OSC IB STUDY & REVISION GUIDES
FOR THE INTERNATIONAL BACCALAUREATE DIPLOMA PROGRAMME

OSC

Business Management

Higher Level

New Edition

Valid for **2016** exams onwards

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Table of Contents

Unit 1: Business organization and environment 1

1.1 Introduction to business management 1

1.2 Types of organizations 7

1.3 Organizational objectives 14

1.4 Stakeholders 23

1.5 External environment 26

1.6 Growth and evolution 29

1.7 Organizational planning tools 37

Unit 2: Human resource management 45

2.1 Functions and evolution of human resource management 45

2.2 Organizational structure 56

2.3 Leadership and management 66

2.4 Motivation 69

2.5 Organizational (corporate) culture 78

2.6 Industrial/employee relations 80

Unit 3: Finance and accounts 85

3.1 Sources of finance 85

3.2 Costs and revenues 89

3.3 Break-even analysis 92

3.4 Final accounts 100

3.5 Profitability and liquidity ratio analysis 109

3.6 Efficiency ratio analysis 113

3.7 Cash flow 115

3.8 Investment appraisal 120

3.9 Budgets 126

Unit 4: Marketing 130

4.1 The role of marketing 130

4.2 Marketing planning (including introduction to the four Ps) 138

4.3 Sales forecasting 146

4.4 Market research 154

4.5 The four Ps (product, price, promotion, place) 158

4.6 The extended marketing mix of seven Ps 173

4.7 International marketing 174

4.8 E-commerce 176

Unit 5: Operations management 179

5.1 The role of operations management (production) 179

5.2 Production methods 180

5.3 Lean production and quality management 184

5.4 Location 188

5.5 Production planning 190

5.6 Research and Development 195

5.7 Crisis management and contingency planning 198

APPENDICES 201

Appendix One: Concepts, Content and Contexts 201

Appendix Two: Assessment objectives and command terms in examination questions 203

Appendix Three: Practice data response questions 205

Appendix Four: Suggested answers to practice data response questions 209

Unit 1: Business organization and environment

1.1 Introduction to business management

✓ The role of businesses in combining human, physical and financial resources to create goods and services *(AO2)*

Definition of 'Business'

A business is an organization engaged in commercial, industrial or professional activities that can be a for-profit or a non-profit. Profit making organizations persuade customers through effective marketing to purchase their products or services at a price higher than it costs to produce them.

A business seeks to meet the needs and wants of consumers, whether private individuals or other businesses by combining human, physical and financial resources to create goods and services.

Businesses can be classified by:

- **Sector** – e.g. whether privately or publicly (state) owned
- **Level of activity** – how close the business is to the customer in the distribution chain, e.g. Businesses extracting raw materials, such as oil, are early in the distribution chain, whereas retail outlets are closer to the final customer
- **Size** – businesses are small, medium or large, measured by capital employed, market share, sales turnover, profit and the number of employees
- **Legal structure** – the way that a business is set up
- **Physical presence** – whether the business operate from physical premises, if it is purely online, or a mixture of the both

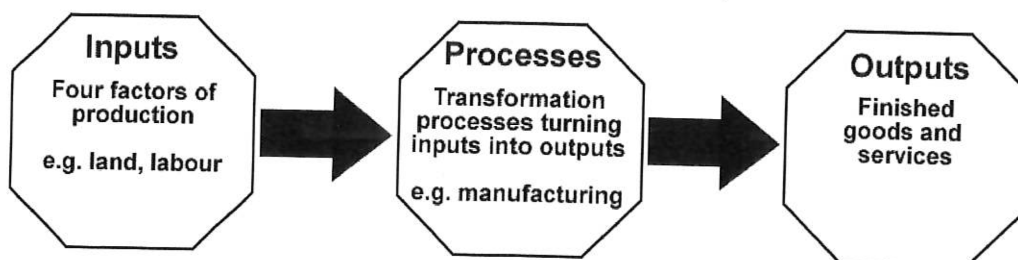
There are many different types of businesses, including service businesses, manufacturing businesses and retail businesses. The legal structure of a business varies from country to country.

Business features:

- A **decision making** organization
- Made up of groups of **workers (employees), managers, directors and shareholders**
- Exists in association with **customers, suppliers, competitors, the environment, local, national** and **other governments**
- Uses **factors of production**
- Produces and sells **goods and/or services**
- Normally **profit-making**

Business activity

A business is a type of system with ***inputs, processes*** and ***outputs***.



Business organizations operate in one or more of the following sectors:

Output	Sector	Activity
Goods	Primary	Extractive industries that acquire raw materials for production e.g. farming, mining, forestry and fishing.
	Secondary	Manufacturing and construction. Raw materials are processed and turned into consumer and/or capital goods.
Services	Tertiary	Personal and commercial services (e.g. shops and banks).
	Quaternary	Specialist technology businesses and/or knowledge industries, such as e-commerce.

- Primary sector activities tend to dominate in *less economically developed countries* (LEDCs).
- Tertiary and quaternary activities tend to dominate in *more economically developed countries* (MEDCs).
- Secondary sector activities tend to dominate in *newly industrialising* or *emerging economies (NICs).*

✓ The nature of business activity in each sector and sectoral change *(AO2)*

Sectoral change is the trend for the percentage of a workforce in agriculture to decline over time and for the secondary and then tertiary sectors to become increasingly important as economies develop. Developing countries are characterised by subsistence primary production and low levels of income. As they develop they industrialise, with manufacturing becoming dominant, with the following effects:

- Urbanisation
- Capital-intensive industries
- Increases in GDP / living standards
- Increasing employment

As development continues, there is a move towards tertiary sector activity, with the following effects:

- Higher incomes and increasing consumption of luxury goods
- Increasing specialisation
- Increasing demand for personal services
- Growth of technology and communication

Development does not always fit this model, e.g. some MEDCs, like Japan and Germany, have significant manufacturing industries.

✓ The role of entrepreneurship and intrapreneurship *(AO3)*

Both entrepreneurship and intrapreneurship innovate and generate income and employment.

KEY TERMS

Entrepreneurs create a business, take financial and personal risks and are accountable for the success or failure of their venture. They spot an opportunity in the marketplace and turn this opportunity into a business.
Intrapreneurs are "dreamers who do." Although employees, they behave like entrepreneurs. Firms, such as Intel, create an environment where employees are free to explore and develop their ideas. Intrapreneurs use their passion and skills to produce profitable innovation, but do not risk their own resources.

✓ Reasons for starting up a business or an enterprise *(AO2)*

Failure rates of new businesses are high. In developed economies, nearly half of new businesses fail within two years. Why do individuals set up businesses when there are so many risks? Reasons include that entrepreneurs:

- Spot a gap in the market
- Want to be their own bosses and organize their business lives
- Enjoy a challenge and have a passion for an activity
- Believe they can produce a good or service better than competitors
- Have skills that are in short supply
- Want to earn a profit and possibly 'get rich'
- Want to pass on wealth to their family

The impact of the World Wide Web

The Web creates opportunities for entrepreneurship without some of the financial risks of setting up a physical business. There are many examples of teenagers creating businesses for relatively little capital, and becoming rich e.g. Mark Zuckerberg and friends set up Facebook at college.

Common steps in the process of starting up a business or an enterprise

Some countries encourage entrepreneurship, while others make it more difficult. The World Bank publishes data on the number of days taken to set up a business. In 2013, for example, it took 4 days to register a business in Belgium, but 144 in Venezuela.

Doing Business measures the number of procedures, time and cost for a small and medium-sized businesses to start up, across 189 economies. In 2013, the following countries had the least number of procedures.

Economy	Start a business ranking	Procedures (number)	Time to set up (days)
Canada	2	1	5.0
New Zealand	1	1	0.5
Armenia	6	2	4.0
Georgia	8	2	2.0
Kyrgyz Republic	12	2	8.0

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Seven main stages setting up a new business:

1. ***Identify a business opportunity and a target market*** and ***generate ideas*** about meeting the needs and wants of that market.
2. ***Research the potential market*** and ***customer base.***
3. Produce ***a business plan.***
4. Select the ***correct form of business organization*** and ***satisfy legal requirements for registration.***
5. ***Raise the initial finance*** from personal savings or borrowing.
6. ***Choose a suitable location.***
7. ***Market the product or service.***

Then it is a matter **of survival.**

✓ Problems faced by a new business *(AO2)*

The failure rate of new businesses is high for the following reasons:

- ***Start-up costs can be high***, e.g. recruitment and marketing.
- ***Initial demand and revenue may be low*** - no brand recognition or customer loyalty.
- ***Time before production begins***.
- ***Cash flow problems***.
- ***Inadequate demand*** for the goods and services.
- ***Poor marketing*** and ***failure to supply*** sufficient goods to satisfy orders.
- ***Changing external environment*** e.g. recession.
- ***Other businesses copy the idea.***
- ***Legal restrictions,*** e.g. licences.
- ***Uncompetitive prices,*** because small firms lack economies of scale.
- ***Poor location as the result of a lack of finance.***
- ***Personality and skills of the entrepreneur inadequate.***

✓ The elements of a business plan *(AO2)*

After deciding to set up a new business, the founders should consider the three questions that underpin strategic decision-making:

- Where is the business going?
- How will it get there?
- How to measure and monitor progress, especially in terms of sales and cash flow?

A **business plan** is a written document setting out the business goals and describing how the business will achieve these. It is drawn up to attract investors/lenders:

- States owners' objectives and how they will achieve these.
- Reminds employees of the purpose of the business; where it is going, its mission, values and key corporate objectives.
- Informs potential investors about the firm's aims.
- Identifies its products and/or services and any unique selling point (USP).
- Lists key personnel and their experience and skills.
- Provides market information, e.g. sales projections.
- Provides profit forecasts, cash flow projections and break-even point.
- Outlines a marketing mix, with pricing strategies, marketing and promotional plans, distribution channels and location.
- Identifies how the product will be made, or service delivered.

1.2 Types of organizations

✓ Distinction between the private and the public sectors *(AO2)*

KEY TERMS

The private sector refers to organizations owned, controlled and managed by private individuals for the purpose of making a profit, e.g. Microsoft

The public sector refers to organizations owned, controlled and managed by the government to provide essential goods and services for the general public, e.g. health.

The balance between public and private ownership varies from country to country. Public ownership is less common than in the 20th Century as private businesses are considered more efficient. Moving firms from public ownership to private ownership is called *privatisation*. Governments may partner with the private sector to operate aspects of public services, e.g. health provision.

✓ The main features of for-profit organizations *(AO3)*

Legal structure

Most organizations operating in the private sector aim to make profits. The choice of legal structure determines how a business is financed, managed and organized, and its growth prospects. When a firm sets up, it chooses between an *unincorporated* or *incorporated status*, which affects the liability of the owners for business debts.

Unincorporated organizations: the owner is '*one and the same as the business itself*'. An unincorporated business has **unlimited liability**. The owner is legally responsible for all debts of the business and his/her personal possessions, such as a house, can be seized to pay outstanding debts.

Incorporated organizations: the firm is a legal entity in itself, with rights and responsibilities separate from those of the owners. Incorporation is like a birth – a legal entity is created with rights and responsibilities – like a new-born baby. The company has a 'legal personality'.

An incorporated business is owned by shareholders, who have **limited liability**. If the business fails the shareholders' liability for debts is *limited* to the maximum value of the shares they hold.

Unincorporated organizations

There are ***two types*** of unincorporated organization:

Sole trader (sole proprietor)

A business owned and run by one individual with no legal distinction between the owner and the business.

Advantages:

- Cheap and easy to set up with few legal formalities.
- All income/profit belongs to the owner.
- Quick decision-making, as only one person makes decisions.
- Being 'your own boss' is motivating.
- Privacy and confidentiality as public accounts not required.
- Flexibility and the ability to offer a personal service.

Disadvantages:

- Unlimited liability – risks personal assets.
- Limited sources of finance, because of high risk of failure. Lenders usually demand security for loans, e.g. the owner's house.
- The owner is responsible for all business functions.
- High risks - few economies of scale and higher costs.
- Workload and stress – owners cannot rely on others for support.
- Lack of legal continuity - the business ends if the owner retires or dies.

Examples: taxi drivers and electricians.

> **Examiner Tip!**
> - Although owned by a single owner, a sole trader *may have many employees.*
> - Sole traders have no shares or shareholders. Do **not** call them companies!

Partnership

Owned by two or more people. The maximum number of partners varies from country to country. The ownership, profit and liabilities are shared between partners. Many professional firms are partnerships, e.g. lawyers and architects. Like sole traders, partnerships cannot sell shares to other people, restricting the raising of capital for expansion.

Advantages:

- Greater financial strength than sole proprietorship, as there are more investors.
- Owners receives a share of all the profits.
- Decision-making shared between partners who may be specialists, allowing the division of labour.
- No responsibility to shareholders.
- Privacy and confidentiality as public accounts are not required.

Disadvantages:

- More complicated to set up than a sole tradership; requiring a legal agreement (*Deed of Partnership).*
- Unlimited liability – partners risks personal assets.
- Limited sources of finance compared to companies.
- Decision making slower than sole proprietorships, as more owners involved.
- Possible disagreements between partners.
- Few economies of scale and vulnerable to competition from larger businesses.
- Lack of legal continuity – if one partner dies or leaves, the partnership ends.
- Partners are responsible for all losses, '*wholly or severally*'. If only one has assets, then this partner is responsible for all debts.

Unlimited liability, difficulties in raising finance and taxation issues may encourage businesses to incorporate.

Incorporated organizations

> **Examiner Tip!**
>
> Do not to confuse *public limited companies* or *corporations*, which are in the private sector and owned by private individuals, with *public corporations* that are owned by the government.

Companies/corporations/joint-stock companies

Organizations owned by shareholders. The business and its owners are separate legal entities with a *'separation of control and ownership'*. Owners may appoint specialist managers to run the business. Incorporated firms are legal bodies in their own right.

Companies are owned by their shareholders, who enjoy limited liability. The most they can lose on a liquidation is the value of their shareholding – personal assets cannot be seized to pay for business debts.

Companies have ***legal continuity*** and *continue* to exist even if the owners change (i.e. shares are transferred on stock markets).

Becoming a company

Owners prepare legal documents to be registered with the authorities, including:

- **Articles of Association**: the ***internal rules*** of the business, e.g. calling of meetings and types of shares.
- **Memorandum of Association**: these detail relationships between the business and its ***external environment***, e.g. the objectives of the business.

There are ***two types*** of company:

Private limited company (Ltd)

Most companies start as ***private*** limited companies, because set up is relatively quick and inexpensive.

Characteristics of private companies

- Each year, companies prepare and publish a set of legal accounts, which are approved (audited) by independent accountants.
- There has to be at least one director. Shares can be sold privately, but not on national stock markets.
- Shareholders have limited liability.
- Many private limited companies are family businesses with less risk of a takeover, as existing shareholders can restrict sale and transfer of shares.

Public limited company (plc)

The shares of public companies are traded on national and international stock exchanges.

A **flotation** or **initial public offering (IPO)** occurs when a private limited company issues shares to the public for the first time, seeking capital to expand. The company becomes a public limited company and is listed on one, or several, stock exchanges and is said to have 'gone public' or been 'floated'.

Becoming a plc is expensive as the company must have a minimum share capital, which is more than many entrepreneurs can afford. Anybody can buy shares of a public company. Shareholders receive one vote for every share, so they control a business if they own more than 50% of the shares, because they can appoint their own directors. In practice, few shareholders vote at general meetings, so, actual control can exist at lower levels of share ownership. A plc can be taken over without the agreement of the directors.

