologised to all customers. Business consultants doubted whether the incident would cause any long-term damage to the company's image or brand names because of the detailed contingency plan that was put into operation.

20 marks, 40 minutes

Evaluate the importance of contingency planning to a business like Cadbury. [20]

OVER TO YOU

Revision checklist

1. Explain, with business examples, the difference between crisis management and contingency planning.
2. Explain the steps your school or college should take in planning for the effects of a serious fire.
3. How can contingency planning reduce the chances of some crises occurring?
4. Explain why effective communication is crucial in crisis management.
5. Explain why contingency planning cannot remove all risks of emergencies occurring.
6. Explain **two** consequences for an oil company of not having planned for how to deal with a major oil-tanker disaster.
7. Analyse **two** possible disadvantages of contingency planning for small businesses.

Exam practice question

THE BP GULF OF MEXICO DISASTER

On 20 April 2010, the Deepwater Horizon drilling rig exploded in the Gulf of Mexico, killing 11 workers and causing an oil spill that became the worst environmental disaster in US history. Following the explosion the Deepwater Horizon sank to the bottom of the Gulf after burning for 36 hours.

The US Coast Guard quickly became involved with the incident, putting a **crisis management** plan into place. Environmental experts raised concerns that the Macondo well Deepwater Horizon was drilling could be releasing up to 40 000 barrels of oil per day into the sea. A few days after the disaster, oil from the leaking well began washing ashore in Louisiana; fragile coastal wetlands were inundated with thick, brown mud and beaches were covered in black tar.

BP made a number of vain attempts to cap the leaking well until it finally stopped the leak in July. BP, under considerable political pressure, announced in June that it would place $20 billion in a fund to compensate victims of the oil spill and said it would not pay a shareholder dividend in 2010. By early July BP's share price had fallen by 50% since the start of the crisis. The BP CEO, Tony Hayward, came under pressure because of his perceived mishandling of the crisis. BP seemed to have no effective contingency plan to deal with the crisis. Tony Hayward was eventually forced to resign.

20 marks, 40 minutes

1. Define the term 'crisis management'. [2]
2. Outline the key steps BP would have gone through to produce a contingency plan for a crisis such as the Deepwater Horizon. [4]
3. Analyse **two** reasons why the BP share price fell by 50% following the Deepwater Horizon crisis. [4]
4. Evaluate the likely benefits and limitations of BP's contingency planning when preparing for any future disasters like Deepwater Horizon. [10]

Key concept question

20 marks, 40 minutes

With reference to one organisation that you have studied, examine the impact of innovation and ethics on crisis management and contingency planning. [20]

Unit
6

EXAMINATION SKILLS

6.1 Examination skills

On completing this chapter you should be able to understand:

- the nature of the different aspects of Business Management assessment
- examination technique in the Business Management examination
- the approach to the pre-issued case study
- the way to tackle the internal assessment
- the way to approach Business Management extended essays.

Introduction

The IB Business Management course combines both internal and external assessment to examine your performance over the two years of the course.

Higher and standard level paper 1 includes questions based on a case study, which is provided by the IBO several weeks before the examination. You will be given the questions to the case study when you sit the examination. The case study is the same for both higher and standard level, but the questions used are different. The main aim of this paper is to assess your ability to answer questions on a given case example. You are expected to show your ability to apply business management knowledge and understanding across the full range of topics covered in the syllabus.

Higher and standard level paper 2 Sections A and B require you to answer structured questions based on stimulus material (short case studies). The objective of this paper is to assess your ability to use your business management knowledge and understanding across a range of different case study situations. Students answer one of three extended response questions. In paper 2 for both higher and standard level you will also have to answer an extended response question that is based on how two of the key concepts of the course (change, culture, ethics, globalisation, innovation, strategy) have been applied to a business you have studied during the course.

The final piece of assessment for both higher and standard level is an internal assessment. This will assess your ability to use your business management knowledge and understanding in a real-world situation and pursue personal interests.

6.1 Examination skills

Tables 6.1.1 and 6.1.2 provide summaries of the higher level and standard level assessments.

	Paper 1	Paper 2	Internal assessment
Method	**Section A**	**Section A**	Students complete an extended research project that considers either an issue or decision facing a business organisation. Students could, alternatively, look at an issue or decision facing a range of different organisations. Maximum 2000 words.
	Students must answer three from four structured questions. Each question is worth 10 marks.	Students answer one of two structured questions based on stimulus material with a quantitative focus. Each question is worth 20 marks.	
	Section B	**Section B**	
	Students must answer one 20-mark compulsory structured question.	Students answer two of three structured questions based on stimulus material. Each question is worth 20 marks.	
	Section C	**Section C**	
	Students answer one 20-mark compulsory extended response question primarily based on HL extension topics.	Students answer one of three 20-mark extended response questions based on two of the key concepts of the course.	
Total marks	70	80	25
Time	135 minutes	135 minutes	30 hours
Weighting	35%	40%	25%

Table 6.1.1 Higher level assessment

	Paper 1	Paper 2	Internal assessment
Method	**Section A**	**Section A**	Students write a commentary based on three to five supporting documents on a real issue facing a business organisation. Maximum 1500 words.
	Students must answer three from four structured questions. Each question is worth 10 marks.	Students must answer one of two structured questions based on stimulus material with a quantitative element. Each question is worth 20 marks.	
	Section B	**Section B**	
	Students must answer one 20-mark compulsory structured question.	Students must answer one of three 20-mark structured questions based on stimulus material.	
		Section C	
		Students answer one of three 20-mark extended response questions based on two of the key concepts of the course.	
Total marks	50	60	25
Time	75 minutes	105 minutes	15 hours
Weighting	35%	40%	25%

Table 6.1.2 Standard level assessment

Examination technique

Timing

It is important to get your time management right when you are approaching the Business Management examination. The timing and marks allocated for each paper across both higher and standard level vary slightly. In the higher level examination you should allocate just under 2 minutes per mark, which means spending about 7 minutes on a 4-mark question or 18 minutes on a 10-mark question.

It is possible to allocate your time in a similar way on the standard level paper, where the allocation for paper 1 is 1.5 minutes per mark and paper 2 is slightly more than this. This means a 4-mark question should take 6 minutes and a 10-mark question 15 minutes.

In the activity questions in each chapter, time and marks have been allocated on two minutes per mark to give you some planning time (this builds in the IB's reading time).

The five minutes' reading time for each of the papers will give you the opportunity to plan how to approach them. It is important to look through the questions and to decide which questions to choose based on the areas you feel most confident about. It is best to make the decision on which questions to choose based on the questions that carry the highest marks rather than choosing a question where you can do the definition for 2 marks but will struggle with the 10-mark evaluation question.

During the reading time in paper 2, to ensure you use the time effectively it is best to read the questions and not the stimulus material because the questions will determine how well you will answer them and not the stimulus material. Obviously, you will read the stimulus material thoroughly when you actually attempt the question.

Using the stimulus material

Once you have finished your reading and you are approaching each question, it is very important in paper 2 to read the stimulus material carefully before answering the questions. The case studies provide the foundation for your answers and must be used to support the points you make in your answers. In a 10-mark paper 2 question in higher and standard level you have to use the stimulus material effectively to reach the top mark band. If you fail to use the stimulus material at all you may well end up in the bottom mark band. For instance, in a question on the Boston Consulting Group matrix, you should use the case study to provide examples of products in different sections of the matrix.

Answering the questions

Reading the question carefully and answering the question precisely are important. You should identify the key command terms in the question to determine how you should answer the question. The command term AO1, such as 'define', requires the lowest level of sophistication and is awarded the lowest number of marks. AO2 questions, such as 'explain', require more depth than AO1 and are awarded more marks. The most sophisticated level of question is AO3, such as 'discuss', where you will need to show evaluative skills in your answer. AO4 questions, such as 'construct', are technical questions that relate to calculations, charts and diagrams. Table 6.1.3 summarises how you should use the command terms when you are answering questions and how they apply to particular questions.