The decision makers (the directors) are not normally the owners. This separation ('divorce') between ownership and control causes problems if directors do not act in the shareholders' interests.

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Advantages of companies:

- Access to large amounts of capital by selling shares.
- Money raised from shares is permanent capital that never has to be repaid, unless the business is liquidated. Companies pay *dividends* to shareholders.
- Legal continuity.
- Directors can be shareholders, incentivising performance to maximise dividends.
- Enjoy economies of scale, lower costs, lower prices, and higher profit.
- Specialist managers and employees improve efficiency.
- Better customer recognition, more trust and brand loyalty.

Disadvantages of companies:

- Lack of confidentiality, because they produce public accounts.
- Less flexibility with the risk of diseconomies of scale.
- More standardised with less personal service.
- High set up costs, because of legal requirements.
- Original owners may lose control, because sales of shares are unrestricted.

Summary of Legal Structures and their Advantages and Disadvantages

	Advantages	Disadvantages
Sole trader	Cheap and easy to start with few legal formalities All the profit belongs to the owner The sole trader is his/her own boss, and makes all the important decisions	Unlimited liability All the risk is with the owner Time off for sickness and holidays will reduce profits as there is unlikely to be cover Sole trader needs to be multi-skilled No legal continuity
Partnerships	Cheap and easy to start with few legal formalities More access to finance than sole traders All the profit belongs to the owners The partners are their own bosses, and makes all the important decisions Greater specialism than sole traders	Unlimited liability All the risk is with the partners individually and severally liable There may be disputes between partners and decision-making may be slower No legal continuity Less access to capital than companies
Private Limited Company	The business has limited liability It is easier to raise larger sums of capital More flexible than Plc's Legal continuity Economies of scale Division of labour	Shares can only be sold to other shareholders. Not very flexible if expansion is planned. More legal formalities than sole traders
Public Limited Company	Limited liability Easier access to cheaper finance More funds available for investment Public awareness gives status Legal continuity Economies of scale Division of labour	The company must publish financial results Accounts must be approved by professional auditors Greater need to conform to legal procedures Owners can lose control as shares are freely available on the Stock Exchange Potentially bureaucratic slowing decision-making

✓ The main features of for-profit social enterprises *(AO3)*

In recent years, for-profit social enterprises have emerged with a social mission built into the business model. Making profit is still essential, but making the world a 'better place' is central to the business mission.

Co-operatives

A co-operative is run by a group of people, each of whom has a financial interest in its success. Most are registered as limited liability companies.

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Three main types:

- Producers or agricultural co-operative
- Workers co-operative
- Retail co-operative

The importance of co-operatives differs from country to country. In Europe, co-operatives are popular in agriculture and retailing.

Microfinance providers

Microfinance refers to services, including credit, savings, insurance and other financial products targeted at low-income groups, who find borrowing difficult from banks. They often operate in rural communities and lend small sums to help individuals set up their own businesses.

Public-private partnerships (PPP)

Governments may not have the finances to provide a required good or service, so may enter into partnership with a private firm(s) to create a 'public-private partnership' (PPPs) to supply the good or service. The private firm operates the business on behalf of the government. PPPs are used to develop infrastructure in education, transport, defence and health.

Public-private partnerships (PPPs) combine two funding types:

1. *Government funded* – the government provides funds for projects operated and managed by private companies using their resources and expertise.
2. *Private sector funded* – government operate and manage projects using private sector funding.

Case study

The Canada Line

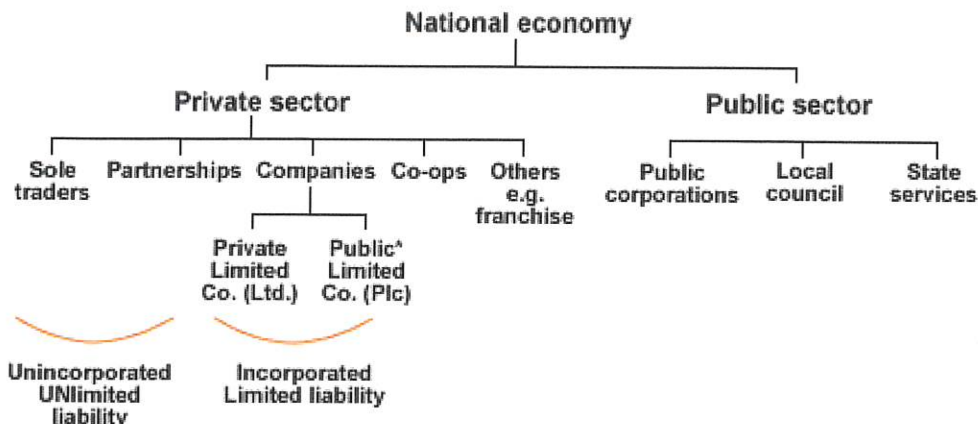
The **Canada Line** is a rapid transit line in the British Columbia, Canada. Opened in 2009, it was built as a public-private partnership, with funding provided by the Canadian government, government agencies and private partners.

Advantages of PPPs over public sector projects

- Quicker and more efficient delivery
- Value for money for the taxpayer
- Combined public and private sector skills, knowledge and expertise
- Better labour and capital productivity
- Competition between bidding firms lowers costs
- Innovation in the provision of public services

However, critics argue that:

- Taxpayers pay the bill for PPP
- Some private firms fail to deliver workable projects
- Private companies cut corners to maximise profits
- Short term savings lead to longer term debts for government
- Private financing is more risky than public finance
- Private firms may not take account of social objectives
- PPP contracts are complex and costly



*Do NOT mix up a PUBLIC Limited Company, which is in the PRIVATE sector, but offers SHARES to the public on the Stock Exchange with a PUBLIC corporation, which is owned by the government on behalf of the whole public.

✓ The main features of non-profit social enterprises (NPOs) *(AO3)*

Non-profit or **not for profit organization**, like private firms, may have a surplus of income over expenditure, but this is re-invested for the benefit of their members. Non-profit organizations include clubs, charities, religious associations and pressure groups. These may share some aims with private business, but profit is not one of them.

Non-governmental organizations (NGOs)

NGO's operate in the **private sector** for the benefit of others and are non-profit organizations, independent from government. In the U.S., they are known **private voluntary organizations**.

NGO's support socially desirable causes, such as:

- *The Red Cross*
- *Amnesty International*
- *The International Olympic Committee*

Charities

Charities are non-profit organizations that raise awareness of social problems, such as homelessness, and pressure governments to increase resources for underprivileged or excluded groups.

Charities use marketing to create brand awareness and frequently use celebrity endorsement. Charities combine professional managers and full-time employees with volunteer staff. Large companies associate with charities to raise their ethical image.

Case study

Oxfam

Oxfam works with more than 3,000 local partner organizations to assist people living in poverty exercise their human rights, assert their dignity as full citizens and take control of their lives. Oxfam operates as a global organization, concentrating on three interlinked areas:

1. **Emergency response**

Oxfam delivers aid, support and protection in emergencies and helps communities develop the capacity to cope with future crises.

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2. **Development work**

Oxfam fights poverty by funding impoverished communities worldwide. With the right support poor people can take control, solve their own problems, and rely on themselves.

3. **Campaigning for change**

Oxfam campaigns pressure leaders and governments to support lasting change. Poverty is not just about lack of resources, it is also about bad decisions made by powerful people.

1.3 Organizational objectives

Organizations need objectives because they:

- Provide a sense of direction
- Underpin strategic and tactical activities
- Provide a means of measuring performance
- Motivate stakeholders
- Develop teamwork

✓ Vision statement and mission statement *(AO2)*

In practice, these two statements may overlap or one may be a part of the other. However, there are differences:

- A mission statement is more specific to what the enterprise can achieve.
- The vision statement describes why it is important to achieve the organization's mission, by defining its purpose, social aims or broader goal, such as health improvements.

The mission statement

A business is not defined by its name, statutes or articles of incorporation. It is defined by the business mission. Only a clear definition of the missions and purpose of the organization makes possible clear and realistic business objectives. Peter Drucker

Mission statements define an organization's purpose and primary objectives, stating '*who we are and what we do*'. They act as a **whole philosophy** for the firm. They may not have quantifiable targets, but aim to inform customers, employees and other stakeholders about firms' objectives. The mission statement should:

- Be a concise statement of where the business is now, and show its future direction
- Provide a statement of what the business wants to achieve in the long term, as well as now
- Allow the business to develop specific goals and objectives to achieve their aims
- Provide inspiration to stakeholders

Walt Disney*:*
The mission of The Walt Disney Company is to be one of the world's leading producers and providers of entertainment and information. Using our portfolio of brands to differentiate our content, services and consumer products, we seek to develop the most creative, innovative and profitable entertainment experiences and related products in the world.

The vision statement

A vision statement is a general statement on where the business desires to be in the future and the values it holds; what it wants to become and what it wants to achieve. The vision should make employees feel proud, motivated and excited to part of the organization's journey.

Heinz

Example

Our vision, quite simply, is to be "the world's premier food company, offering nutritious, superior tasting foods to people everywhere." Being the premier food company does not mean being the biggest but it does mean being the best in terms of consumer value, customer service, employee talent, and consistent and predictable growth. We are well on our way to realizing this vision but there is more we must do to fully achieve it.

Case study

Mission and Vision Statements: Coca-Cola and Innocent

In 2010, Coca-Cola bought a controlling stake in the Innocent smoothie company. Many commentators criticised the owners of Innocent, accusing them of selling out on their ideals.

Innocent is the Europe's favourite smoothie company, selling natural healthy products in over 13 countries and employing over 220 people across Europe. Innocent's mission is to make it easy for people to do themselves some good and to make it taste good too. In addition to 100% pure fruit smoothies, their successful latest products – orange juice and veg pots - fit with their mission of getting natural healthy products to as many people as possible.

✓ Aims, objectives, strategies and tactics, and their relationships *(AO3)*

'Why' organizations exist

Aims and objectives allow businesses to measure success by comparing actual performance against targeted performance. Aims and objectives drive decision-making and provide targets to motivate to staff.

As a business, Innocent wants to leave things better than they find them. This is reflected in everything they do, from sourcing their fruit from farms with higher social and environmental standards to developing the world's first 100% recycled plastic bottle to donating 10% of profits every year to charity.

"Being accountable to our customers is something that is in our blood. In the summer of 1998 when we had developed our first smoothie recipes but were still nervous about giving up our proper jobs, we bought £500 worth of fruit, turned it into smoothies and sold them from a stall at a little music festival in London. We put up a big sign saying 'Do you think we should give up our jobs to make these smoothies?' and put out a bin saying 'YES' and a bin saying 'NO' and asked people to put the empty bottle in the right bin. At the end of the weekend the 'YES' bin was full so we went in the next day and resigned."

✓ Classifying aims and objectives

Aim

A statement of intent written in broad terms, describing what an organization wants to achieve and where it wants to be in the future.

Objective

Specific objectives required to achieve its desired aims, defined in measurable outcomes.

Example: An individual aims to become a journalist. To achieve this aim, the individual sets specific objectives in terms of qualifications.

Business strategy

A plan illustrating how the business will achieve its corporate objectives. Strategic objectives are significant long-term goals, relating to key business objectives such as market share.

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Business tactics

Operational activities undertaken on a regular basis to implement the business strategy.

Long-term

Often defined as a period of 1- 5 years. In terms of business, long-term planning is associated with strategy.

Short-term

Refers to planning for one year or less. Tactical objectives may be daily, weekly or monthly.

Planning process

The aims of a firm are its strategy. From these are derived tactical objectives; shorter-term objectives to provide immediate targets and motivators for managers and other employees.

The first, the most basic and the perpetual goal of any firm is **survival**. Only after this has been secured can it develop significant strategic aims, e.g.:

- Increased profit
- Greater market share
- Elimination of competition
- Possible takeovers
- International expansion
- Improving corporate image
- Improving quality

Management by Objectives: SMART(ER) objectives

The term, *management by objectives*, popularised by the management theorist, Peter Drucker, refers to the process of management and employees agreeing on objectives for the organization. Objectives set in this way need to be 'SMART' or 'SMARTER'.

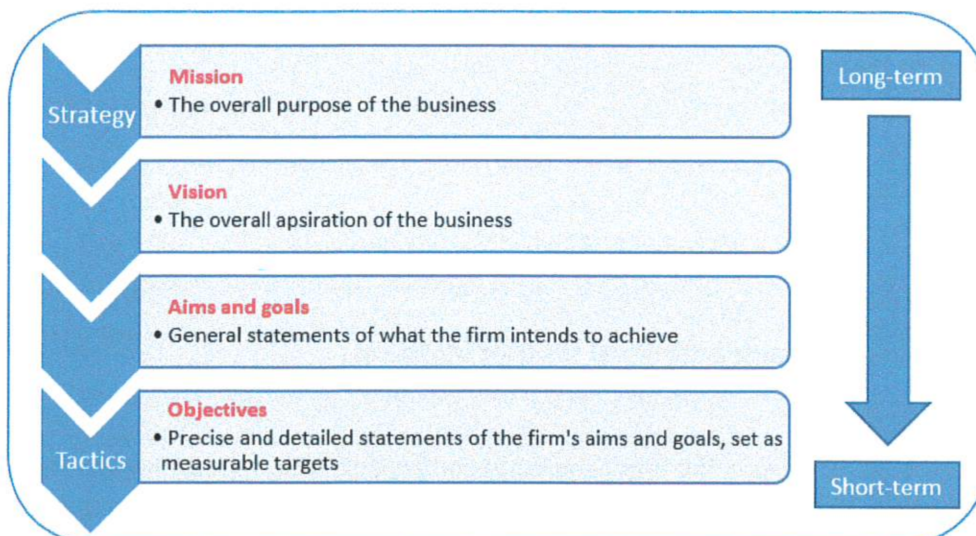
SMART objectives

- S = Specific, clear and easily defined
- M = Measurable and quantifiable targets and tasks
- A = Achievable using existing resources, so objectives should be realistic
- R = Relevant and must not conflict with other objectives
- T = Time-bound (within a specified period of time) allowing measurement

A business can make objectives **SMARTer** by ensuring it can:

- Extend the target to account for new circumstances and/or make them Exciting
- Reward the achievement of objectives and/or Record the results

Hierarchy of Objectives



Case study

HP's Corporate Objectives:

HP corporate objectives and shared values:

- **Customer loyalty:** To earn customer respect and loyalty by consistently providing the highest quality and value.
- **Profit:** To achieve sufficient profit to finance growth, create value for our shareholders and achieve our corporate objectives.
- **Growth:** To recognize and seize opportunities for growth that builds upon our strengths and competencies.
- **Market leadership:** To lead in the marketplace by developing and delivering useful and innovative products, services and solutions.

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Ethics varies from country to country, culture to culture and individual to individual. Even within a firm there will be a range of opinions about what is right and wrong. A business may act legally, but in a manner that many consider unethical, e.g. selling weapons.

Case study

Texas Instruments

Ethics is the cornerstone of TI:

Our reputation at TI depends upon all of the decisions we make and all the actions we take personally each day. Our values define how we will evaluate our decisions and actions and how we will conduct our business. We are working in a difficult, demanding, ever-changing business environment. Together, we are building a work environment on the foundation of integrity, innovation and commitment.