The Business Management guide sets out the assessment objective (AO) that can be used to examine each term in the guide. Retained profit, for example, is an AO2 term and can be examined up to that level in the examination. You could not be asked an AO3 question that requires evaluation on an AO2 term like retained profit, although you could be asked an AO1 question on it. You could be asked an AO3 question on, for example, the benefits and limitations of the break-even analysis because it is an AO3 term in the IB guide.

When you are preparing for the Business Management examination it is important to be aware of the level of answer you will be required to use when answering a question on a term from the guide and this can be done by referring to Table 6.1.3.

Assessment objective	Term	Meaning	Example of application in Business Management questions
AO1	Define	Give a clear, precise statement of the meaning of a business term, word or concept.	Define the term 'current asset'.
AO1	Describe	Give an account of the characteristics of an object or idea.	Describe the CEO's management style.
AO1	Outline	Give a brief summary of the points raised on an issue or idea.	Outline the different types of secondary market research.
AO1	State	Give a specific name, value or other brief answer.	State the net profit business XYZ made in 2013.
AO2	Explain	Describe, giving reasons, a business idea, observation or issue.	Explain how XYZ plc has increased its sales.
AO2	Comment	Give a judgement on a given statement or result of a calculation.	Comment on the rise in ABC plc's market share.
AO2	Analyse	Separate business material or information into its constituent parts and determine its essential features.	Analyse the factors that have led to a rise in business B's profits.
AO2	Apply	Use an idea, equation, principle, theory or law in relation to a given problem or issue.	Apply the Boston Consulting Group matrix to analyse ABC plc's product portfolio.
AO2	Distinguish	Make clear the differences between two or more concepts or ideas.	Distinguish between a democratic and autocratic leadership style.
AO2	Interpret	Draw out and explain information from business issues or observations.	Interpret the change in XYZ Ltd's acid-test ratio.
AO2	Suggest	Give a solution, reason, hypothesis or other possible answer to a business situation.	Suggest a ratio that could be used to measure the liquidity position of business Y.
AO2	Demonstrate	Use reasoning, evidence or examples to explain a business decision or situation.	Demonstrate why company C has increased spending on advertising.
AO3	Compare and contrast	Explain similarities and differences between two (or more) ideas or concepts, referring to both (all) of them throughout.	Compare and contrast Herzberg's and Taylor's approaches to motivating workers.
AO3	Examine	Look at an argument, decision or concept in a way that considers its assumptions and interrelationships.	Examine ABC plc's decision to open new outlets in Indonesia.

Table 6.1.3 Assessment objectives and command terms [*table continues over*]

Assessment objective	Term	Meaning	Example of application in Business Management questions
AO3	Discuss	Give a balanced review of a variety of arguments, factors or theories. The view developed should be based on a reasoned argument supported by evidence.	Discuss business XYZ's decision to cut prices to increase its market share.
AO3	Evaluate	Consider the advantages and disadvantages of a business decision or proposal.	Evaluate the use of JIT stock management by ABC Ltd.
AO3	Justify	Provide evidence or reasons to support an argument, conclusion or decision.	Justify ABC's decision to open a new factory.
AO3	Recommend	On an issue or decision, put forward a plan of action supported by reasoning and evidence.	Recommend a promotional strategy to retailer A.
AO3	To what extent	Consider the relative strength of an argument based on reasoning and evidence.	To what extent is the decision by business A to adopt profit-related pay a successful way to improve staff motivation?
AO4	Plot	Mark the position of points on a graph, chart or diagram.	Plot the position of company Y's product on the product position map.
AO4	Complete	Add information or data.	Complete the asset and liability figures in XYZ's balance sheet diagram.
AO4	Construct	Present business data or information in the form of a diagram or table.	Construct a decision tree for XYZ's different options.
AO4	Annotate	Add information or notes to a diagram, chart or graph.	Draw and annotate an Ansoff's matrix for company Y.
AO4	Draw	Represent by means of a labelled, accurate diagram or graph.	Draw a product life cycle for product Y.
AO4	Identify	Give an answer from a number of possible options.	Identify a reason for a fall in company Z's market share.
AO4	Prepare	Put data into the format of a chart, table or diagram.	Prepare a cash flow table for business X for 2014.
AO4	Calculate	Give a precise numerical value.	Calculate XYZ's payback time on its new machine.

Table 6.1.3 *Continued*

Setting out your answer

To score well in the Business Management examinations you will need to set out your answer in a way that clearly presents itself effectively to the examiner. As we have already seen, an answer is not about making a certain number of points; it is about responding appropriately to the command terms in the question and communicating this effectively.

Effective use of paragraphs is an important style to adopt when answering questions because it allows you to express your points in a structured way and presents your ideas in a form that makes it easy for an examiner to see and understand your answers. Avoid using bullet points – they are ineffective because you cannot express yourself in any detail and your answer will read like a list. Also avoid long passages of blocks of text which are often impenetrable to examiners.

The key thing examiners will look for is an answer to the question. If you drift from the question asked and, for example, use a pre-prepared answer that is not quite what the question is looking for, then you will not score highly. It is also important to avoid repeating the same point.

Here is a useful technique to have in mind:

- Make your point.
- Use business theory to support it.
- Use an example from the case study or stimulus material.

Quantitative questions

Papers 1 and 2 for higher and standard level have quantitative questions where you will be expected to carry out simple arithmetic operations, and you will need to approach these questions in the right way to maximise your marks.

It is essential to show your working clearly so that the examiner can see where the answer has been derived from. If a question requires you to calculate the average annual rate of return, you will need to set out the figures using the formula required to calculate this value. Remember, a small calculation error will give the wrong answer, but if the method is correct your answer will still receive most of the marks.

The layout of calculations, diagrams and charts is also important. Examiners find it much easier to interpret and mark answers where, for example, the decision-tree diagram is drawn neatly with a ruler and is well set out on the examination paper. Things like decision trees, break-even charts and Gantt charts need careful planning. It is advisable to draw your charts and diagrams in pencil so you can rub out mistakes.

Approaching the key concept question

Higher and standard level students will have to do a compulsory key concept question in paper 2 of the Business Management examination. This is a 20-mark extended response (essay) question based on the key concept themes: change, culture, ethics, globalisation, innovation and strategy.

You will need to approach the key concept question using at least one real-world organisation that you have studied in the Business Management course. This could include case examples you have looked at in class or for homework or from your internal assessment. You could also draw examples from any extra reading you have done. When you are applying case study examples to the key concept question you must focus on the perspectives of individuals and societies on which the real-world organisation impacts.

The key concept question is a sophisticated piece of writing that wants you to answer a question and apply business theory to a real world. You will need to demonstrate knowledge, reasoning, analysis and evaluation when you are writing your answer so the marking level goes up to assessment objective AO3.

The key concept question will be marked on the following criteria with four marks for each criterion.

Criterion A: Knowledge and understanding of tools, techniques and theories

Criterion B: Application

Criterion C: Reasoned arguments

Criterion D: Structure

Criterion E: Individual and societies

Here is an example of a key concept question:

With reference to one or two organisation(s) that you have studied, discuss how innovation and globalisation have affected their marketing strategy/strategies. [20 marks]

Table 6.1.4 sets out how you might approach this question to meet the demands of the marking criteria. The case study organisations chosen here as examples are Google and Starbucks.

Criterion	Achievement required	Key question examples for the sample question using Starbucks and Google
A	Good knowledge and understanding of relevant tools, techniques and theories are demonstrated.	Marketing strategy, marketing mix, marketing models (Boston Consulting Group matrix), market research.
B	The relevant business management tools, techniques and theories are well applied to explain the situation and issues of the case study organisations. Examples are appropriate and illustrative.	The marketing mix and Boston Consulting Group matrix have been effectively applied to Google and Starbucks.
C	Relevant, balanced arguments are made and these are well justified.	The importance of innovation and globalisation in the way Google and Starbucks promote their products is developed.
D	An introduction, body, conclusion and fit-for-purpose paragraphs are present, and ideas are clearly organised.	On how globalisation and innovation have affected the marketing strategies of Google and Starbucks there is a clear introduction, argument and conclusion.
E	Balanced consideration is given to relevant individual and group perspectives.	The essay considers the impact of the question on the internal and external stakeholder groups affected by Starbucks' and Google's marketing strategies.