Together, we are moving our company into a new century one good decision at a time. Our high standards have rewarded us with an enviable reputation in today's marketplace: a reputation of integrity, honesty and trustworthiness. That strong ethical reputation is a vital asset, and each of us shares a personal responsibility to protect, preserve and enhance it. Our reputation is a strong, but silent partner in all business relationships. By understanding and applying the values presented here, each of us can say to ourselves and to others, "TI is a good company and one reason is that I am a part of it."

Know what's right. Value what's right. Do what's right.

✓ The evolving role and nature of Corporate Social Responsibility (CSR) *(AO3)*

Firms have responsibilities to various stakeholders. By being socially responsible firms hope to be seen as:

- Good employers
- Responsible capitalists
- Preserving a good corporate image
- Trustworthy
- Reducing the risks of legal actions

Firms may act ethically when profits are high, but change their behaviour when under economic pressure.

Differing views on Social Responsibility

There are two main schools of thought:

- **Free market (capitalist) view** - the prime objective of a business is to maximise profit for the owners of that business.
- **Corporate social responsibility view** - business organizations, like all 'citizens', have a responsibility to society to minimise the effects of their operations.

Changes in a firm's social responsibility over time

A firm's attitude to social responsibility is formed by:

Internal factors:

- A business is made up of individuals, who are also consumers and citizens. The business must reflect the views and norms of employees, who are influenced by the society in which they live.
- Corporate cultures evolve over time with staff joining and leaving the business.
- Profitability and cash-flow influence the extent of socially responsibility.
- Shareholders may elect new managers who reflect their views.

External factors:

- Government laws and regulations constrain business behaviour.
- The state of the economy influences how much firms are prepared to spend on improving their socially responsible image.
- Pressure groups may force changes to business practices by lobbying governments.
- Firms benchmark their behaviour against their competitors.
- Social attitudes change over time.

Policies to implement objectives of Social Responsibility

Many businesses produce an 'environmental audit' or 'sustainability report' outlining the impact their operations have on the environment.

Case study

BP

BP produces an annual sustainability report. Although this commits BP's to be socially responsible, the 2010 oil spill in the Gulf of Mexico led to much criticism of its environmental credentials.

✓ SWOT analysis *(AO3/AO4)*

A ***SWOT analysis*** is an ***INTERNAL audit*** of where a business is at the present, and how it is affected by its ***EXTERNAL environment***:

STRENGTHS – what the firm does well and its advantages e.g. experience

WEAKNESSES – what the firm does not do well e.g. customer service

OPPORTUNITIES – changes in external conditions that allow the firm to develop markets, expand and make more profits

THREATS – external factors that may prevent the firm achieving its aims (constraints and barriers)

A SWOT analysis supports effective strategic planning, based on an examination of a firm's capabilities and its external environment. The strengths and weaknesses are a summary of the present position of the product, decision or organization, whereas the opportunities and threats represent future positive or negative concerns for the business.

Below is an example of a SWOT analysis for an engineering company

Strengths	**Weaknesses**
Excellent brand name Well trained management Good liquidity position Customer loyalty	High labour turnover of unskilled staff Declining profit margin Old machinery Quality control problems
Opportunities	**Threats**
New technologies available to improve control production New markets for products in Eastern Europe Recent failure of a major competitor Demographic change will lead to higher demand for products	Increasing protectionism in some destination countries Increasing raw material costs Risk of a double-dip recession New online competition Local pressure group attempting to prevent factory emission

SWOT analysis:

- Provides a picture of the firm's market position.
- Is a good training tool.
- Develops a better understanding of the firm's service level, product range and brands.
- Forces the firm to examine its business and consider the present and future competition.
- Examines external influences and future changes.
- Encourages an assessment of strategic opportunities, e.g. relocation.

Examiner Tip!

N.B. Although, a SWOT analysis can support the setting of a strategy, it should **NOT** be used to assess a strategy.

There are links between:

- ***Strengths*** and ***Opportunities,*** and
- ***Weaknesses*** and ***Threats***.

Strategic development

Firms with well-trained workforces (*strengths*) will be in a good position to adapt to market changes (*opportunities*) and to produce products and services to meet new customer needs. Firms *build on their strengths* to put them in a position *to take advantage of new opportunities.*

Firms with unmotivated workforces and poor quality service (*weaknesses*) may not be in a good position to compete with new suppliers in the market place (*threats*). Firms *reduce weaknesses* to *address growing threats*.

✓ The Ansoff (Growth) Matrix *(AO3/AO4)*

The Ansoff product-market matrix helps firms understand and assess their *growth potential*, set marketing objectives and consider the *risk* of various growth strategies. Firms should concentrate on those things that *they know and do well* already, and build on these *core competences*.
In essence, there are *only four* ways to grow:

- Selling more of what a firm already sells to existing customers
- Entering new markets with existing products and/or services
- Producing new goods or services
- Selling new goods and services to new customers

Ansoff summed these options up in his matrix:

PRODUCT

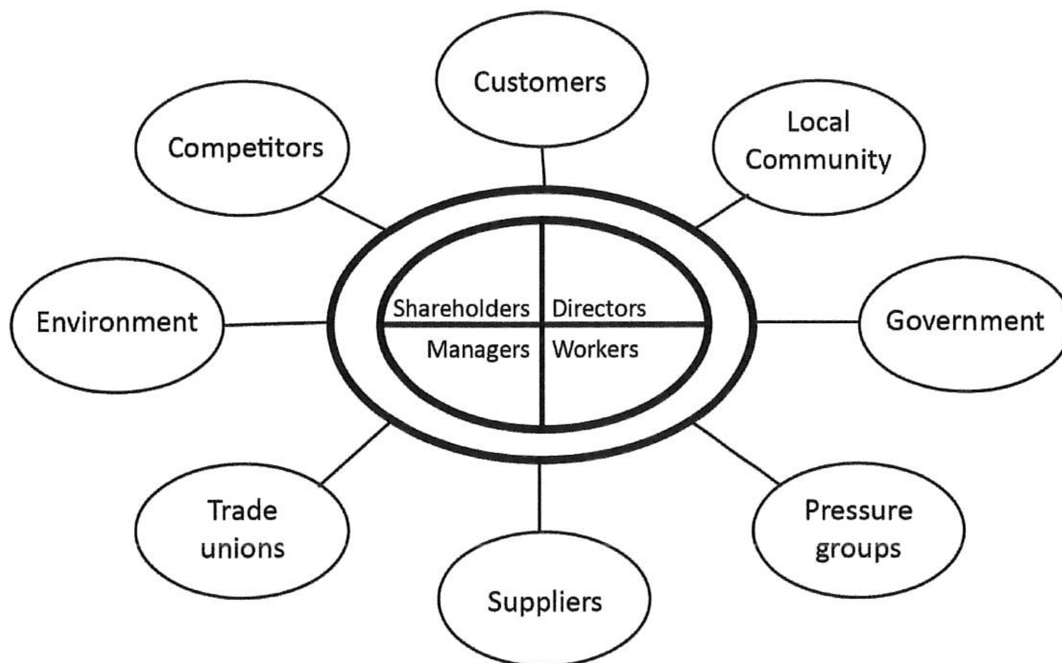
MARKET		Existing	New
	Existing	Market penetration	Product development
	New	Market development	Diversification

1. **Market Penetration:** selling more goods and services to existing customers, by doing what it is already doing, but better. This involves changing the marketing mix, e.g. price or promotion to:
   - Increase brand loyalty to reduce brand switching
   - Differentiate products by creating a unique selling proposition (USP)
   - Persuade existing customers to use the product more frequently
   - Encourage customers to use more of the product at a time, e.g. King size
2. **Product Development:** marketing new, or modified, products to existing markets, e.g. a car manufacturer introduces new models, such as electric cars.
3. **Market Development**: marketing existing products into new markets, e.g. Carrefour, the French supermarket, opened its first Indian branch in 2010.
4. **Diversification:** selling new products and services to a new market, e.g. a retailer sets up a bank. This is the riskiest strategy as it moves the firm away from its core competences.

1.4 Stakeholders

A range of individuals and groups, as well as other firms and public organizations, have an interest in the survival and operation of a business. These are called **stakeholders**, as they have a stake, investment, or interest in the firm's success. Normally, this stake is financial.

Stakeholders can be separated into internal and external stakeholders.



Stakeholders – internal and external

Stakeholder groups have varying requirements from the firm, and their interests often conflict, particularly in the short-term.

Other possible approaches to minimise stakeholder conflicts:

- *Rewarding employees* by linking their performance to business success using share options and performance-related pay.
- *Involving more stakeholders* in the *decision-making process*.
- *Improving channels of communication* between stakeholder groups.
- Using *Public Relations (PR)* channels to inform stakeholders of the positive aspects of the business operations.

1.5 External environment

Activities and events outside a firm affects its operations and choices. Although, the external environment is uncontrollable by the firm, it will seek to forecast and prepare for change. The external environment provides both ***Opportunities*** and ***Threats.***

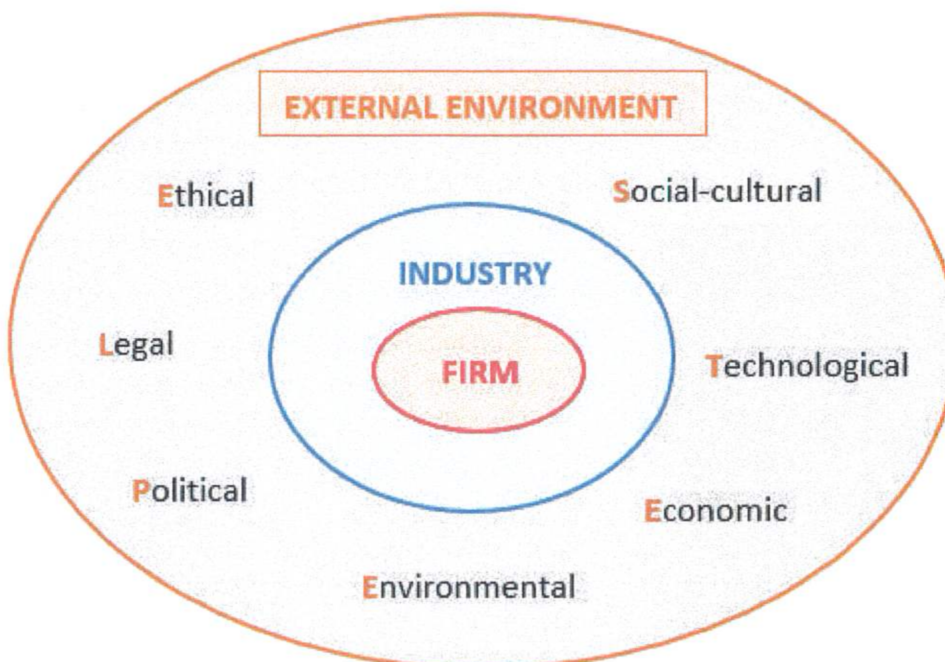
For example, a **recession** may be an *opportunity* for companies that produce cheaper, basic goods, but a *threat* for luxury goods manufacturers, as customers have lower disposable income.

Organizations need to understand the wider 'macro-economic' environments in which they operate, so they can maximise their opportunities and minimise the threats.

✓ STEEPLE analysis of the external environment *(AO2/AO4)*

Marketers use acronyms as a shorthand classification of the external environment.

- **PEST:** Political, Economic, Social-cultural, Technological
- **PESTLE**: Political, Economic, Social-cultural, Technological, Legal, Environmental
- **STEEPLE**: Social-cultural, Technological, Economic, Environmental, Political, Legal, Ethical



EXTERNAL ENVIRONMENT ANALYSIS: KEY FACTORS

STEEPLE	FACTORS
Social-cultural	demographics, social mobility, cultural influences, education, health, fashion, leisure
Technological	technological innovation, technological incentives, research and development, e-commerce, technology transfer, internet and web developments and trends, automation and robotics, nanotechnology
Economic	GDP growth rate, inflation rates, interest rates, government spending, unemployment, recession, exchange rates, business cycle, trade, FDI, membership of trading blocs, stock market trends
Environmental	weather and climate, natural resources, sustainability, flora and fauna, carbon footprint, pollution levels, waste disposal and recycling
Political	Environment regulation, fiscal and monetary policy, trade policies, terrorism, press freedom, government stability, immigration policy
Legal	consumer and employment legislation, competition laws, corporate governance, contract law, health and safety standards, discrimination protections, anti-trust legislation, data protection
Ethics	corruption, intellectual property, Fairtrade, employment standards business ethics, confidentiality, accounting standards

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

Potential questions asked by the firm:

- How will the political situation affect the firm?
- What are the future economic forecasts?
- What are the impacts of cultural changes on demand patterns?
- How will technological innovation affect market structure?
- What are the environmental concerns for the industry?

STEEPLE for Nike Inc.

Example

Nike Inc. is an American MNC engaged in the design, development, manufacturing and worldwide marketing and selling of footwear, apparel, equipment, accessories and services.

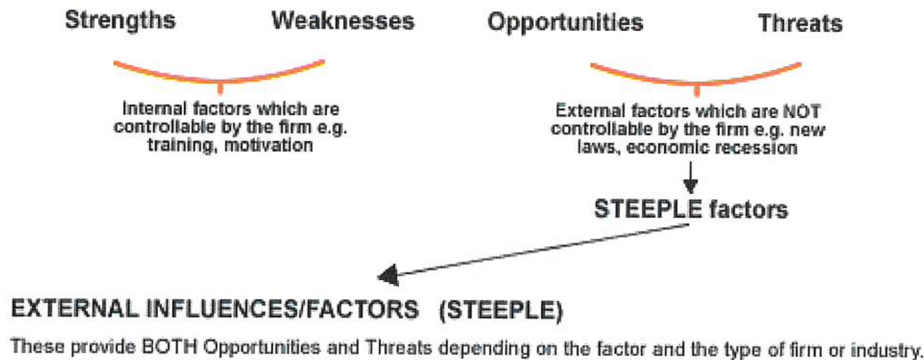
A steeple analysis for **Nike** might include the following change factors:

STEEPLE	FACTORS
Social-cultural	lifestyle changes and a focus on health, ageing population, brand loyalty, increasing brand awareness, higher disposable incomes in target markets
Technological	innovation resulting in higher productivity, technological transfer to supplier countries, growth of e-commerce, automation and robotics, nanotechnology improving clothing performance
Economic	relatively low US GDP growth, increasing inflation risks, interest rate rises, government spending, appreciating dollar, recession in US and target markets, developing new free trade areas, increasing commodity prices
Environmental	climate change affecting cotton harvests, stakeholders demand better sustainability, pressure to reduce carbon footprint to lower taxes, pollution levels, emphasis on waste disposal and recycling
Political	US political treaties, risks of terrorism and political unrest in supplier countries, promotion of entrepreneurship, low corporation taxes, stable US government
Legal	consumer and employment legislation, competition laws, stricter health and safety standards, anti-trust actions, need for better data protection
Ethics	Pressure group and media reporting on employment standards and business ethics

Combining SWOT and STEEPLE Analysis

- ***Strengths*** and ***weaknesses*** of a firm are internal *controllable* factors
- ***Opportunities*** and ***threats*** are derived from the external environment and are *uncontrollable* by the firm

Firms seek to reduce their weaknesses to minimise threats to their operations and develop their strengths to capitalise on opportunities.