Table 6.1.4 Answering the key concept question

Sample questions and answers

Below are two example questions for you to practise your examination technique. The examples given are from standard and higher level paper 2.

The answers provided are model top grade seven responses.

Exam practice question 1 (higher and standard level)

CORPORATE AND SOCIAL RESPONSIBILITY AT NIKE, INC.

The Nike 'Swoosh' logo is one of the most famous corporate symbols in the world. Nike, Inc. is an organisation that people look to as a leading sports brand and a business that encapsulates US corporate power and globalisation.

Nike, Inc.'s mission statement has two elements:

- To bring inspiration and innovation to every athlete in the world
- If you have a body you are an athlete.

Much of Nike, Inc.'s success is based on the way it focuses on consumers in a sporting context and provides products which strongly support this. In recent years it has, like many multinational companies, suffered from adverse publicity on issues such as working conditions in its factories. It has tried to answer its critics by becoming a socially responsible organisation by using meticulous social audits. It has also developed the way it communicates its social objectives to its stakeholders.

Source: Adapted from www.nike.com

20 marks, 40 minutes

1. Define the term 'mission statement'. [2]
2. Explain **two** components you might expect to see in Nike's social audit. [4]
3. Analyse **two** strategic objectives that Nike, Inc. might try to achieve. [4]
4. Evaluate Nike's decision of aiming to be a socially responsible organisation. [10]

Answers

1. A mission statement is a statement of the business's core aims, phrased in a way to motivate employees and to stimulate interest by outside groups. Nike's mission is 'to bring inspiration and innovation to every athlete in the world'.
2. A social audit reports on a firm's 'social' performance. Nike could have included a statement of the proportion of materials used in the production of its footwear and clothing from ethical sources like fair trade which shows it sourcing materials responsibly. The second aspect could be a statement that sets out how Nike has contributed to local communities where it operates to show how it contributes positively to those communities. These two aspects of its audits form part of Nike's CSR report.
3. A strategic objective is a long-term aim for Nike. This could include to increase its market share in the sports goods market. This means increasing the percentage of sales value its goods account for as a proportion of total market sales. This objective is one way of showing the relative success Nike has in marketing its goods in the market. Nike's second aim could be to enhance its image as a socially responsible company. By doing this it creates a better image for the business which makes it a more attractive prospect for customers, investors and employees.

4. By aiming to be a socially responsible organisation Nike could become a more attractive business for customers who are more socially aware and want to buy goods from an organisation with these values. This could, in turn, lead to a rise in Nike's revenue and profits. By being more socially aware, however, Nike's costs might be pushed up which increases its prices and this could lead to a fall in its revenues and profits.

   Nike may also benefit from being a more socially responsible organisation because it attracts funding from investors who like the idea of investing in a socially responsible investment. This funding provides extra finance to the business for its investment projects which may well be in socially responsible areas like improving the working conditions in its factories. Some investors might, however, see the higher costs and lower profits associated with being a socially responsible business as reducing profits and their returns to investors which means Nike becomes less attractive to those investors.

   A decision to become more socially responsible seems to fit with Nike's strategic direction and in a global economy that may well be becoming more socially conscious, this may be the best long-term approach even if costs are increased in the short run.

Exam practice question 2 (higher level)

MFLEX TO EXPAND OPERATIONS IN MALAYSIA

MFLEX, the leading global maker of high-quality advanced circuit boards to the electronics industry, has leased a 35 000-square-metre factory in Johor Darul Takzim, Malaysia. It has purchased new manufacturing equipment for the plant and employed 125 workers, which will mean a considerable increase in capacity and scale of operation for the company. Directors hope that, within two years, the rate of capacity utilisation of the new factory will be 90%. This expansion follows a decision by the directors to make more components rather than buy them in from external suppliers.

The factory will allow the business to respond more rapidly and flexibly to just-in-time demands from its customers. MFLEX will also expect its suppliers to be able to deliver materials and components on a JIT basis and it has signed exclusive deals with certain suppliers and is connected to them by computer link to speed up ordering.

Rapid inflation in Malaysia, as in other countries, is forcing some businesses to rethink their use of JIT manufacturing systems. With rising costs of industrial materials and components and much higher charges for transport, some operations managers are looking again at whether the 'no buffer stock' policy of the JIT method with frequent small orders being delivered is actually costing more than a large stock-order policy.

Source: Adapted from http://biz.yahoo.com

20 marks, 40 minutes

1. Define the term 'capacity utilisation of 90%'. [2]
2. Explain the difference between stock-holding costs and the costs of not holding enough stock. [4]
3. Outline **two** criteria MFLEX needs to meet in order to use JIT stock management successfully. [4]
4. Evaluate MFLEX's decision to use JIT stock management. [10]

Answers

1. A 90% capacity utilisation is the proportion of the maximum output of an organisation's capacity that can be achieved. MFLEX is hoping to achieve this in its new factory.
2. Stock-holding costs are the costs to a business of keeping stock. For MFLEX this would include the costs of the space used to keep the stock of components or the cost of insuring the stock it holds. The cost of not holding enough stock would be the sales lost if MFLEX cannot meet the demands of a customer or loss of future customers the business might suffer if it has a reputation for not having stock when customers need it.
3. In order to use JIT successfully MFLEX would need to be able to source components quickly from reliable suppliers. This means goods can be produced immediately to meet the demands of customers for circuit boards. MFLEX also needs to be able to forecast demand for its products accurately so that it can manufacture the right quantities to meet demand from its customers.
4. If MFLEX uses JIT it will gain the following benefits. It will be able to reduce stock levels, which means it can reduce the factory space needed to keep its stock of circuit boards and use this to produce more circuit boards and generate more sales and profits from this. It will see costs such as insurance and cost of maintaining the stored circuit boards fall. It means cash will not be tied up unprofitably in stock and this will improve MFLEX's liquidity. The computerised ordering system used by MFLEX may well help this JIT process. Using JIT is all part of the Japanese practice of continuous improvement which allows MFLEX to achieve the high levels of productivity it has reached.

   The JIT approach does, however, come with disadvantages. It needs reliable suppliers who can meet MFLEX's demand for components and if one supplier lets MFLEX down, the production line may have to be slowed down or stopped. It also relies on accurate forecasts for demand and this is always something which is open to error. If demand is forecasted inaccurately, MFLEX may not be able to meet demand or it risks building up stock. JIT also relies on a flexible, well-trained labour force which may lead to higher labour costs. Wages will need to be high to attract and retain staff good enough to apply JIT. The final, crucial problem seems to be rising inflation which adds to the significant transport costs associated with JIT because more regular deliveries are needed.

   The evidence of the case material is that despite the problem of inflation JIT will continue to make MFLEX an efficient, competitive business.

The pre-issued case study

Approaching the case study

Once you have received the pre-issued case study it is important for you to spend some time with your teacher and on your own preparing for it. Here are some important tips on how to approach the case study.

- Read through the case study carefully to understand fully the issues it raises. This can be done using a highlighter pen to indicate key points; another useful approach is to write a short summary by each paragraph to sum up what it is about. In the Millennium Sports case study which is provided as an example below, the first part is: *background to the business, partnership, sports and leisure market, high-quality product targeting specialist consumers.* Repeat this approach for the whole case study and you will develop a good understanding of the story it tells.

- Draw up a time line for the case study organisation that summarises the changes it has gone through in a chronological order. This will help you to understand the case study.
- Consider the syllabus area covered by the case study to focus your revision for the paper. In the example case study below, Nils Marks' management style could be a clue to a possible question about leadership and management style and its appropriateness. The cash flow data on the surfing machine could be a clue for an investment appraisal question. Remember, more information can be added to the case study on the day of the examination, so you will need to have done broad-based revision for the paper.
- Do some reading about the market the case study company is involved in. In the Millennium Sports example, you could do some research about the nature of the sports and leisure-centre market.
- Do practice questions using the case study. This will help you to familiarise yourself with the case study and the issues it raises. It will also get you into the habit of using the case study to provide examples for the points you make. However, in the actual examination make sure you answer the questions that are asked – they may not be exactly the ones you practised.
- Be careful not to over-prepare. In the end your success will depend on the way you tackle the case study on the day of the examination – if your head is filled with too much extra information on the business and market you may not be able to respond to the questions you are asked.

Case study example

Below is an example of the type of pre-issued case study you will get in the Business Management examination. A piece of additional information will also be given to you when you sit the examination for the part B section of the paper. This is included in the case study below. Try to approach it in the same way you would if it was the real thing.

MILLENNIUM SPORTS

Background

Millennium Sports was started in 2001 by a partnership of Anders Rikard and Erik Brolyn. The two founders were ex-professional basketball players who had a substantial amount of money saved from their long and successful careers in the NBA. The players decided to build and operate a private sports complex that would target a different market segment to the traditional 'gym'. The facility has a 50-metre Olympic-sized swimming pool, state-of-the-art gym, dance studio, indoor tennis courts and 'double' sports hall, climbing wall and glass-backed squash courts. The facility also offers physiotherapy, sports science and sports psychology on the site. Millennium Sports has subcontracted the catering to a company that operates a health-food restaurant on site. The objective of the business is to offer a world-class sports facility that:

- targets national, professional and amateur sports teams and clubs
- has its own sports academy linked to local schools and universities
- provides a gym and sports-club facility for individuals.

Millennium's mission statement is 'to give serious athletes a sporting environment where they can fully realise their potential'.

Human resources

Millennium Sports employs 10 full-time staff and 50 contract staff. The full-time staff run and operate the centre and contract coaches are brought in to run the different sporting activities the centre offers. The contract coaches are paid by the clubs and individuals that use them and as part of the centre. There are, for example, four tennis coaches who use the centre regularly to give lessons and coaching sessions. The ten full-time staff are responsible for accounting, marketing, operations (maintenance and cleaning), booking and human resources.

The centre manager, Nils Marks, has been hired by Anders and Erik to run the centre in a strict, disciplined way. Nils is an autocratic leader who expects the highest standards from the centre's employees. Staff turnover is high and this is a concern to Erik and Anders. There has also been some conflict between the contract coaches and Nils.

Finance

To start Millennium Sports required an initial investment by Anders and Erik to build the sports centre. The centre cost $30 million; Anders and Erik invested $20 million of their own funds and the remaining $10 million was put in by a venture capital company, Asterix Finance, which took a 33% stake in the business in return for its investment. Asterix is concerned about the low dividend it is receiving from Millennium and this is a major source of tension in the organisation. Anders and Erik want to retain profit to improve the centre facilities along with the quality of the service they offer and Asterix is concerned with cost efficiency. Asterix is also concerned about the number of members of Millennium Sports who are behind with their membership payments and it wants to introduce penalty charges to members who do not pay on time. Tension between Asterix's directors and Anders and Erik has become so intense that they have considered trying to buy Asterix's 33% shareholding.

Millennium Sports' final accounts for 2012 and 2013 are set out below.

$m	2012	2013
Fixed assets		
Tangible	32.4	33.4
Intangible	3.1	3.1
	35.5	36.5
Current assets		
Stock	0.2	0.2
Debtors	0.2	0.5
Cash	0.8	1.5
	1.2	2.2
Current liabilities	0.8	0.8
Working capital	0.4	1.4
Net assets	35.9	37.9
Share capital	30.0	30.0
Retained profit	5.9	7.9
Capital employed	35.9	37.9

Millenium Sports' balance sheet for the year ending 31.03.2013

$m	2012	2013
Sales	6.5	6.8
Cost of sales	1.4	1.5
Gross profit	5.1	5.3
Expenses	2.1	2.1
Net profit	3.0	3.2
Tax	0.5	0.6
Dividends	0.8	0.6
Retained profit	1.7	2.0

Millennium Sports' profit and loss account, 31.03.2013

Marketing

Millennium Sports has aimed its service at a particular market segment of the sports and recreation market. The facilities are state of the art and the business is looking to attract individuals and sports clubs that play sports at a high level. Marketing is Erik's particular area of interest and he has set up a project team to develop a new promotion strategy for Millennium. Another area of concern for Millennium is pricing. Currently, the business uses a cost-based pricing strategy for its memberships and charges to teams and individuals using the facility. The key aspect of pricing is to set a price that gives Millennium enough contribution to pay the fixed costs of operation while remaining competitive in the sports and recreation market.

Operations management

One of Anders' key strategic objectives for Millennium Sports since the organisation started was to achieve the highest quality of operation possible from every aspect of its business. To achieve this Anders has relied on the following principles:

- Invest in the highest-quality equipment.
- Recruit and retain the best staff and invest extensively in training.
- Delegate responsibility for quality assurance to every employee.
- Use quality circles to continuously review and improve operations.

This approach has been one of the reasons behind Millennium Sports' success since it started in 2001. Asterix Finance has, however, raised concerns about the cost of this approach and believes that using less-expensive equipment could improve Millennium's profits.

Higher level questions

Section A

Answer **three** questions.

1. a. (i) Define the term 'mission statement'. [2]
   (ii) Define the term 'strategic objective'. [2]
   b. Analyse how Anders Rikard's approach to operations management helps Millennium Sports achieve its mission. [6]
2. a. Describe **two** elements of Millennium Sports' target market segment. [4]
   b. Analyse how Millennium Sports can use its marketing mix to attract its target market segment. [6]
3. a. Outline **two** possible sources of working capital available to Millennium Sports. [4]
   b. Analyse the effect the late payment of membership fees will have on Millennium Sports' current ratio. [6]
4. a. Outline **two** possible sources of funds Anders and Erik could access to buy Asterix's 33% shareholding. [4]
   b. Analyse the effect an increase in borrowing would have on Millenium Sports' financial position. [6]

Section B

Answer the compulsory question in this section.

Anders and Erik want to develop the range of sports Millennium offers. It is currently looking at surfing. This is a big growth area and something Erik feels the business ought to develop. Millennium has been approached by XTC Surf Ltd which has developed an artificial surf machine. The machine is expensive and will cost $1.2 million. The projected cash inflows and outflows are set out in the table below. Anders and Erik look favourably at projects that pay back within four years and have an average annual rate of return of over 20%.

$000	2014	2015	2016	2017	2018
Cash inflow	200	300	400	400	400
Cash outflow	50	60	70	70	70

Asterix Finance does not want this project to go ahead because it believes that it will not be sufficiently profitable. Erik, however, feels that Millennium needs to offer a range of services that other sports clubs and gyms do not offer to keep it ahead of the competition.

5. a. Define the term 'cash inflow'. [2]
   b. Explain a reason why Millennium might have chosen the payback method of investment appraisal for the surf machine project. [4]
   c. For the surf machine project calculate the project's payback and average annual rate of return. [4]
   d. Using monetary and non-monetary factors evaluate Millennium Sports' decision to invest in the new surf machine. [10]

Section C

Answer the compulsory question in this section.

6. Millennium Sports has been approached by a regional hotel chain, Merx Hotels, to enter into a joint venture to provide accommodation to sports teams and individuals who travel long distances to use Millennium's facilities. The joint venture would involve Merx Hotels building a 50-room hotel on Millennium Sports' site. Merx has carried out market research which suggests a sports hotel would open up Millennium's market to a national and international level. This could be particularly important for the success of the new surf machine. Merx would build the hotel and would pay Millennium Sport 10% of the hotel's revenue each year. Asterix Finance is a strong driver behind the joint venture.

Evaluate Millennium Sports' decision to enter into a joint venture with Merx Hotels. [20]

Standard level questions

Section A

Answer **three** questions.

1. **a.** Describe what is happening to the staff turnover at Millennium Sports. [4]

b. Analyse a consequence to Millennium Sports of high staff turnover. [6]

2. **a.** **(i)** Define the term 'cost-based pricing'. [2]

(ii) Define the term 'fixed cost'. [2]

b. Analyse how appropriate 'cost-based pricing' is for Millennium Sports. [6]

3. **a.** Describe **two** examples of strategic objectives Millennium Sports might make. [4]

b. Analyse the difference between the strategic objectives of Asterix Finance and Millennium's founders Anders Rikard and Erik Brolyn. [6]

4. **a.** Describe the **two** sources of finance used to start up Millennium Sports. [4]

b. Analyse the appropriateness to Millennium Sports of using borrowed funds to buy out Asterix Finance. [6]

Section B

Answer the compulsory question in this section.