EXTERNAL INFLUENCES/FACTORS (STEEPLE)

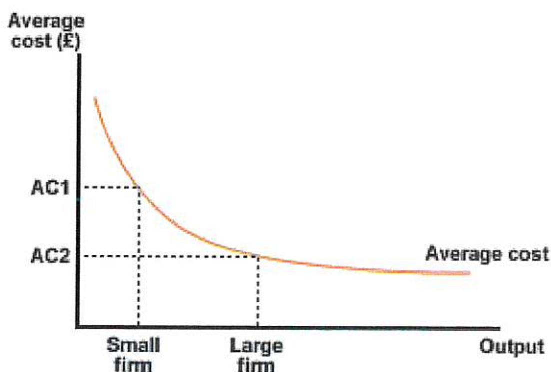
These provide BOTH Opportunities and Threats depending on the factor and the type of firm or industry.

1.6 Growth and evolution

Most firms start as small businesses. Why do entrepreneurs seek growth as a major objective? Growth brings both advantages and disadvantages:

✓ Economies and diseconomies of scale *(AO2)*

Economies of scale: as a business grows it becomes more efficient, cutting its average cost of production (*unit cost*). Larger firms may enjoy lower costs that smaller competitors, creating larger profit margins and allowing lower prices.



The effect of economies of scale on average cost

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Internal economies of scale

Costs fall as the firm itself grows in size. These efficiencies benefit the individual firm.

Internal economies of scale

Type	Economy
Technical	More expensive technology is usually more productive and cheaper per item, e.g. a computer that is twice as powerful as another will NOT cost twice as much to buy. **Fixed costs** can be **spread** across more output **lowering average fixed cost.**
Purchasing	Raw materials and finished goods can be bought in **bulk** and at a **discount (bulk-buying).**
Financial	**Loans** are **easier** to get and **interest** charged is **lower – larger firms have more collateral (security).**
Marketing	**Marketing is more professional and effective** – advertising and marketing by large companies is more impressive e.g. may include celebrities.
Managerial	The **Division of Labour** can be used – the production of a product can be split up into smaller and less complicated activities – e.g. production lines makes manufacturing cheaper and more efficient. Specialist managers are recruited for functional areas.
Risk bearing	**Diversification**: by producing many products, a firm can compensate for falling demand for one product by increasing output of another.

External economies of scale

External economies of scale benefit the industry as a whole, as it grows, e.g. the availability of specialised training services.

Diseconomies of scale

Diseconomies of scale: as a business becomes larger it becomes less efficient, leading to a higher average cost of production (*unit cost*).

Internal diseconomies of scale

- Co-ordination problems as increasing delegation slows decision-making.
- Larger firms have many layers of hierarchy resulting in delayed communications.
- Motivation may fall as junior employees feel disengaged from decision makers.
- Monitoring productivity and quality in big corporations is difficult and potentially costly.

External diseconomies of scale

As an industry grows the demand for labour increases. If skilled labour is in short supply, wages and salaries rise, increasing the costs of individual firms.

✓ The merits of small versus large organizations *(AO3)*

KEY TERMS
A **small organization** is privately owned and operated, with a small number of employees and relatively low volume of sales. It is likely to have fewer than 500 employees.

The optimum size for a business, is the point where average costs are at their lowest. However, it is more likely that other factors are more influential, such as:

- The aims, objectives and goals of the owners
- The potential size of the market
- Access to funding and investment
- Competition in the market

There are many reasons why small organizations survive and prosper. A small organization can:

- Be started at a very low cost, carried out with minimum investment and potentially run on a part-time basis
- Be run from the home with low overheads, making it price competitive despite its lack of scale
- Be entrepreneurial with a highly motivated owner
- Manage its cash transactions relatively easily
- Be close to its customers
- Be suited to e-commerce operations, because it serves specialised niches
- Be more flexible to change

Small businesses face a variety of problems:

- Working on a low budget
- Poor liquidity and cash flow caused by larger firms delaying bill payments
- Higher costs than large firms, e.g. Higher interest rates
- Excessive government regulation
- Customers prefer better known brands
- Lack of management skills

Large businesses have advantages including:

- Economies of scale
- Brand loyalty
- The ability to diversify and reduce risks with a wider range of products
- Access to greater funds
- A better chance of longer-term survival

✓ The difference between internal and external growth *(AO2)*

Internal (organic) growth

KEY TERMS

Organic (natural) growth is where a firm grows by using its own resources to increase sales and profits.

Organic growth is achieved by:

- Improving products and services
- Better marketing

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- Investment in research and development
- Improving workforce training
- Expanding the number of offices, factories and outlets

Internal growth is relatively inexpensive, because the firm can use retained profits, rather than external loans.

✓ Methods of external (inorganic) growth *(AO3)*

KEY TERMS

External growth is growth in business operations that arises from mergers or takeovers, rather than an increase in the firm's own business activity.

Major types of external growth:

- Mergers and acquisitions (M&As) and takeovers
- Joint ventures
- Strategic alliances
- Franchising

Merger and acquisition (M&A)

The joining of two firms is known as an **integration**.

- In a **merger**, two firms agree to become partners in a larger business.
- A **takeover (acquisition)** is when one firm buys another, with (voluntary) or without its approval (hostile). One firm is dominant and becomes the owner. The taken-over firm faces redundancies, cost cutting or closures of branches.

The reasons for Mergers and Acquisitions include:

- Cost economies through rationalisation
- Greater market share
- Reducing business risk
- Better control of distribution channels
- Complementary activities

Firms operate in one of the following sectors:

- **Primary sector** - farming, mining, etc.
- **Secondary sector** - manufacturing
- **Tertiary sector** - services
- **Quaternary sector** - high technology

Takeovers and mergers can be ***horizontal*** or ***vertical.***

Horizontal merger

Firms in the same industry and at the same sector merge, e.g. a merger between two car manufacturers. Also known as horizontal integration, e.g. Daimler-Benz and Chrysler.

Vertical merger

Firms in different sectors merge, e.g. *Walt Disney Company* and the *American Broadcasting Company*. It may be a:

- Vertical *forward* integration: a firm merges with another further up the chain, e.g. a brewery takes over a chain of bars, often to secure a retail outlet.
- Vertical *backward* integration: a firm merges with one further down the production chain, e.g. a wine producer takes over a vineyard, to ensure supply.

If a firm controls the whole distribution channel it is *totally vertically integrated*, e.g. Shell owns oil-rigs, oil tankers and pipes, refineries and petrol stations.

Types of integration

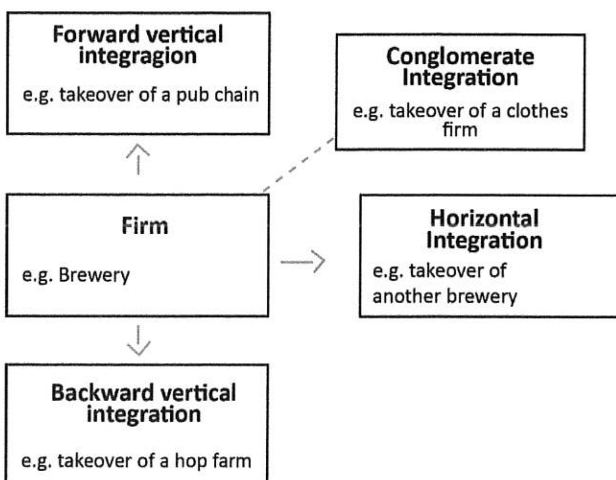
Conglomerate merger

The integration of firms in different businesses and/or sectors with a range of activities. The main motive is *diversification* and spreading risk. Most conglomerates are multinationals, operating in more than one country, e.g. Sahara is an Indian conglomerate with business interests in finance, media and entertainment, retail, manufacturing and information technology.

Results from mergers and acquisitions are often disappointing, because of:

- Culture clashes
- Increased bureaucracy and loss of control
- Internal competition
- Lack of experience in another industry
- Negative publicity as employees are made redundant

Types of merger



Joint venture

An agreement between two, or more organizations, to undertake a particular business activity for a limited period. The contractual agreement creates a new business division with a separate legal entity, allowing the participants to grow, while maintaining their own identity and brands. The organizations share profits or losses and the investment.

Strategic alliance

A collaborative agreement between two or more firms to pursue a set of agreed goals and to commit resources to achieve these. The firms remain completely independent and the alliance ends when the goals are achieved.

Advantages and disadvantages of joint ventures and strategic alliances

Advantages:

- Competition may be reduced as firms cooperate.
- A synergy is created where the combined skills, resources and experience of the businesses exceed those of the two businesses acting independently.
- By partnering with a local firm, there are fewer logistical problems entering a new and/or overseas market, lowering distribution costs.
- Mergers or takeovers are expensive and difficult to reverse.
- Enable a firm to move into a new product or market much faster.

Disadvantages:

- Profits are shared.
- Communication and control issues caused by different cultures, languages and management styles.
- Conflict and disagreements between the partner organizations.

Franchise

A franchise is an agreement where a business (*franchisor*) sells rights to another business, or individual (franchisee) allowing them to use the brand name, logo, trademark and products/services of the franchisor in return for a fixed fee and/or a percentage of the annual sales turnover (*royalty*). This model is less risky and costly than setting up a new business.

Examples of franchises: Body Shop, Subway, McDonald's.

Advantages and disadvantages for the *Franchisee*:

Advantages	Disadvantages
No need for a new idea - someone else had the idea and tested it, too!	High initial and ongoing costs. The franchisee may be contracted to buy products from the franchisor, which may not be the best or the cheapest.
Failure rates are far lower than other start-ups, often around one in ten.	The franchisor might go out of business, or change the way they do things.
Well-established franchise operations have national advertising campaigns and a respected brand and trading name.	Restrictions on the operation of the business preventing changes to suit the local market.
Good franchisors offer comprehensive training programmes in business skills.	Other franchisees could give the brand a bad reputation.
Good franchisors help secure investment funding for your investment and discount suppliers.	The franchisee may find it difficult to sell the franchise – the terms of the contract may restrict sale to someone approved by the franchisor.
Customers believe the franchise is part of a larger organization with existing credibility.	Reduced risk usually means lower profits than an independent, riskier venture.

Advantages and disadvantages for the *Franchisor:*

Advantages	Disadvantages
The business can achieve rapid growth without high capital investment and running costs.	Poor or unscrupulous franchisee may affect the brand image of the entire business.
Franchisees are likely to be more motivated and committed than paid managers as increasing profits is a major incentive.	It is not unknown for franchisees to 'steal' the franchise idea and set up in opposition.
Able to use the franchisees' local knowledge and expertise.	Loses day-to-control over the operations of the business.

✓ The role and impact of globalization on the growth and evolution of businesses *(AO3)*

> *Fundamentally, globalization is the closer integration of countries and peoples of the world which has been brought about by the enormous reductions of costs of transport and communications and the breaking down of artificial barriers to the flow of goods, services, capital, knowledge and, to a lesser extent, people across borders.*
>
> *Joseph Stiglitz*, former Chief Economist at the World Bank

The impact of globalization on businesses

Businesses are subject to constant change in their internal and external environments. The rate of change is accelerating with increasing globalization and the application of new technologies, making markets more competitive and complex.

Why is globalization increasing?

- Increasing opportunities for international trade and easier capital transfers.
- De-regulation allowing foreign enterprises to tender for local contracts.
- Increased competition caused by increasing foreign investment.
- The growth of emerging markets, e.g. BRIC countries.
- Global strategies creating global brand and corporate awareness.
- Multinational businesses acquire economies of scale and competitive advantage.
- Modern production techniques allow location flexibility and access to lower resource costs.
- Increased mergers and joint ventures support access to global markets.
- Two-way skills transfers as multinationals locate in new markets and recruit local residents.
- Transportation costs have fallen e.g. bulk containers.

✓ Reasons for the growth of multinational companies (MNCs) *(AO3)*

Multinational or transnational corporations (MNC/TNC) are businesses with a headquarters in one country, but with business operations in a number of others. Multinationals are normally conglomerates with many brands.

Drivers to become multinational:

- Reduced transport and distribution costs: producing goods and services locally.
- By locating in overseas markets, firms avoid tariffs, quotas and other protectionism.
- By locating overseas, firms ensure access to raw materials at reduced prices and lower labour, energy and property costs.
- Expanding overseas provides access to large markets, e.g. Asian markets.

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- Increasing scale of operations results in internal and external economies of scale and spreading of risk.
- '*First Mover Advantage*': getting into markets first provides marketing and distribution advantages.
- 'Foreign' brands may be more desirable, allowing premium pricing.
- Government grants and tax incentives.
- New communication technologies.

✓ The impact of MNCs on the host countries *(AO3)*

MNCs provide developing countries with finances and infrastructure for economic and social development, but may exploit limited resources.

Advantages for the host country	Disadvantages for the host country
Foreign direct investment (FDI) usually result in more local jobs, improving economic growth.	MNCs want to produce as efficiently and as cheaply as possible and may cut corners on health and safety.
Profits of multinationals are locally taxed, providing a valuable source of revenue for the domestic government.	Depletion of natural resources.
Inward investment should help a country's balance of payment.	MNCs are increasingly 'footloose', meaning they can move location at short notice, creating uncertainty for the local economy.
MNCs introduce new technology and local employees are trained to use these (technology transfer).	Newly arrived MNCs increases the competition in the local economy. Local firms may lose market share, or close.
Local population gains from a wider choice of goods and services at lower prices.	Borrowing by MNCs in the domestic economy may reduce access to funds and increase interest rates for local firms.
The presence of one multinational may improve the reputation of the host country and other MNCs may follow.	MNCs may have a disproportionate influence in the host country. Governments may agree to changes that will not benefit the local population.
MNCs help build new infrastructure, such as roads and factories.	Jobs created in the local environment may be low-skilled. Expatriate workers are recruited for more senior and skilled roles.
Local firms are forced to become more efficient to complete with the new MNCs.	Large numbers of foreign businesses dilute local customs and traditional cultures, e.g. *McDonaldization* describes increasing standardisation.
	Large multinational repatriate profits to their 'home country', leaving little financial benefits for the host country.