Question 5 is based on the additional information included in the higher level section B.

5. **a.** Define the term 'cash inflow'. [2]

b. Explain a reason why Millennium might have chosen the payback method of investment appraisal for the surf machine project. [4]

c. For the surf machine project calculate the project's payback and average annual rate of return. [4]

d. Using monetary and non-monetary factors evaluate Millennium Sports' decision to invest in the new surf machine. [10]

Sample answers

The sample answers below can also be used to understand the approach to answering questions on paper 1.

Answers to higher and standard level question 5:

a. Cash inflow is the cash that comes into a business as a result of a particular event or business activity. The surf machine, for example, will generate a cash inflow as a result of customers paying to use the machine.

b. The payback method of investment appraisal tells Millennium how long it will take the initial \$1.2 million investment made on the surf machine to be paid back by the cash inflows generated by the project. As a small company the payback time is important because cash flow and liquidity are so important to small businesses.

c. Payback:

\$000	Year 0	1	2	3	4	5
Cash inflow		200	300	400	400	400
Cash outflow	1200	50	60	70	70	70
Net cash flow	–1200	150	240	330	330	330
Cumulative	–1200	–1050	–810	–480	–150	180

$-150/330 \times 12 = 4$ years 5.5 months

Average annual rate of return:

$$\frac{\dfrac{([150 + 240 + 330 + 330 + 330) - 1200]}{5} \times 100}{1200} = 3\%$$

d. The payback time of the project is longer than the four years Millennium Sports wants from its projects, so on this basis the project is unfavourable. The surf machine's 3% ARR is below the 20% required by Millennium's management for a viable project. So, on financial terms, the project is unfavourable.

A key non-financial factor is the image the surf machine may give Millennium as an innovative, forward-looking organisation. This may enhance it in the minds of the consumer. Surfing is, however, a different type of sport from the normal sports the business specialises in – it is perhaps an outdoor activity rather than a formal sport – and this might adversely affect the image Millennium wants as a place for serious athletes.

On balance, the financial and non-financial factors do not support the investment in the new machine because of the unfavourable financial factors and the fact the machine takes the business away from the normal sports it focuses on.

Internal assessment

Higher level internal assessment: research project

Introduction

If you are taking Business Management higher level, you will need to produce a 2000-word research project as your internal assessment. The project should be based on a real business organisation and the research question you are considering must be a real one facing the organisation. The research question can be based on a decision a business is taking or an issue it is facing. You could also consider a decision or issue facing a range of organisations.

Choice of topic and organisation

You should choose a topic that interests you and which you can tackle effectively within the word limit. It is a good idea to select a topic and organisation that will enable you to score well on the marking criteria. Your teacher will be able to advise you.

You will need to have a thorough understanding of the business and the market in which it operates – the more information you can obtain from the organisation, the better. Local businesses are often a good choice because you can access them easily – for example, an estate agent, a small engineering firm, a garage, a computer company, a theatre.

Choosing a title

The title of your project should be in the form of a question. This will enable you to focus your research and analysis precisely and to come to an effective conclusion. It is essential for you to choose a title that allows you to apply business techniques to solve a problem.

Try to avoid backward-looking titles that lead to descriptive rather than analytical projects. For example, 'What is the most effective form of marketing at fast-food retailer Z?' would be better phrased as 'How could the promotional mix of retailer Z be improved?' Your title should also allow you to come to a conclusion and make a recommendation to the business.

Here are some examples of sample titles:

- Should XYZ estate agents invest in a new computer system?
- How could staff efficiency at ABC retailer be improved?
- How could the stock-management system employed by Z and Sons Engineering be improved?
- Should QRS financial services sell their products on the internet?
- What would be the most effective way for LNM Leisure to promote its new range of sports clothing?
- What would be the most effective promotional strategy for the XYZ Theatre to use to market its productions?
- Should LNM Bank provide its own catering service or use an outside contractor?
- What would be the best way for ABC Retailers to motivate its sales staff?
- How can customer service at the ABC Hardware Centre be improved?
- How could XYZ Sports improve its cash flow?

The research proposal

Part of the internal assessment involves writing a research proposal that outlines how you are going to produce your report. It should be written as a plan and set out in the following way:

- The research question
- The rationale for study – why you have chosen this topic
- Areas of the syllabus to be covered
- Possible sources of information
- Organisations and individuals to be approached
- Methods to be used to collect and analyse data, and the reasons for choosing them
- Anticipated difficulties
- Action plan that sets out the order of activities and time scale of the project.

The research proposal is part of the assessment criteria, so it should be included as a separate document with your report.

Setting out your report

1. Presentation

Your report is a formal document, so it must be meticulously presented. The formal layout should be:

- Title page
- Acknowledgements
- Contents page
- Executive summary (abstract)
- Introduction
- Research question
- Procedure or method
- Main results and findings
- Analysis and discussion
- Conclusions and recommendations
- Bibliography and references
- Appendices.

2. Introduction

This includes a background to the business and should cover:

- who the business's customers are
- how big the business is
- where it is located
- the business's basic legal structure (whether it is a partnership, private limited company, plc, etc.)
- the market within which the business operates
- the context of the problem – how the decision you are looking at will affect the business.

Try to keep this section fairly brief (around 200–300 words as a guideline) – avoid long descriptions of the company's history or its market(s).

3. Procedure or method

This is a short section that is structured around how you are going to research and then answer the question. For example:

'What would be the best way for ABC Retailers to motivate its sales staff?'

The procedure for this could be to use primary research techniques to ascertain the views of the staff.

4. Main results and findings

This section includes the results of your primary and secondary research. You could use tables, pie charts, bar charts and so on.

5. Analysis and discussion

This section gives you the opportunity to analyse your data by applying the business techniques you have used in the course. It is the substance of the project and needs to be focused precisely on the project's title. There is a huge variety of techniques you could use – some will be quantitative, such as discounted cash flow and decision trees, but they could also be qualitative, such as applying the promotional mix or the work of behavioural theorists. Table 6.1.5 lists some example titles and identifies appropriate analytical techniques.

When business tools are used in the analysis they need to be briefly introduced and there must be an explanation of why they have been chosen. It is important not to copy out sections from the textbook. Any weaknesses of the methods used and their assumptions should be made clear, particularly in the way they affect the final outcome of the project.

6. Conclusions and recommendations

The conclusion of the project should be based on the evidence and analysis included in your report and should answer the question set in the title. Your recommendation to the business should be based on the conclusions you have drawn. In the project 'Should XYZ Industrial invest in a new cutting machine?', for example, the recommendation should state whether XYZ should buy the new machine or not.

Example titles	Appropriate analytical techniques
Should ABC estate agents invest in a new computer system?	Cash flow forecasting, investment appraisal
How could staff efficiency at retailer X be improved?	Work study, motivation theory, leadership theory, group theory
Should ABC Engineering introduce JIT stock management?	Ratio analysis, stock theory, just-in-time stock management
Should ABC Financial Services market its products on the internet?	Marketing strategy, marketing mix, SWOT analysis
How can customer service at the Hardware Centre be improved?	TQM, motivational theory

Table 6.1.5 Appropriate analytical techniques

Higher level marking criteria

Table 6.1.6 sets out the marking criteria used to assess your research project and how to achieve the top mark for each of the criteria.

Criteria	Nature	Marks available	What is needed to achieve the top mark for each of the criteria
A	Research proposal and action plan	3	The research proposal and action plan must: • be appropriate, clear and focused • have a clearly identified and explained methodology and theoretical framework.
B	Sources and data (written report)	3	The primary sources selected and the data collected must: be appropriate, varied and sufficient.
C	Use of tools, techniques and theories (written report)	3	The tools, techniques and theories must: • show a good understanding of relevant business management tools, techniques and theories • be skilfully applied.
D	Analysis and evaluation (written report)	6	The analysis and evaluation must: • be a skilful analysis of the results and findings • have a coherent integration of ideas • have consistent evidence of substantiated evaluation.
E	Conclusions (written report)	2	The conclusion must: • be substantiated and consistent with the evidence presented in the main body of the written report • suggest areas for further study.
F	Recommendations (written report)	2	The recommendation must: • be substantiated and consistent with the conclusions • answer the research question.
G	Structure (written report)	2	The structure must be organised into an argument that is appropriate for the research question and easy to follow.
H	Presentation (written report)	2	The report must include all of the required components in the correct order and format.
I	Reflective thinking (written report)	2	The report must include appropriate evidence of reflective thinking on the approach taken in this piece of research and its limitations.
	Total	25	

Table 6.1.6 Higher level marking criteria for internal assessment

Standard level internal assessment: written commentary

Introduction

The standard level internal assessment requires you to write a commentary on a real business issue or problem of your choice. It gives you the opportunity to demonstrate how you would apply business management tools, techniques and theories. The commentary has a 1500-word limit.

Choosing a topic

You will need to choose a topic that interests you and which you can tackle effectively within the word limit. It is a good idea to select a topic that will enable you to score well on the marking criteria. Your teacher will be able to advise you.

Setting a question

The title of the commentary should be in the form of a question which faces a single business organisation, or a market/industry-wide issue that could affect an organisation. For example:

- Should restaurant ABC introduce a line of healthy options to its menu?
- Could an improvement in working conditions at supermarket X improve the motivation of its staff?

- Should company Y purchase new machinery to increase output and improve product quality?
- Where should retailer ABC locate a new outlet to maximise sales?

Supporting documents and additional sources

Your commentary must be based on secondary data and may be supported by primary data that you have obtained. You will need to select three to five supporting documents which will be attached to your commentary and will form part of your assessment. The best commentaries will use a range of different types of sources to support them.

Here are some examples of the secondary sources you could use as supporting documents:

- final accounts
- market research reports
- newspaper articles
- market research surveys
- business plans
- extracts from web-based articles.

You could also use primary sources such as:

- responses to questionnaires
- transcripts of interviews you have conducted.

The supporting documents must have been written within two years of the date the commentary is submitted. You may find it helpful to highlight the relevant parts of the document you have used to support your commentary.

You are not limited to using the supporting documents as sources of information – you may also use textbooks, class notes and DVDs/videos (only officially sourced). Remember to include supporting documents and additional sources in your bibliography.

Use of business tools and techniques

A good commentary will use suitable business tools to answer the question in the title. In the example 'Should restaurant ABC introduce a line of healthy options to its menu?' it would be useful to carry out a PEST analysis that looks at changes in the business environment and how this affects consumer choice. Ansoff's matrix could also be used to consider the strategic change in the products the restaurant is offering.

Analysis and synthesis of data

You will need to demonstrate that you can use appropriate analytical skills in your commentary. In the question 'Could an improvement in working conditions at supermarket X improve the motivation of its staff?' for example, it would be important to analyse the impact working conditions have on staff motivation by using the data you have collected and secondary sources such as the work of a theorist like Herzberg. To analyse information effectively you need to refer to source material and show how it contributes to the title of your commentary.

Evaluative and critical thinking

To show effective evaluative and critical thinking you should question the evidence you have used in your commentary. For example, you could evaluate the question of staff motivation by saying how the impact of working conditions varies from worker to worker and so it is difficult to draw precise conclusions that apply to all workers.

Writing a conclusion

Your commentary should conclude with a judgement about the decision that the business should take. The question 'Where should retailer ABC locate a new outlet to maximise sales?' for example, would need to say where, based on your evidence, the retailer should locate.

Presentation

Good commentaries are clearly structured and well presented. As mentioned earlier, you should also reference your work accurately in a bibliography.

There is no required format for the commentary but an effective layout might be:

- Title
- Introduction
- Research using supporting documents
- Research findings
- Analysis and evaluation of the findings
- Conclusion
- Bibliography
- Appendices (the supporting documents).

Standard level marking criteria

Your commentary is marked internally based on the marking criteria set out in Table 6.1.7.

Criteria	Nature	Marks available	What is needed to achieve the top mark for each of the criteria
A	Supporting documents	4	The supporting documents must: • be relevant • be sufficiently in-depth • provide a range of ideas and views.
B	Choice and application of business tools, techniques and theory	5	The business tools, techniques and theory used in the commentary must be: • appropriate • skilfully applied.
C	Choice and analysis of data and integration of ideas	5	The data selected from the supporting documents must be: • appropriate • skilfully analysed • a coherent integration of ideas.
D	Conclusions	3	The conclusion to the commentary must: • be consistent with the evidence presented • answer the commentary question.
E	Evaluation	4	The commentary must show: • evidence of thorough evaluation • judgements are well substantiated.
F	Structure	2	The structure must be organised into an argument that is appropriate for the research question and easy to follow.
G	Presentation	2	The commentary must include: • a title page • an accurate table of contents • appropriate headings and sub-headings • consistent referencing • a complete bibliography • numbered pages.
	Total	25	

Table 6.1.7 Standard level marking criteria for internal assessment

Extended essay in Business Management

The extended essay in Business Management gives you the opportunity to study an area of the subject that particularly interests you. It is a 4000-word, research-based essay that will allow you to:

- develop your research skills
- understand how business theory, concepts and principles are used in the real world
- collect business information from a wide range of sources
- critically analyse real business information
- develop your report-writing skills
- manage your own piece of original academic work.

Choosing a title

Choosing the title of the extended essay is probably the most important part of the whole process. The title is the factor that will enable you to produce work which is manageable within the 4000-word limit and allows you to meet the extended essay marking criteria. Make sure your title is:

- a question
- easy to understand
- focused
- accessible to secondary research and primary research (although essays can just be based on secondary research)
- accessible to analysis and evaluation using business techniques
- manageable within the 4000-word limit.

Poor titles are ones that are too broad and unfocused to give you the opportunity to answer them well. A title such as 'Analysis of motivation in the workplace' is too open-ended and imprecise to allow you to answer it effectively. A better title would be 'To what extent has staff motivation at ABC hairdresser's been improved by use of different non-financial rewards?' Titles often focus on individual firms but they can also be based on industries.

Unlike the higher level internal assessment, the emphasis of the extended essay research question is being backward-looking rather than forward-looking: 'How motivation has been improved' rather than 'How motivation can be improved'.

Possible titles

- To what extent has ABC shoe shop's sales been increased by its promotion strategy?
- Has Italian restaurant X's market share been increased by changes in its product portfolio?
- Has law firm X's investment in a new computer system increased its efficiency?
- What has been the most important factor that has increased staff motivation at supermarket XYZ?
- Has the introduction of TQM at XYZ Ltd improved the quality of the firm's products?
- To what extent has the economic recovery in the UK in 2013–14 affected estate agent LMN and Co?

- Why has the practice of publishing environmental audits been adopted more widely in industry X than in industry Y?
- Has the new pricing strategy used by airline X increased its sales revenue over the last two years?
- Has the increased use of e-commerce over the last three years benefited the firms in industry XYZ?
- Has the launch of a new promotion strategy by media company XTZ improved its sales performance?
- Has the outsourcing of its catering service by FGH Ltd been beneficial to the company?

Planning the essay

The basic plan sets out how you are going to approach your essay in terms of methods of research and business theory you are going to use. Table 6.1.8 can be used as guide to an extended essay plan.

1. Research question	What has been the most important factor that has increased staff motivation at supermarket XYZ?
2. Research method	• Books on or containing motivation theory and human resource management • Secondary survey on staff motivation in the retail industry • Articles on the human resource management in the supermarket industry • Research paper on staff motivation in the retail industry • Interview with the managers and staff at supermarket XYZ
3. Theory to be used	• Work of motivational theorists (Taylor, Maslow, Pink, Hertzberg, Adams) • Financial rewards • Non-financial rewards • Corporate culture • Employer–employee relations

Table 6.1.8 Extended essay plan – a suggested guide

Writing the essay

The introduction

You should write an introduction that sets out the context of the essay and why it is worth studying. In your essay you will need to include:

- some background about the organisation
- the research question
- the importance of the research question.