1.7 Organizational planning tools

✓ The following planning tools are used to support decision-making *(AO2/AO4)*

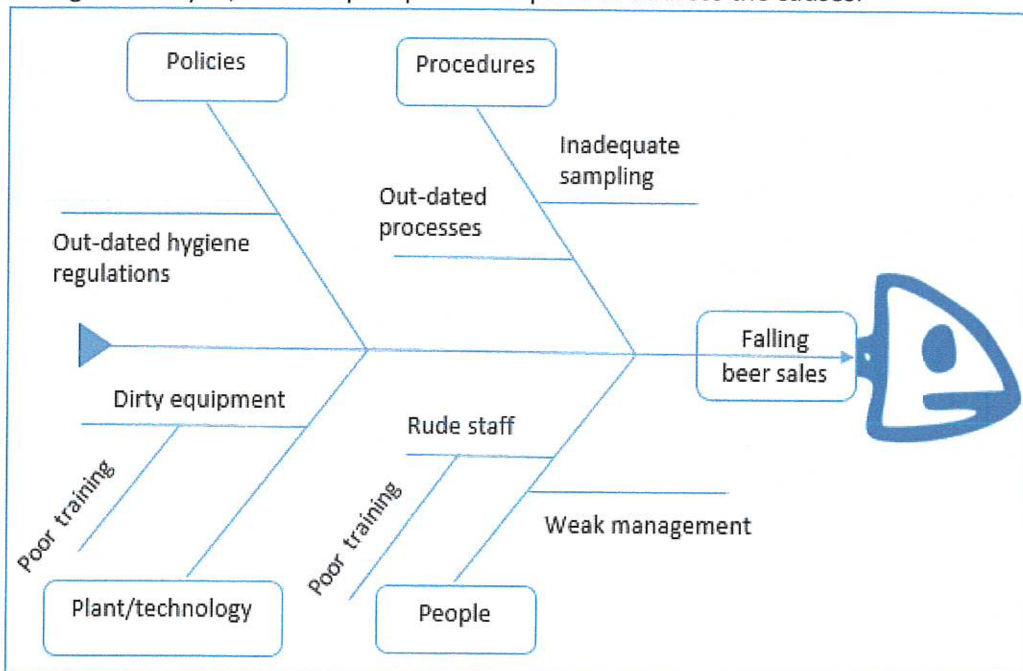
The fishbone (cause and effect) diagram or Ishikawa diagram

A visual tool developed by Kaoru Ishikawa to support decision-making. By identifying the causes of a certain event, problems can be overcome or avoided. The diagram resembles the skeleton of a fish with a main bone running horizontally, with a number of smaller bones coming off it. Causes in the fishbone diagram are usually arranged into four or six major categories, linked to the situation. For example:

- 6 Ms: manpower, methods, machinery, materials, mother nature (environment), measurements (recommended for manufacturing of goods)
- 4 Ps: policies, procedures, plant/technology, people (recommended for services)

Construction of a Fishbone diagram

1. The problem is placed it on the right hand side of the diagram, with a horizontal arrow drawn to the problem creating the main bone, to which possible causes are added.
2. Following a brainstorm, possible causal factors are placed on lines off the spine, including people, machinery employed, methods used and materials.
3. With complex problems there may be related sub-causes or reasons for the problem. These are shown as smaller lines coming off the 'bones' of the fish.
4. Work groups analyse the diagram and discuss the most likely causes of the problem identified on the diagram.
5. Following the analysis, the firm puts policies in place to address the causes.



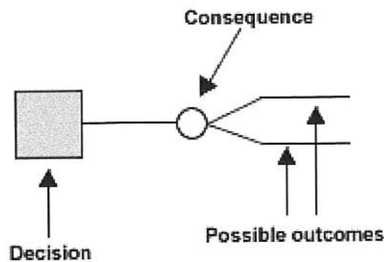
Decision tree

Decision trees present options and probabilities diagrammatically, reflecting the fact that firms frequently have to make decisions in circumstances of doubt and uncertainty.

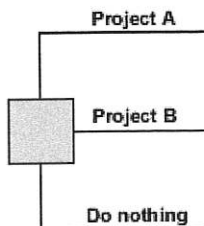
Constructing a decision tree

A decision tree is constructed working from ***left to right***, but all calculations are made from ***right to left***. A decision tree consists of:

- Squares: decisions points
- Circles: chance or probability nodes

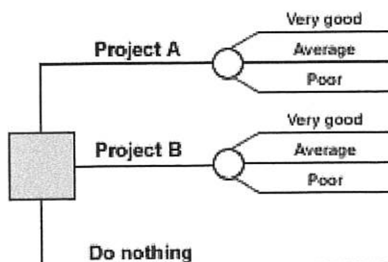


Decision tree – key



The lines that come out of the squares or decision points represent the available ***options*** to the decision maker. In the example below, these are Project A, Project B and 'do nothing'. The choices are decided by the decision-maker, i.e. they are *controllable*.

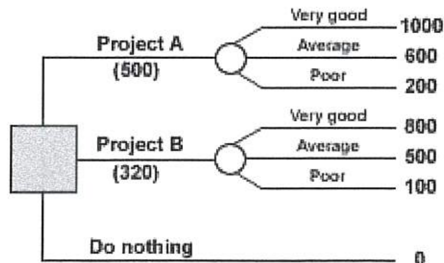
Decision tree choices



The lines that come out of the circles or chance nodes represent the various ***outcomes***. These outcomes may be *uncontrollable* by the decision-maker, such as success of failure. For example, gains from the projects will depend on marketing success. In the diagram, the outcomes are ***very good***, ***average*** or ***poor***. These consequences are added to the decision diagram to give the outline decision tree.

Outline decision tree

Data is collected on possible costs, returns and probabilities and added to the outline decision tree. The figures in brackets indicate a cost; all others are incomes or revenues.



Decision tree with costs and returns

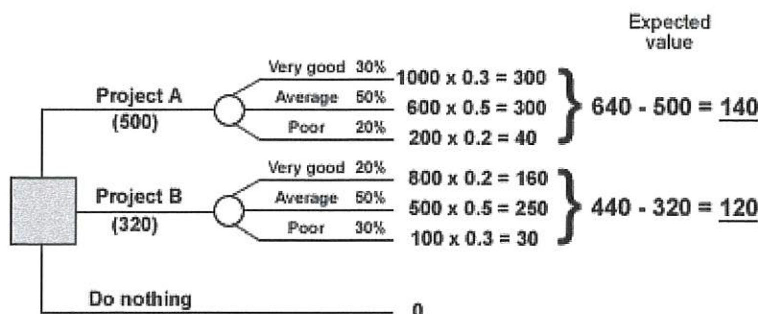
It is necessary to work out the ***expected value***, or ***weighted average return*** for each option.

Project A has three possible outcomes; each expressed as a percentage chance, e.g. it is estimated that 'very good gains' has a 30% chance of being the outcome, 'average gains' a 50% chance and 'poor gains' a 20% chance. The value of all the probabilities must add up to 100% (in other words, one of the possibilities must happen). By multiplying the possible outcomes by their probabilities and adding them together, we get the *expected value*.

	Outcome	x	Probability	=	Expected Value
Very good marketing	1000	x	0.3	=	300
Average marketing	600	x	0.5	=	300
Poor marketing	200	x	0.2	=	40
				Total	**640**

However, there are costs associated with the each project. Project A costs 500, so the **net Expected Value** is 140 (640 - 500).

The full decision tree with similar calculations for project B is shown below.

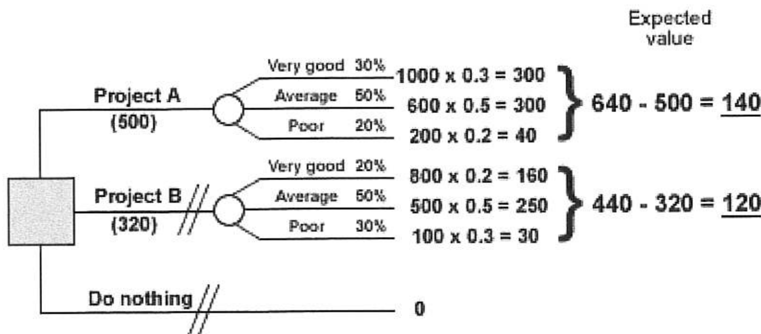


A full decision tree with probabilities and expected returns

What does the completed diagram show?

To complete the diagram, the decision-maker rejects options on purely financial grounds; the options with the lower financial returns. In this example, the expected values of Project A is 140 and for project B is 120. Project A returns the greater expected outcome, so this would be the choice based on net expected value.

The decision maker shows the two rejected options by drawing two parallel lines through the rejected options. The completed diagram is shown below:



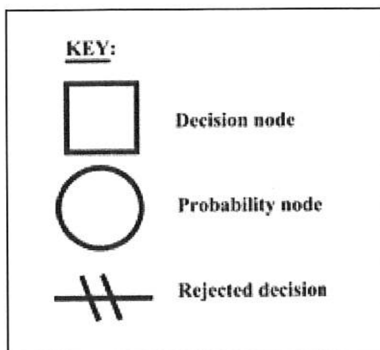
A full decision tree with probabilities, expected returns and rejected options

The expected returns for project A and project B are quite similar. At this point the decision maker considers other financial and non-financial factors, such as:

- Training costs
- Maintenance
- Motivation
- Competitor behaviour
- Business objectives
- Mission and vision statements
- Stakeholder views

The cheapest option may not necessarily be the best, if non-financial factors do not support the financial outcome.

It is good practice to place a ***key*** on the finished diagram:



Advantages and disadvantages of using a decision tree

Advantages	Disadvantages
Reveals alternative courses of action not previously identified	Not all factors can be given numerical values
Decision making more objective and logical	Probabilities are usually estimates
Offers a visual presentation of the options	Ignores important qualitative factors
Numerical values are more reliable	Data may be out of date
Management is forced to consider risk	Expected values are weighted averages of outcomes

✓ Force field analysis

The German psychologist Kurt Lewin believed that people's behaviour is affected by forces in their surrounding environment or 'field'. Successful firms need to adapt to changes in the environment.

Force field analysis uses the concepts of:

- **Driving** forces, and
- **Restraining** forces

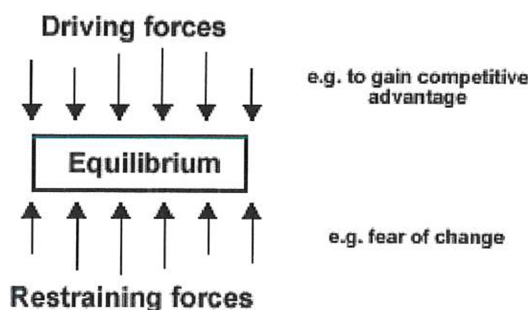
Driving forces promote change, while restraining forces hinder change. Things such as ambitions or profit constitute driving forces. Restraining forces, act to oppose driving forces.

Lewin asked two questions:

- *Why does a process continue at its current level under the present circumstances?*
- *What conditions would change these circumstances?*

Force field analysis helps when driving and restraining forces are not in balance, creating an opportunity for change. To move towards a desired change, the firm develops a strategy to minimise the restraining forces and/or maximise the driving forces. These form the basis of change management.

A force field analysis diagram shows the forces in opposite directions.



Force-field analysis

It is common for the strength of the force to be represented by:

- The **length** of the arrow; the longer the arrow, the stronger the force.
- A **weight** attached to the arrow ; usually between 1 and 5

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The force-field diagram helps managers decide whether a change is worth pursuing by:

- Examining the balance between driving and restraining forces by totalling the weights for each
- Identifying the individuals or groups affected by a change
- Identifying supporters and opponents of the change

Managers examine each of the forces to establish strategies to reduce restraining factors and strengthen driving forces.

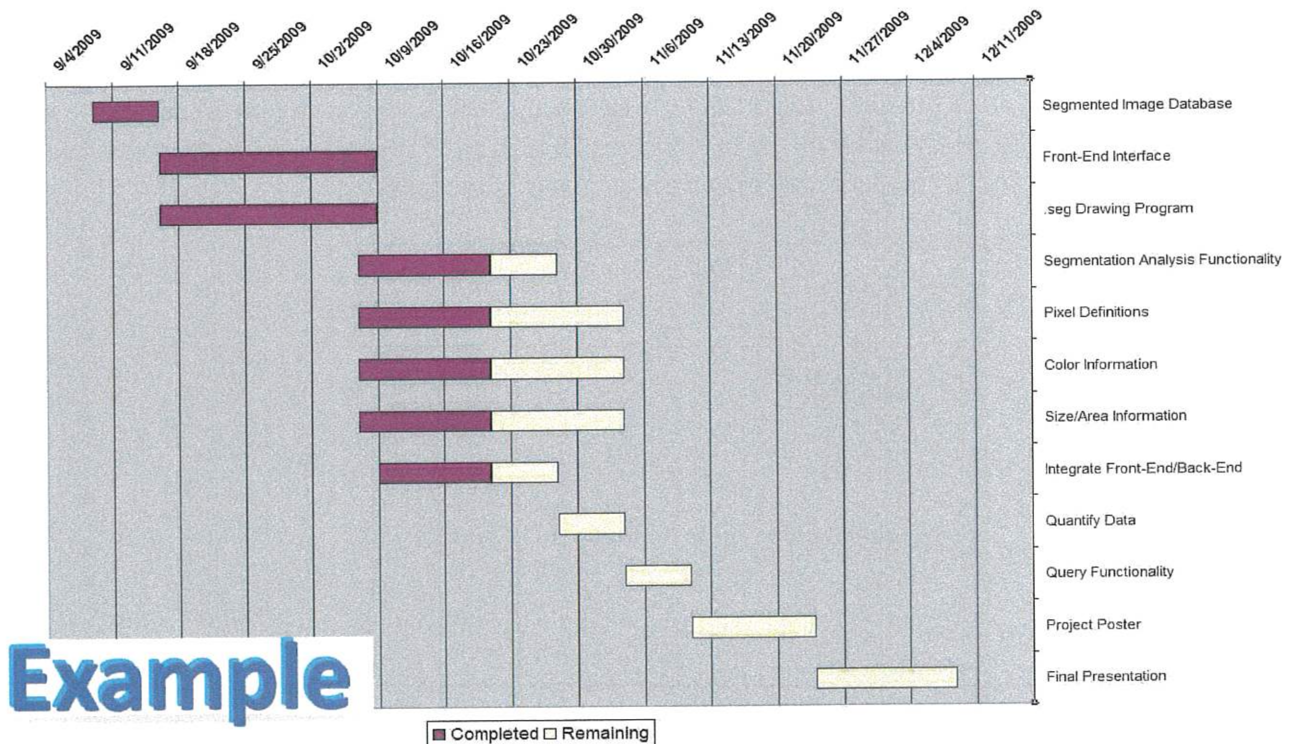
✓ Gantt chart

A visual representation of the progress of a project, broken down into its component tasks. It is commonly found in offices and factories and used to schedule projects.

Gantt charts show:

- A list of the activities in the project and how they are scheduled
- The start and end of each activity
- The date today
- The percentage of the task completed and the percentage unfinished
- Relationships between tasks
- Delays requiring action and resources required to bring tasks back on time

Examples of a Gantt Chart



✓ The value to an organization of these planning tools *(AO3)*

Tool	Value
Fishbone diagram	Helps a business identify the root causes of problems and supports the development of policies to reduce these. Promotes group work.
Decision tree	Encourages a logical approach to decision making and supports the process of strategic planning.
Force field analysis	Used as part of change management and supports the process of strategic planning.
Gantt chart	Helps plan complex projects by supporting scheduling and promoting effective resource allocation and management.

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✓ Potential IB question on Unit One topics for each assessment objective

AO1

- Identify inputs, outputs and processes of a business
- Describe the various business functions and explain their role

AO2

- Explain the nature of business activity in different sectors: primary, secondary and tertiary
- Distinguish between organizations in the private and public sector
- Explain the reasons for setting up an organization and the processes required
- Explain the purpose of mission and vision statements and analyse their role
- Distinguish between objectives, strategies and tactics and how they interrelate
- Explain the different views that firms may take of their social responsibility
- Explain the interests of internal and external stakeholders and possible areas of conflict between them
- Explain how external opportunities and threats can impact on decision making and SWOT analysis
- Comment on the importance of the information in a business plan to different stakeholders
- Demonstrate the impact that external opportunities and threats may have on business objectives and strategy
- Explain the differences between internal and external growth
- Explain the nature of public-private enterprise and analyse the costs of co-operation
- Analyse the costs and benefits of cooperation between the public and private sector
- Analyse the problems new set-ups face

AO3

- Compare and contrast the objectives of non-profit and profit making organizations
- Justify the setting of ethical objectives for a MNC
- Examine the value of social and environmental audits to different stakeholders
- Examine the role played by multinationals in the global business environment
- Evaluate the relative merits of small and large scale organizations
- Evaluate joint venture, strategic alliances, mergers and takeovers as methods of achieving growth
- Evaluate the use of franchising as a growth strategy
- Discuss reasons for the growth of multinational organizations in response to increasing globalisation
- Evaluate the impact of multinationals companies on the host country
- Evaluate possible ways to overcome stakeholder conflict

AO4

- Prepare a PEST analysis for an organization and use it to analyse the impact of the external environment on a firm
- Prepare a SWOT analysis for a given situation and use this to analyse an organizations position
- Construct and interpret decision trees and evaluate their value as a decision making tool

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Unit 2: Human resource management

2.1 Functions and evolution of human resource management

Human resource management (HRM) is the process of managing the personnel of the firm to ensure that the firm meets its objectives, including control and management of:

- Terms and conditions of employment
- Recruitment and training
- Motivation
- Wage bargaining
- Pensions
- Manpower planning

✓ Human resource planning (workforce planning) *(AO1)*

A firm's workforce produces goods and services. The number of employees and their required skill levels vary with changing demand patterns and a dynamic external environment. Success of a firm is determined by the ability to plan workforce requirements. It takes time to recruit and train the right people, so firms forecast their future requirements, which is the basis of *workforce planning* (or *human resource planning*).