In the essay 'What has been the most important factor that has increased staff motivation at supermarket XYZ?', you would need to discuss the nature of supermarket XYZ – the size of the organisation, how long it has been operating in town Y, its customers and what type of legal structure the firm has. You could then say why staff motivation is important to supermarket XYZ and how motivation impacts on the supermarket's performance. You could finish by contextualising your research question by explaining how important employee motivation is as an issue facing all businesses.

Research methodology

You will need to include both primary and secondary research. Sources of secondary research include:

- books
- newspapers
- periodicals
- government reports
- business reports
- academic articles.

In the essay 'Has the new pricing strategy used by airline X increased its sales revenue over the last two years?', you could obtain your information from business textbooks and business periodicals on pricing theory. Primary research is also useful to support good essays on organisation-based topics. For example, you could use:

- interviews
- organisation-based observations.

In the essay 'Has the new pricing strategy used by airline X increased its sales revenue over the last two years?', you could interview the managers at the airline.

Research analysis

Once you have completed your research, your next task will be to analyse the results. This will involve presenting your results in a form that can be interpreted effectively such as tables and charts. In the research question 'Has the new pricing strategy used by airline X increased its sales revenue over the last two years?', you could use graphs and bar charts to illustrate how the revenue of the airline has increased over the last two years. You could explain how this rise in revenue has happened at the same time as the airline has increased its use of price discrimination and penetration pricing which suggests the pricing strategy has led to an increase in revenue. You could then evaluate this by considering the other factors that could have led to an increased revenue, other than price, such as strong growth in the economy.

Developing a business argument

The nature of a Business Management extended essay means you should be developing each point of your argument to answer the research question. This will involve business theory and techniques to give your essay academic rigour. In the essay 'Has the new pricing strategy used by airline X increased its sales revenue over the last two years?', you could develop the main argument that the use of price discrimination and price penetration by the airline have led to an increase in revenue and consider other factors that could also have affected the airline's revenue like growth in the economy and the airline industry. Each point you make needs to be developed logically and evaluated.

Writing a conclusion

Your conclusion must focus on the research question set at the start of your essay. For the essay 'Has the new pricing strategy used by airline X increased its sales revenue over the last two years?', your conclusion could include:

- the pricing strategy used by airline X
- the sales data of airline X

- the strength of the relationship between the pricing strategy and the sales data
- other factors that could have affected sales data or airline X.

Finally, you need to say whether the pricing strategy has led to an increase in airline X's sales revenue. You must also consider any unanswered questions you may have, for example considering the promotional strategy of airline X.

Presentation

Your essay must include:

- a title page
- a table of contents
- page numbers
- labels on all tables, charts and graphs
- clear sub-headings
- a full, clearly set-out bibliography using footnotes.

Try to keep the presentation simple. Print it in font size 11 and use a normal font style such as Times New Roman or Calibri. Do not make presentation errors such as getting the numbering wrong in your table of contents. You can include appendices for related material that is not part of your essay, but anything that contributes to your argument should be in the main body. If you use appendices, then refer to them accurately.

The abstract

This is a 300-word summary of the essay. It must clearly state:

- the title of the essay
- how you researched the question and developed an argument
- your final conclusion.

What is it worth?

The extended essay is marked out of 36 and is based on the set marking criteria. The way these criteria are applied is set out in Table 6.1.9.

Criteria		Marks available	What is needed to achieve the top mark for each of the criteria
A	Research question	2	The research question should be: • clearly stated in the introduction • sharply focused • effectively addressed within the word limit.
B	Introduction	2	The introduction should clearly: • state the context of the research question • explain the significance of the topic and why it is worthy of investigation.
C	Investigation	4	The data and sources should: • be appropriate • have an imaginative range • be carefully selected • be well planned.
D	Knowledge and understanding of the topic studied	4	The essay should show: • a very good knowledge and understanding of the topic studied • clearly and precisely the essay in an academic context.

Table 6.1.9 Extended essay marking criteria [*table continues over*]

Criteria		Marks available	What is needed to achieve the top mark for each of the criteria
E	Reasoned argument	4	The argument should be: • presented in a clear, logical and coherent manner • a reasoned and convincing argument to the research question.
F	Application of analytical and evaluative skills appropriate to the subject	4	The essay should show: • appropriate use of analytical and evaluative skills • effective and sophisticated application of them.
G	Use of language appropriate to the subject	4	The language used should: • communicate information clearly and precisely • use terminology appropriate to the subject accurately • be used with skill and understanding.
H	Conclusion	2	The conclusion should: • be clearly stated • be relevant to the research question • be consistent with the evidence presented in the essay • include unresolved questions.
I	Formal presentation	4	Excellent presentation must achieve the highest standard of layout, organisation and appearance in terms of its: • title page • table of contents • page numbers • text • illustrative material • quotations • references • bibliography • appendices.
J	Abstract	2	The abstract must clearly state: • the research question • how the investigation was undertaken • the conclusion(s) of the essay.
K	Holistic judgement	4	This is a holistic judgement of the essay; an excellent essay should show: • intellectual initiative • deep understanding • insight.
	Total	36	

Table 6.1.9 *Continued*

Viva voce

This is an interview where you may need to explain your extended essay to your supervisor. This is optional and your school or college may not require you to attend a viva voce. There are no marks awarded for it, but it will help your supervisor to write his or her report on your essay. This will then be sent to the external examiner who will consider the report when he or she is awarding criterion K: Holistic judgement.

The grade boundaries

Table 6.1.10 sets out the approximate grade boundaries for the extended essay.

Grade	A	B	C	D	E
Mark range	29–36	23–28	16–22	8–15	0–7

Table 6.1.10 Approximate grade boundaries for the extended essay

Remember, the final bonus points you receive for your extended essay are based on a combination of grades with your Theory of Knowledge essay. Table 6.1.11 sets out the combination of extended essay and Theory of Knowledge grades needed to achieve bonus points.

Theory of Knowledge	A	B	C	D	E
Extended essay					
A	3	3	2	2	0
B	3	2	1	1	0
C	2	1	1	0	0
D	2	1	0	0	0
E	0	0	0	0	0

Table 6.1.11 Combination of extended essay and Theory of Knowledge grades needed to achieve bonus points

A final thought

It is very easy to get wrapped up in the marking criteria, grades and bonus points associated with the extended essay and obviously these things are important. In the end, however, the extended essay should be an intellectually challenging, enjoyable experience. It is your chance to write something really original, so go ahead and embrace this part of the IB programme.

Index

Index

Index

Index

Acknowledgements

The authors and publishers acknowledge the following sources of copyright material and are grateful for the permissions granted. While every effort has been made, it has not always been possible to identify the sources of all the material used, or to trace all copyright holders. If any omissions are brought to our notice, we will be happy to include the appropriate acknowledgements on reprinting.