There are two sides to human resource management – a *soft side*, such as motivation, and a *hard side* relating to the quantitative aspects of human resource planning.

Soft side	Hard side
Organizational culture	Analysing needs of employees
Motivation	Predicting future workforce requirements
Employee support	Measuring/quantifying labour turnover
Employer/employee relations	

✓ Labour turnover (LTO) *(AO2)*

A measure of the success of the firm's retention policies is labour turnover, i.e. what percentage of the workforce leave in any given year. Shown by the formula:

$$\text{Labour turnover} = \frac{\text{Numbers of staff leaving the firm in one year}}{\text{Average workforce during a period (usually one year)}} \times 100$$

Worked example:

Leavers = 120

Workforce at the start of the year = 1250

Workforce at the end of the year = 1150

$$\text{LTO} = \frac{120}{1200} \times 100 = 10\% \text{ staff turnover.}$$

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All firms lose staff for various reasons including:

- Retirement
- Death, maternity leave and health issues
- Employee dissatisfaction e.g. Salary
- Promotion with another organization
- Closure of branches, factories etc.
- Seasonal factors

Labour turnover varies between industries and regions. Some low-skill industries routinely experience high labour turnover, such as the agricultural and leisure sectors, where jobs are temporary and seasonal.

High labour turnover is of concern, where:

- Employees leave voluntarily
- Turnover is higher than competitors
- There is an increasing trend

Labour turnover is beneficial if poor staff leave and are replaced with more efficient employees, bringing new ideas and energy.

✓ Internal and external factors that influence human resource (HR) planning *(AO3)*

HR planning supports the future direction of the organization. It is important that the firm includes the costs of recruitment, training and appraisal in its operating budget.

The supply of labour is the number of workers willing and able to work in a given occupation for a given wage. It varies between countries, and regions within countries, and is affected by demographic change. Workforce planning is constrained by labour availability.

Internal factor influencing HR planning

The **internal environment** impacts on the firm's employment policies.

- The firm's **strategic plan** will include a workforce assessment in terms of numbers and skills.
- **As firms grow** they are likely to recruit more employees, although there may be substitution of labour through automation.
- **Changes to the nature of the firm's operations** will affect the types, and skill levels, of its workforce, e.g. new international operations.
- **Increasing, or falling profitability**, will affect the level of the required workforce and terms and conditions.
- **New management** may lead to higher staff turnover.

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External factors influencing HR planning

The **external environment** impacts on the supply of labour available to potential employers.

1. **Demographic change** influences the supply of labour. Demography is the study of the size, growth, age and geographical distribution of human populations, e.g.
   - Increases in the world population
   - Changes in birth and death rates
   - Increasing migration
   - Ageing populations
2. **Social–cultural** trends are closely related to demographic changes. For example:
   - Increased female participation in the workforce
   - Desire for a better work-leisure balance
   - More part-time and fixed-term employment
   - Less loyalty from employers and employees
3. **Technological change** has impacted on the required employment skills and the nature of the employment. For example, new information and communication technologies (ICT) allowed more people to telework; working from home or from a remote location.
4. **Labour mobility**
   - *Occupational mobility* (movement between occupations) is influenced by the level of education and training.
   - *Geographical mobility* (movement between locations) is influenced by the attractiveness of regions in terms of environment, climate, infrastructure, communications and wage rates.
5. The **state of the economy** has a significant impact related to the economic cycle. In a recession, wages fall and labour availability increases. In boom periods, higher wages boost the number of people willing and able to work.
6. **Employment laws and regulations** impact on the structure of a workforce, e.g. laws on maximum working hours.

The role of the HR department

The purpose of HRM is to recruit, develop and utilise an organization's personnel to meet the firm's objectives. There are four key roles:

- Recruitment and selection
- Training
- Appraisal
- Dismissal or termination

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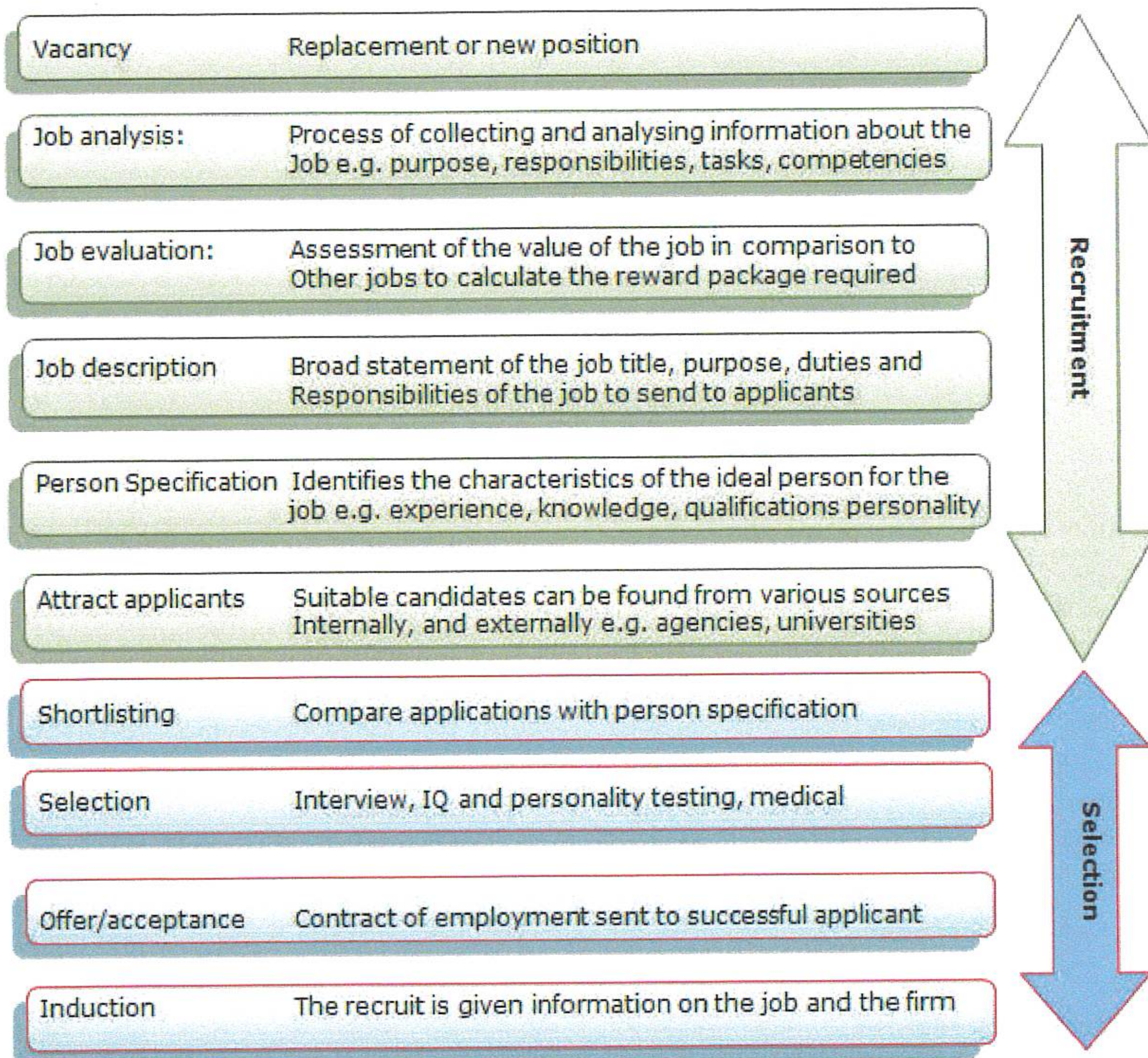
✓ **The process of recruitment** ***(AO2)***



Recruitment is the process of attracting, screening, and selecting qualified people for a job vacancy.

Having established the nature and reason for a vacancy, the firm will:

1. Draw up a **job analysis,** detailing the nature of the responsibilities, tasks, accountability, competencies and training required for that post.
2. Prepare a **job evaluation,** which is an assessment of the value of the job in relation to other jobs, so that the remuneration reflects its value.
3. Develop a **job description**, covering its title, purpose, tasks, authority and performance targets.
4. Prepare a **personnel profile** (**job/person specification**) describing the qualities of the individual needed e.g. qualifications, experience, personality, skills, classified as 'essential' or 'desirable'.
5. Decide on the **best way of obtaining the right person**, e.g. *externally* or *internally*.
6. Decide on the **route for attracting qualified applicants** by selecting the appropriate media for advertising the vacancy.
7. Decide on the **interview and selection procedure** appropriate for the position.
8. Decide on any **testing and review** procedures.
9. Make certain all the relevant **legal obligations** have been met.

Attracting candidates

An organization can fill vacancies by:

- Recruiting from within the firm by re-skilling, redeployment or promotion of an existing employee
- Recruiting externally

External or internal recruitment?

Internal recruitment will be used if the business decides they already have the right people with the right skills to do the job, or can develop skills through training.

Advantages of internal recruitment:

- Knowledge of employees' strengths and weaknesses
- Retains valuable employees and avoids recruitment costs
- Promotion improves motivation of existing staff
- Requires shorter induction period
- Quicker and more cost-effective

Disadvantages of internal recruitment:

- Limited number of applicants: external candidates might be better qualified
- Creates another vacancy to be filled
- Individuals may be resistant to change
- Fewer ideas and innovations brought into the organization
- Possible discontent from those overlooked

External recruitment is used to address the disadvantages of internal recruitment.

The application process

Application form

A standardised form customised to include details necessary for the specific post or generalised to all applications. It is accompanied by job details and information about application and selection.

Curriculum vitae (CV) or résumé

The 'story' of the candidate's life to date. It is more personalised than an application form and focuses on the suitability of the candidate including information, such as educational and professional qualifications, employment history and a career 'vision'. A CV can be supported by a ***letter of application*** explaining reasons for the candidate's interest in the position.

The selection process

The process varies with the nature and the seniority of the vacant post; the more senior the post, the more formal and potentially lengthy.

The most common selection process:

- Prepare a reduced list (***shortlist***) of suitable candidates for interview.
- Call for ***references*** from previous employees.
- ***Invite for interview*** candidates with favourable references.

The interview

Interviews provide the applicant and the firm the opportunity to meet and learn about each other. This may be done:

- By individual managers or a panel
- Face-to-face, or by a remote method, such as Skype
- As a single process or through stages of interviews or aptitude tests

Research shows that interviewing is not a particularly reliable form of selection, because interviewers are influenced by personal characteristics that do not necessarily impact on job performance.

Testing

Interviews are often combined with:

- **Achievement tests** – what the candidate knows and can do.
- **Aptitude tests** – the potential of the candidate to perform specific job-related tasks.
- **Psychometric tests** – assessment of candidate's personality, attitudes and character traits.
- **Intelligence tests** – whether the candidate has the mental abilities required, e.g. numeracy skills.
- **Group situational tests** – observation of candidates performing team tasks.

Contract of employment

At the end of the process, the successful candidate is offered a contract of employment, including:

- Job title
- Date of commencement
- Job role and specification
- Terms and conditions, e.g. Hours and remuneration
- Disciplinary and grievance procedures
- Notice requirements

✓ Types and suitability of training *(AO2)*

Increasing pressure on firms to improve performance to create competitive advantage, coupled with accelerating technological change, has increased the importance of training and staff development.

Induction

Induction introduces new employees into the organization, by outlining aspects such as its mission and culture. It also includes specific information about job responsibilities and practical information, e.g. the location of photocopiers.

Internal / 'On-the-job' training

The trainee learns from experienced colleagues in the workplace by observing them undertaking the role and its tasks, using the actual equipment, documents or materials that trainees will use when trained

Advantages

- Relatively cheap, because it uses in-house resources
- Focuses on the firm's needs
- Develops team work and improves motivation
- Trainee contribute to the firm's output
- Convenient as there is no travelling
- Delivered at the optimum time: e.g. immediately before a job is to be performed

However, the trainer may not be competent or may be uninterested in developing someone else.

External / 'Off-the-job' training

The employee is sent to a location outside of the business, such as a college, to learn a skill or acquire knowledge. This may include:

- Lectures and demonstrations
- Simulations
- Role-plays
- Self-study
- Day-release courses

Advantages:

- Specialists used for instruction
- Employees removed from work pressures and can concentrate on the training
- Organized for groups of trainees
- Effective for developing new skills, concepts and ideas
- Suitable for theoretical instruction
- Covers topics which the firm does not have the resources to run
- Trainee may establish useful business contacts

Disadvantages:

- No direct link with the job
- Can be artificial and trainees may not 'see the point'
- Trainers may not know the specific conditions of the employment
- More expensive than internal training
- Employees cannot work during training

Cognitive training

Focuses on thinking and processing skills, rather than specific vocational abilities. Typically, consists of exercises to develop attention, visual and auditory processing, listening and reading designed to improve decision-making and productivity.

Behavioural training

Behavioural training focuses on employees interpersonal skills, such as:

- Communication skills
- Dealing with change
- Assertiveness
- Negotiating skills
- Conflict resolution
- Presentation skills
- Coaching skills
- Customer service skills
- Time management

✓ Appraisal *(AO2)*

The formal process of assessing an employee's performance by comparing actual performance against goals. Sometimes conducted through a questionnaire, but more often by a one-to-one discussion between employees and their line managers. Following the appraisal, the manager and employee may identify training and development needs.

Formative appraisal

An appraisal at the beginning, middle and end of a training placement or at regular intervals during an employee's employment. The purpose is to *inform* the employee about their performance; where they have done well and areas in which they can improve.

Summative appraisal

Conducted at the end of a project or contract period, the appraisal *summarises* the employee's performance against pre-agreed targets. This influences employee retention, bonus payments or promotion.

360-degree feedback

A performance appraisal system that gathers feedback on an individual from colleagues, customers or clients. Typically eight to ten people complete questionnaires describing the individual's performance.

Self-appraisal

Employees reflect on their own performance and rate themselves against performance targets and objectives agreed with their line manager. They may identify personal training needs.

✓ Dismissal and redundancy *(AO1)*

In addition to recruitment, the HRM department deals with termination, such as:

1. Dismissal ('firing')
2. Redundancy (lay-off/retrenchment)
3. Resignation
4. Retirement

Terms describing reductions in staff numbers include *redundancy, downsizing* or *delayering.*

Examiner Tip!

It is important to know the difference between dismissal and redundancy.