p. 18 "French TxCell going public", European Biotechnology News, © 2014 BIOCOM AG; p. 34 "Siemens plans savings of €6 billion by 2014", © 2012 Siemens AG; p. 53 "Peugeot Citroen's road ahead laid out" by Carl Mortished, © 2007 The Times/News Syndication; pp. 68, 547 IB Learner Profile, International Baccalaureate Organization. "This work has been developed independently from and is not endorsed by the International Baccalaureate (IB)"; p. 84 "Political instability affecting Russia's investment climate" by Ben Aris, © 2014 Russia Beyond the Headlines; p. 126 "adidas is a trade mark of the adidas Group used with permission"; p. 133 Courtesy of Exxon Mobil Corporation; p. 139 HRM Today, Institute for Corporate Productivity (i4cp); p. 142 "What is happening to organizational structures?", The Times/News Syndication; p. 197 Extract from "Corporate culture: The view from the top, and bottom", The Economist, 24 Sept 2011; http://www.economist.com/node/21530171; p. 198 Globoforce Limited; p. 207 "Trade union? India's BPO workers say 'no'" by S. Srinivasan. Used with permission of The Associated Press Copyright © 2014. All rights reserved; p. 211 "Barclays to cut 19,000 jobs as it scales back investment arm" by Jill Treanor. Copyright Guardian News & Media Ltd 2014; p. 221 "Saudi Arabia bans trade unions and violates all international labour standards", 25-January, 2012, International Trade Union Confederation; p. 222 "Walmart workers in China remain resolute and defiant", 24 April, 2014, China Labour Bulletin; p. 349 Excerpt from PepsiCo Annual Report 2013, used with permission of PepsiCo.; p. 352 "Seven avoidable mistakes in global marketing" by Christian Arno, 2012, E-consultancy.com Limited; p. 353 "Samsung releases four new affordable Galaxy smartphones" by Rhiannon Williams, © Telegraph Media Group Limited 2014; pp. 362, 363 Labbrand, a China-originated global brand consultancy; p. 367 "Retail-led strategy by Burberry to target high net worth individuals in Asia Pacific by Ashirvad Tomar, 27 Feb 2013, MarketLine, an informa business; p. 432 "Non-US customers kept in dark after Zappos cleans up after data breach" by Lucian Constantin. Used with permission of Computerworld Online Copyright © 2014. All rights reserved; p. 434 Carrefour Group; p. 451 "India's e-commerce industry may reach $70 billion by 2020", 9 Feb 2014, IANS India Pvt. Ltd; p. 466 (1) "Manufacturing Operations Management: Lessons from Dell" by Matthew Littlefield, Manufacturing net. Copyright © 2012 Matthew Littlefield; p. 466 (2) Sustainable Life Media Inc; p. 467 Trickle Out Project Africa, Copyright © University of Essex; p. 468 responsibletravel.com**;** p. 479 From: Mind Your Business, Production Methods, Teamwork, Motivation and Change Management – 090204, Copyright © 2004 Biz/ed.co.uk. Reproduced by permission of Cengage Learning EMEA Ltd; p. 488 Source: www.process-improvement-japan.com/lean-hotel-operations.html, Authors: Kozo Sakano & Angela Corriero; p. 493 Excerpt from www.subway.com; p. 515 "Burberry stops handbag production in Chinese factory in ethics row", 18 Sept. 2012. Used with permission of The Associated Press Copyright ©2014. All rights reserved; p. 518 "Zara's Fast-Fashion Edge" by Susan Berfield and Manuel Baigorri. Used with permission of Bloomberg L.P. Copyright © 2014. All rights reserved; p. 542 "Gillette: Managing Product Innovation", ICMR, © IBS Hyderabad. All rights Reserved;

Photos

p. 2 Smirnov Vasily/iStock/Thinkstock; p. 5tl Kreutzer/Image Broker/Alamy; p. 5tr Amanda Hall/Robert Harding; p. 5c F.Bettex – Mysterra.org/Alamy; p. 18 Monkey Business Images/Shutterstock; p. 27 Mondragon Corporation; p. 31 Ton Koene/Horizons WWP/Alamy; p. 35 Clynt Garnham Business/Alamy; p. 53b William Ju/Alamy; p. 53t Colin Garratt/Terra/Corbis; p. 61 Tata/Rex Features; p. 65 Rich Carey/Shutterstock; p. 69 Farjana K Godhuly/Stringer/AFP/Getty Images; p. 70 Andrew Howe/iStock/Thinkstock; p. 74 Kevin Foy/Alamy; p. 75

Acknowledgements

Agencja Fotograficzna Caro/Alamy; p. 87 Epa European pressphoto Agency b.v./Alamy; p. 88 F. Jack Jackson/Alamy; p. 92 The Body Shop International Plc; p. 105 Mamahoohooba/iStock/Thinkstock; p. 119 Ragnar Schmuck/Getty Images; p. 124 Gautier Stephane/Sagaphoto.Com/Alamy; p. 142 Charles Platiau/Reuters/Corbis; p. 150 Neil Setchfield/Alamy; p. 155 Monkey Business Images/Shutterstock; p. 161 Dpa Picture Alliance/Alamy; p. 169 Urban Zone/Alamy; p. 174 Digital Vision/Photodisc/Thinkstock; p. 176 Ford Motor Company; p. 184 Dpa Picture Alliance/Alamy; p. 193 XiXinXing/iStock/Thinkstock; p. 194 Stockbyte/Thinkstock; p. 197 ZUMA Press, Inc/Alamy; p. 198 Dencg/Shutterstock; p. 199l TranstockInc./Alamy; p. 199r Linda Matlow/Rex Features; 200 Baloon111/Dreamstime; p. 204 Monkey Business Images/Shutterstock; p. 205 Jeremy Graham/DB Images/Alamy; p. 207 David Pearson/Alamy; p. 210 Epa European Pressphoto Agency b.v./Alamy; p. 216 Dpa Picture Alliance Archive/Alamy; p. 225 VanderWolf Images/Shutterstock; p. 227 Roy Morsch/Age Fotostock Spain, S.L./Alamy; p. 231 Eric Audras/PhotoAlto/Alamy; p. 235 Micheline Pelletier/Corbis; p. 240 UK Retail Alan King/Alamy; p. 242 Peter Horree/Alamy; p. 247 Jose Fuste Raga/Latitude/Corbis; p. 257 Daniel-Hjalmarson/iStock/Thinkstock; p. 263 Scott J. Ferrell/Congressional Quarterly/Alamy; p. 272 Sharon Day/Hemera/Thinkstock; p. 275 Hongqi Zhang/Hemera/Thinkstock; p. 276 Ryan McVay/Photodisc/Thinkstock; p. 277 Jeff Greenberg 3 of 6/Alamy; p. 284 Alex Segre/Alamy; p. 288 Les Gibbon/Alamy; p. 294 Richard Wareham Vervoer/Alamy; p. 296 Lisa Werner/Alamy; p. 298 Chris Cooper-Smith/Alamy; p. 313 Nick Greaves/Images of Africa Photobank/Alamy; p. 316 Anthony Kay/Flight/Alamy; p. 319 View Stock/Alamy; p. 322 Andrei Kiselev/Hemera/Thinkstock; p. 324 Andrew Fox/Alamy; p. 326 DeAgostini/Getty Images; p. 334 Yampi/Shutterstock; p. 336 Daniel Berehulak/Staff/Getty Images; p. 341 NetPhotos/Alamy; p. 343 Agencja Fotograficzna Caro/Alamy; p. 345 Scott J. Ferrell/Congressional Quarterly/Alamy; p. 347 Dan Vincent/Alamy; p. 351 Kidstock/Blend Images/Alamy; p. 354 Chris Rout/Alamy; p. 364 Iain Masterton/Alamy; p. 365 Adrian Sherratt/Alamy; p. 369 Patti McConville/Alamy; p. 378 PSL Images/Alamy; p. 382 Sam Edwards/OJO Images Ltd/Alamy; p. 396 Ian Dagnall Computing/Alamy; p. 415l Advertising Archives; p. 415r Advertising Archives; p. 422 David Colbran/Alamy; p. 429 Neustock images/Vetta/Getty Images; p. 435 Clement Philippe/Arterra Picture Library/Alamy; p. 438 Lou Linwei/Alamy; p. 441 Ryan Pyle/Corbis; p. 448 Ming WU/Alamy; p. 451 Sze Fei Wong/iStock/Thinkstock; p. 453 Mvaligursky/iStock/Thinkstock; p. 456 Alex Segre/Alamy; p. 460 Andre Jenny/Alamy; p. 463l You can more/Shutterstock; p. 463r Pic4you/iStock; p. 467 Tony Karumba/Stringer/AFP/Getty Images; p. 469 Ben Molyneux Retail/Alamy; p. 470 Oleksiy Maksymenko/Alamy; p. 471b Hoang Dinh Nam/AFP/Getty Images; p. 471t Michael Rosenfeld/Science Faction/Corbis; p. 472 Acnakelsy/iStock/Thinkstock; p. 480 xPacifica/Alamy; p. 493 Sven Hagolani/Zefa/Corbis; p. 501 Trinigourmet.com; p. 507 Bloomberg/Getty Images; p. 510 Eyevine; p. 514 Paul Prescott/Shutterstock; p. 517 Don Couch/Alamy; p. 521 Philipus/Alamy; p. 534 MutluKurtbas/iStockphoto; p. 537 Howard Harrison/Alamy.