Dismissal

In most countries, there are limited grounds for firing an employee. The firm must show the employee is:

- *Negligent or incompetent* in carrying out duties.
- Guilty of repeated acts of *misconduct,* e.g. persistent lateness or unexplained absence.
- Guilty of *gross misconduct* justifying immediate dismissal, such as theft of company property.
- *Unable to perform the job* she/he was hired to do, e.g. the employee has lost his driving licence.

Organizations must follow legal requirements before dismissing an employee or they may be accused of **unfair dismissal**. If the employee can prove unfair dismissal, they will be entitled to their job back or financial compensation.

Redundancy

The firm may need to *reduce their workforce*, perhaps because of reduced demand. In this case, a job function is no longer required – the *job* is 'redundant', not the person.

Firm have two methods of laying-off employees:

- Asking for ***voluntary redundancies***, often offering incentives to staff willing to leave.
- Imposing ***involuntary*** or ***compulsory redundancies*** by selecting those employees/jobs to be made redundant based on criteria, such as length of service.

Employees have legal protections. If made redundant they are entitled to redundancy pay, based on length of service and pay level.

✓ Changes in work patterns, practices and preferences *(AO2)*

Improvements in information and communication technologies, combined with shifting attitudes to work-life balance, have led to changing work patterns, practices and preferences.

Firms wish to lower human resource costs to increase competitiveness, which has led to the following trends:

- *Downsizing* of workforces
- *Disposal of peripheral activities*
- *Outsourcing of support activities* to concentrate on core activities
- *Project based management* and *team working*
- Creation of a *flexible workforce*

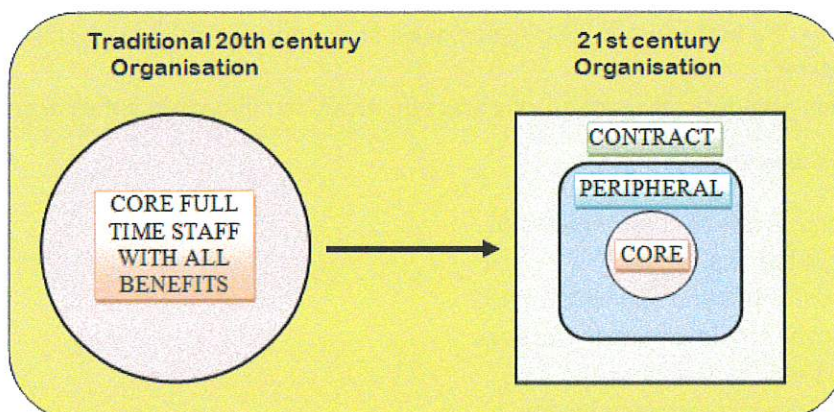
Flexible workforces

Employers are developing more ***flexible working patterns*** by:

- Reducing *full-time employees*
- Using *contractors* and *consultants*
- Increasing *self-employment*
- Increasing *part-time working*
- Increasing *temporary contracts*

Improved communications technology supports flexible working arrangements, enabling firms to adapt their employee levels to fluctuating demand.

Organizations use fewer full-time 'core' staff, because these can access expensive benefits, such as pensions.



Part-time employment

Part-time employees are cheaper to hire as they do not attract the allowances and benefits awarded to full-time staff. Employees have more flexibility in their personal lives.

Temporary employment

A job is temporary if its end is determined by conditions, such as a specific date or task completion.

Typical cases are employees:

- With seasonal employment
- Engaged by an agency to perform a specific task
- With specific training contracts

Flexitime arrangements

Flexitime covers any variations in working hours from the standard working day, in the form of:

- Flexible working hours
- Job sharing
- Employments breaks
- Annualised hours

Portfolio working

Employment is not dependant on a single firm. Individuals are paid for skills, products or services that they offer. A person is a portfolio worker if s/he offers different services to a variety of clients.

Teleworking (telecommuting) / homeworking

- To **telecommute** is to periodically or regularly perform work for one's employer from home, or another remote location.
- To **telework** is to perform all of one's work either from home or another remote location.

If a person works at a distance from their colleagues or base, using communications technology to do their work, they are a teleworker, whatever job they do, and whether they are employed or self-employed.

Flexible working: benefits for the employer and employee

Whilst flexible working is often viewed as 'family friendly', rather than 'business friendly', it is both.

- Research shows that flexible workers are more productive, reliable and loyal than their office based counterparts.
- Teleworkers have a better work-life balance, waste less time and money on travel and a reduced 'carbon footprint'.
- Flexible working helps firms react quickly and effectively to changes in external environments.

Drawbacks of flexible working:

- Reduces effectiveness of communications
- Difficult to build teams
- Problems of co-ordination and consistency
- Less control over employee work practices
- Homeworkers feel permanently 'on call'
- Scheduling work rotas is time consuming
- Full-time employees may be resentful of the freedom enjoyed by peripheral workers

✓ Outsourcing, offshoring and re-shoring as human resource strategies *(AO3)*

Many firms have moved customer support operations to overseas call centres and some are relocating accounting, HRM and IT functions to make them more efficient and responsive to customers.

Outsourcing

Outsourcing (contracting out): a firm moves a business function or activity to external contractors that complete the function for less than the firm's internal cost. Some firms move all production overseas where manufacturing costs are lower, or simply outsource component production. Outsourcing is usually overseas, but production could be by another firm in the same country.

Entertainment Industry

Case study

Many entertainment companies, from Disney to MTV, outsource animated features to studios offshore. Shows like "The Simpsons" and "Futurama," were conceived in the United States, but brought to life overseas. A $100 million full-length animated film made in America could be made in India for about $20 million [source: Asia Times].

Offshoring

Offshoring is the transfer of a business function or activity overseas, regardless of whether the function stays within the firm or not.

Reshoring

Reshoring is when outsourced functions are returned to the location from which they were originally offshored. This may follow concerns about declining productivity and quality, and increasing costs in overseas markets. Governments may offer reshoring incentives to reduce domestic unemployment.

Potential benefits of outsourcing:

Many firms outsource or offshore human resource management (HRM) functions, such as recruitment, training, payroll and grievance procedures, because specialist HRM firms (often overseas):

- Have lower costs and deliver the HRM function more effectively
- Offer greater potential capacity to support a firm's growth
- Have greater breadth and depth of knowledge of the HR role

Possible costs of outsourcing:

- Employees may feel alienated dealing with an external HR provider and may not trust them to look after confidential information.
- It is difficult to pass on local expertise and cultural knowledge to an external provider.
- Firms may have to accept an off-the-shelf system from the external provider that may not meet their individual needs.
- Higher long-term costs – external providers offer short-term cost saving, but this may not last into the long-term as environments change.

✓ The influence of innovation, ethics and cultural differences *(AO3)*

Innovation

Innovation is finding a better way of doing something using a *novel idea* or *method*, whereas *invention* refers directly to the creation of the new idea or method itself.

Innovation is a human activity. Firms which value innovation recruit, train and motivate creative people and provide a working environment, which encourages and rewards self-expression.

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3M

Case study

In 1974, 3M scientist Art Fry came up with an innovative product called the *Post-It Note*, using an adhesive which did not dry. He developed the product during his '15 percent time'; a program at 3M that allows employees to use part of their paid time to 'hatch their own ideas'. This time produced many of the company's best-selling products and set a precedent for other technology companies of the day, like Google and Hewlett-Packard.

Ethical considerations

Ethical problems arise when people work together, such as:

- Discrimination
- Bullying
- Unequal rewards

The HR department supports ethical management through a code of ethics included in employment contracts and reinforced through training e.g., the appropriate use of social media and other websites.

Research shows that businesses encouraging ethical behaviour achieve higher long-term profits.

Cultural differences

According to the *International Organization for Migration* (IOM), 3.1% of the world's population were migrants in 2010, with migration numbers increasing as the world becomes more turbulent. Global migration creates increasingly diverse workforces, with different expectations, attitudes and cultural norms. HR policies and practices must ensure the workplace reflects, and caters for, cultural and religious differences.

2.2 Organizational structure

With a small family business, it is unnecessary to have a formal structure as everybody knows their individual roles and responsibilities. However, as the business grows and the number of managers and employees increases, the common goals may become increasingly unclear requiring a *more formal* organization with clear rules and procedures. This process involves:

- Structuring activities
- Allocating roles and identifying responsibility and authority for each role
- Establishing rules, procedures and systems
- Separating functions into departments

Henri Fayol (1841 – 1925)

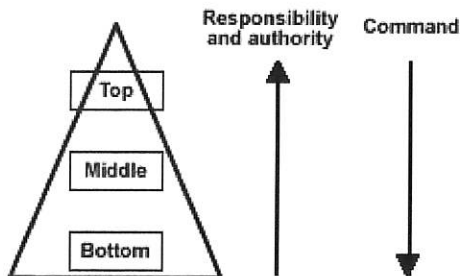
Henri Fayol developed modern concepts of management and *formal* organizations. He was responsible for introducing the concept of the *organization chart,* as well as *spans of control* and the *chain of command.*

Informal organization

Many relationships between employees are unplanned and spontaneous, creating the **informal organization**. The informal organization is based on personal relationships and guided by group norms (notions of what is acceptable), rather than by the more formal rules of the organization.

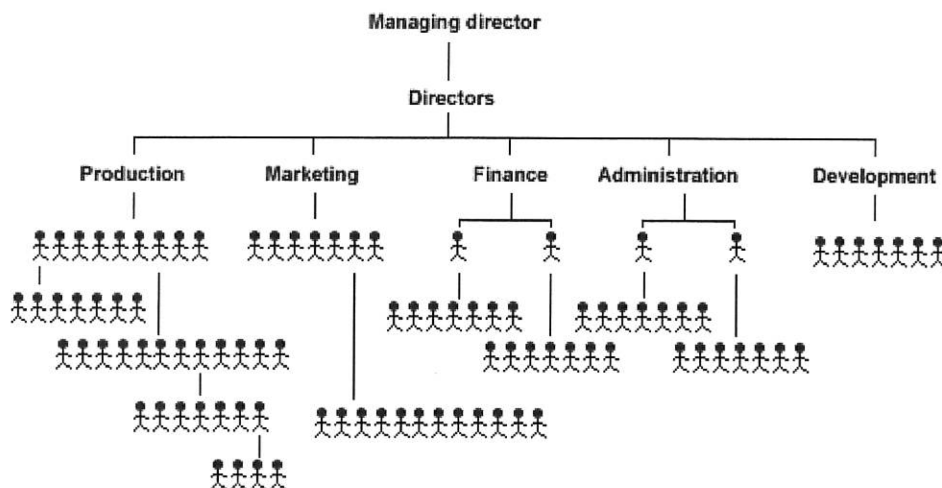
Organization charts and structures

New employees to a firm are often given an **organization chart** – a diagram showing the functions and departments of a firm and the people within them. These are normally shaped like a triangle, called **a hierarchy** as they have a clear **top, middle** and **bottom**.



Organization chart

The position of employees within this hierarchy indicates **status** and **authority**. Those at the top are the most important with more **responsibility** and a **larger salary**. Each *layer* of authority is called a **level of authority (or command)**. The vertical **chain of command** is clear, e.g. the accounts clerk reports to the accounts supervisor, who in turn reports to the accounts manager. Information is communicated up the hierarchy through the layers, and orders are communicated downwards along the same channels.



✓ Terminology used to understand organizational structures *(AO1)*

Delegation

Delegation is the passing of control, authority and responsibility to another person (normally a manager to a subordinate) to carry out specific activities. Delegation empowers a subordinate to make decisions, but the person delegating remains *accountable for the outcome* of the delegated work. Delegation is only effective if the manager trusts the subordinate to carry out the task without constantly interfering. Modern management theory suggests managers should delegate and consult more.

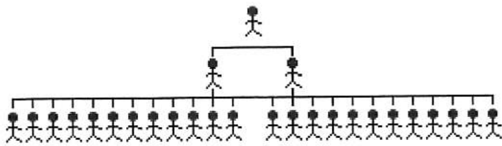
Span of control and levels of hierarchy

Levels of hierarchy

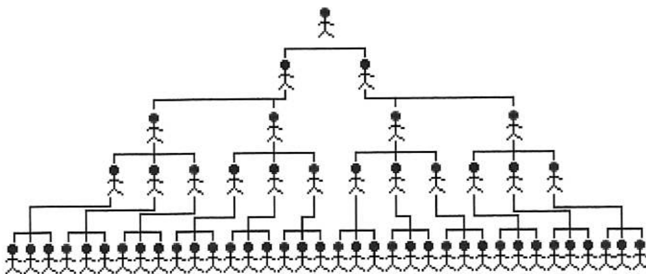
Each **layer** of authority from the top to the bottom of the organization is called a **level of hierarchy** or authority. Each person in a level of hierarchy has the equivalent status and authority.

Span of control

The span of control is the number of people directly accountable, and reporting, to one manager. A large span of control means that a manager has many staff under their direct control, while a small span of control means that each manager looks after a small group. The wider the span of control, the fewer levels of hierarchy.



A flat hierarchy – a wide span of control



A tall hierarchy – a narrow span of control

Early management writers argued that any span in excess of six would result in ineffective supervision, but later this was modified to a span of 4 to 8 for managerial functions and 8 to 15 at the lower levels of the organization.

With a narrow span of control:

- There is less opportunity for delegation and empowerment of employees.
- Those at the top can keep a tight control over employees.
- A distance can appear between those at the top and bottom of the organization.
- Greater communication is encouraged between layers of the structure.
- There can be closer scrutiny of work to maintain quality.

Chain of command

The **chain of command** are the vertical lines of authority through which orders are passed down the hierarchy. Organization charts show the employees, managers are responsible for, and which managers employees are accountable to. Chains of command are harder to see in more flexible structures, such as matrix organizations.

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Bureaucracy

Bureaucracy is an organization structure with many levels of authority and a rigid hierarchy, held together by a central administration. A bureaucratic organization is characterised by:

- A high degree of specialisation
- A hierarchy with well-defined levels of authority
- A system with formal rules and procedures
- Written records of decisions
- Authority resting with the higher position in the hierarchy

Bureaucracy was appropriate when organizations were small. As large scale businesses developed, bureaucratic principles began to get in the way of the efficient operation, slowing decision making and creating considerable 'red-tape'.

Centralization

A centralized structure is where authority and responsibility for decision-making rests with those at the top of the business hierarchy.

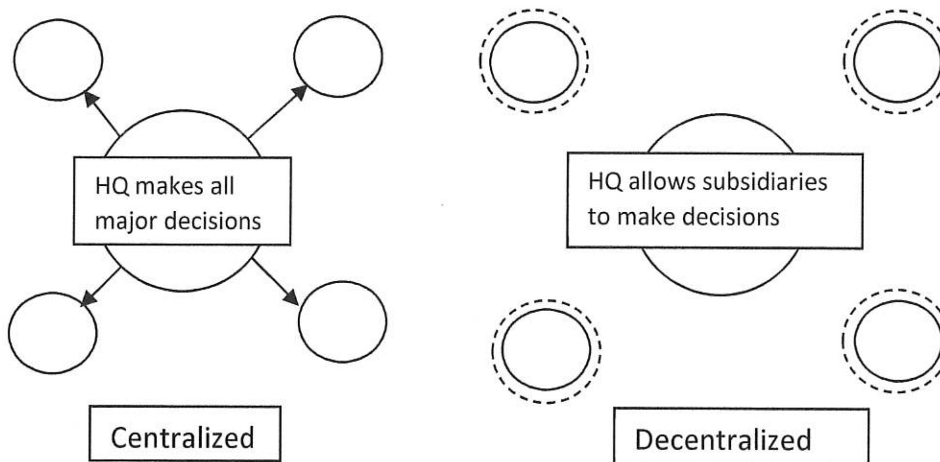
A centralized structure:

- Control rests with senior managers who have access to more information, and better appreciate the wider implications of decisions, than those further down the chain
- Gives senior management more control over the decision-making process
- Concentrates power in the hands of a few senior managers

Decentralization

A decentralized structure delegates responsibility to those lower down the chain of command e.g. to individual departments. Decentralization:

- Encourages greater empowerment and motivates those lower down
- Offers greater personal development for all employees
- Increases the speed of decisions and can include local market features



Delayering

Since the 1980s, the response to corporate inefficiency and bureaucracy was delayering and downsizing. Delayering means reducing staff numbers and costs by removing layers of authority, e.g. in a school this could mean removing deputy heads and delegating their responsibilities to heads of departments.

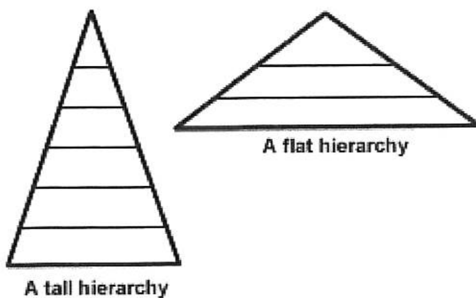
✓ Types of organization chart *(AO1)*

Tall (vertical) organization structure

When an organization has many levels of authority or hierarchy, it is called a **tall** organization.

Flat (horizontal) organizational structure

When an organization has few levels of authority or hierarchy, it is called a **flat** organization.



Tall and flat hierarchies

Characteristics of a ***tall organization*** structure:

- Many levels of hierarchy
- Narrow spans of control
- Centralized decision-making
- Autocratic leadership
- Limited delegation

Characteristics of a ***flat organization*** structure:

- Few levels of hierarchy
- Wide spans of control
- Decentralized decision-making
- Democratic leadership
- Widespread delegation and empowerment

Hierarchical organizations

A **hierarchical organization** is arranged with the senior management at the top and each subsequent level of power below them. This is the dominant form in large organizations.

A functional organization

In most businesses, jobs are grouped together into **functions** (departments), e.g. the firm has separate marketing and finance departments. Within each department there are clear channels of communication and a recognised hierarchy with employees having defined roles and responsibilities. The decision-making is focused on a few 'at the top', operating as a **centralized structure**.

Advantages of functional organizations:

- **Accountability** – managers are responsible for the work of their department.
- **Clarity** – it is clear to all employees who is responsible for each function.
- **Specialisation** – each department has specialist personnel, increasing productivity.

Disadvantages of functional organizations:

- **Bureaucracy / lack of flexibility** – departments have set rules and procedures and may do things the 'department way'.
- **Communication problems** – departments may not communicate well with each other.
- **Inertia** – departments may be resistant to change.

Organization by product

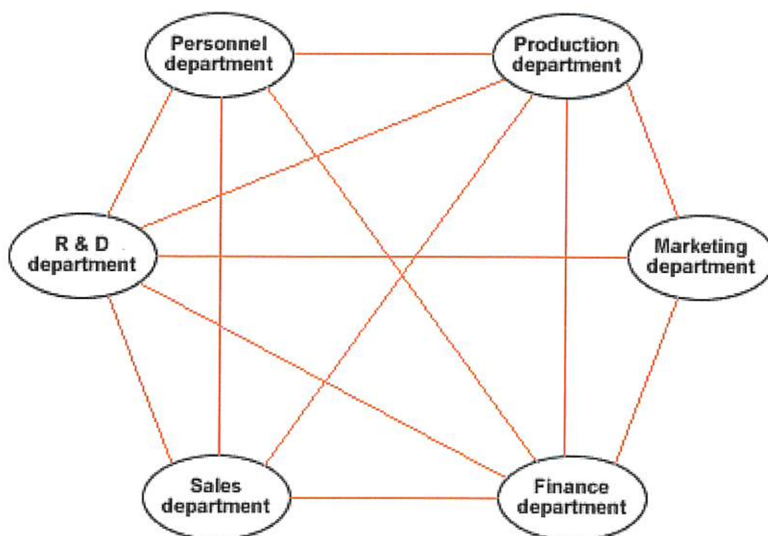
Large firms often have an extensive product range and may organize by *type of product*. Each product may be organized as a separate company owned by the main holding company. Within each product line, the firm may be organized by function.

✓ Changes in organizational structures *(AO2)*

Matrix structure / project teams

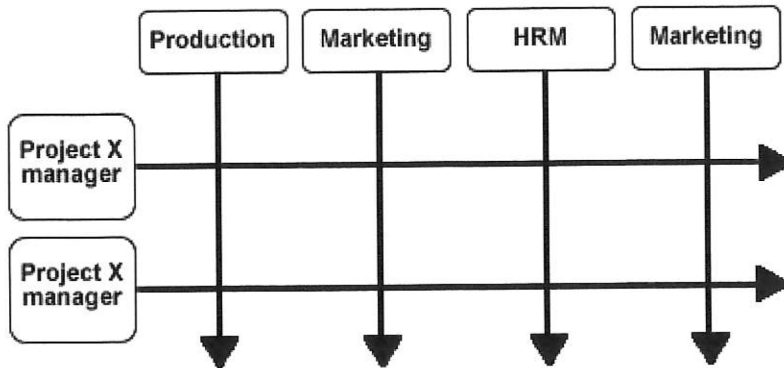
A **matrix structure** is a based on horizontal and vertical relationship, linked closely to **project management**. Project management coordinates different skills across department and professions. One of the first major uses of project management was the US space programme.

A **matrix structure** allows flexibility in operations. Businesses draw together experts from several fields to work as a team as shown below.



Matrix structure

Matrix structures involves the creation of project teams, with project managers responsible for the work of each team. Tasks are delegated to functional experts. At the end of the project, the team often disbands with members moving to other teams or leaving the firm.



The advantages and disadvantages of a matrix structure

Advantages:

- **Flexibility**
- Combines individuals from different disciplines with **different skills**
- Encourages **creative thinking**
- **Decentralized form of organization**
- **Managers focus on strategic planning**
- **Encourages cooperation** between different functional areas
- **Used within traditional bureaucratic structures** to encourage creativity

Disadvantages:

- Possible **power struggles** between departments
- Team members have two managers – the project team manager and their functional line manager, which may lead to conflicts
- **Requires a change in corporate culture**
- Can lead to **slower decision-making,** because of the need for agreement and cooperation
- Can create **problems of control** with overlapping lines of authority

The Entrepreneurial Organization

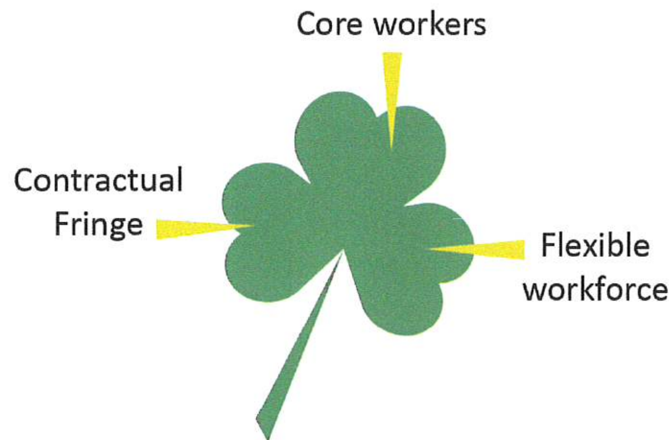
This type of organization has a simple, flat structure, consisting of one large unit with one or a few top managers, e.g. a new business tightly controlled by the owner. The organization is relatively unstructured and is fast, flexible and lean - a model that many established companies would like to copy.

Charles Handy's Shamrock organization

A flexible organization reacts quickly to changes in its external environment. Since the 1990s, firms have tried to reduce their workforce to a **multi-skilled core**, concerned with the creation or delivery of a product or service. Wherever possible, all other support functions are outsourced.

Charles Handy suggested that organizations do not consist of just the *Core* and the *Periphery*, since the periphery can be subdivided. He calls this a Shamrock organization:

- The first leaf represents the multi-skilled ***core of professional technicians and managers,*** essential to the continuity of the business.
- The second leaf Handy calls the ***contractual fringe.*** Non-central activities are contracted out to specialist firms, such as marketing, computing and communications.
- The third leaf consists of a ***flexible workforce*** made up of part-time, temporary and seasonal employees.



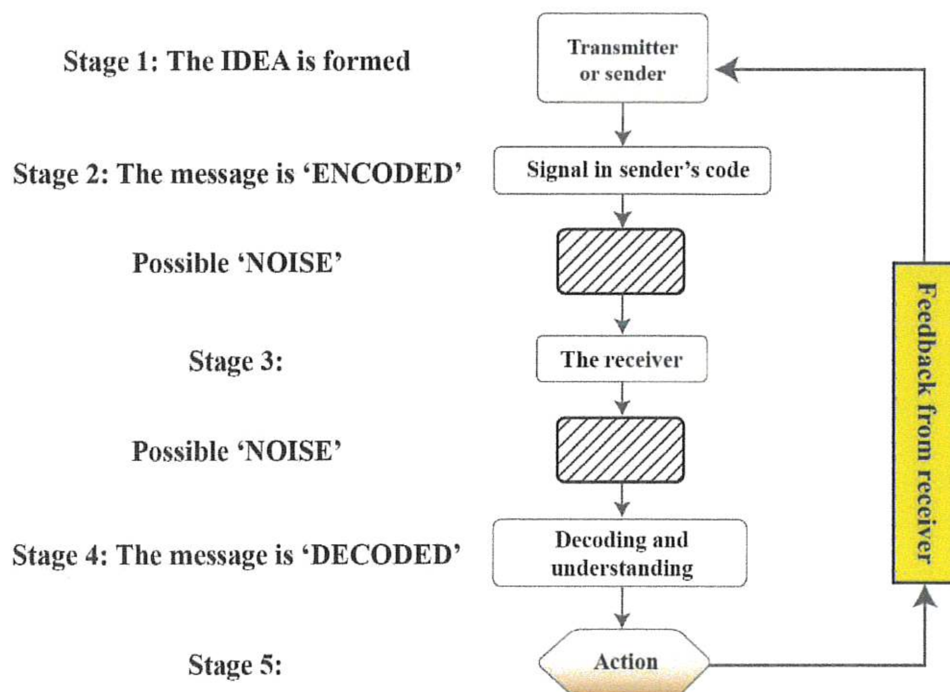
Handy's *shamrock* organization

✓ The impact of culture, innovation and technology on communication *(AO3)*

Communication is the process, by which information is sent and received, and involves an exchange of thoughts, opinions and ideas between individuals or groups. Effective communication requires the combination of skills such as *active listening, observing, speaking, questioning, analysing,* and *evaluating,* leading to some outcome or change.

The process of communication

A diagram of the mechanics of communication

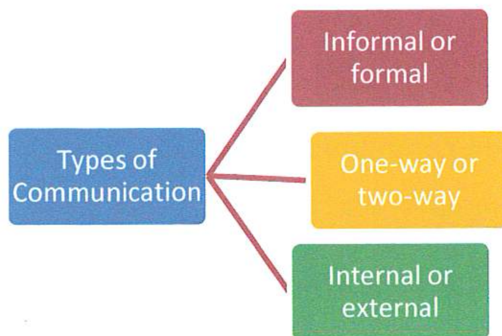


5 main stages in the communication process

1. The *sender* decides on the nature and purpose of the message.
2. The message is *encoded* by using the appropriate form of words and/or symbols to explain the message.
3. A *channel* of communication is chosen.
4. The *receiver* 'decodes' the message, looking for its meaning.
5. The message should lead to an outcome, response or action that provides feedback to the sender confirming the message was received **and** understood.

Types of communication

Communication can be classified into different types:



✓ Communication methods

All forms of communication, except oral communication are termed **non-verbal communication**. Research suggests that non-verbal behaviour accounts for 93% of a message.

✓ Verbal / oral communication

Oral communication is expressing information, ideas and messages by speaking and listening and is usually quick. The sender and receiver are in direct contact, possibly face-to-face, or using some medium such as telephone allowing instant feedback and clarification.

Examples of formal oral communication

- Meetings
- Video conferencing
- Presentations such as speeches

Examples of informal oral communication

- Social conversations
- Gossip or the 'grapevine'

Advantages of oral communication:

- Quick to send a message
- Questions can be asked immediately
- Instant feedback
- Inexpensive

Disadvantages:

- No formal record
- Not be suited to confidential information
- Relies on the presenter's verbal skills
- Meetings and interviews are time-consuming

Visual communication

Visual Communication is the transmission of ideas and information in forms that can be read or viewed.

Written communication

Written communication is the sending and receiving of messages or information through the written word, usually printed or handwritten, although they may use digital devices, and include:

- Reports
- E-mails
- Memos and letters
- Notice boards announcements
- Minutes of meetings
- Blogs
- Printed media, e.g. Magazines

When used in business, written communication uses formal language and accepted formats. It offers a permanent record of communication, but is not as quick as verbal communication.

Images and visualisations

Written text is often supported by a range of images, tables, photographs, diagrams adding meaning and interest. Many learners prefer to learn using images, and online resource are usually image rich. Visual communication is important when surfing the Internet and accessing web pages.

Non-verbal communication (NVC)

How something is expressed may carry more significance than the words spoken. Non-verbal communication is powerful, because most people respond in an emotional and immediate way.

Non-verbal cues

Non-verbal cues are those 'giveaways' about our true feelings and include:

- Gesture – movement of our body, particularly the hands
- Eye contact – frequency and length
- Paralanguage – inflection, tone, pitch, intensity and speed of speech
- Touch – frequency and nature
- Expression – facial expression shows emotion
- Posture – body stance, e.g. Upright or slumped

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Barriers to successful communication: 'noise'

Communication is only effective if the message is received ***and*** understood. Barriers to communication are called '***noise***', because they prevent messages being sent, received and understood. Noise includes factors, such as bias and the timing of the message.

'Noise' factors

Cultural differences may impact on the quality and success of information. In particular there may be issues with diverse workforces such as:

- Complex language or jargon
- Culturally offensive language
- Subtleties of speech and dialects
- Delivery speed
- Colloquial phrases
- Sarcasm and humour

The impact of innovation on communication

New technology, such as instant messaging, give the sender and receiver more control over the communication process. As technology evolves, choosing communication channels and appropriate language becomes more important and context driven.

The volume of information is increasing rapidly and computers and other mobile devices can capture, store and deliver information as required, which can be personalised and filtered. The rapidly changing technological environment must be recognised by HR departments in their planning, policies and training.

2.3 Leadership and management

The role of management

Management's function is the effective and efficient deployment of the resources of the firm. Good managers possess the ability to turn employee skills and talents into improved performance and the satisfaction of organizational goals.

✓ The key functions of management *(AO2)*

Henri Fayol is described as the 'father of modern management'. He identified 5 key universal managerial functions to increase efficiency:

- **Planning** – setting strategic, tactical and operational objectives based on sales forecasts and other trends. Managers set targets for workforce levels, finance, marketing and production and match these to available resources.
- **Organizing** – scheduling activities and resources.
- **Commanding** - define activities, motivate the workforce to achieve targets, make decisions, maintain discipline and issue orders.
- **Coordinating** – hold meetings to solve problems of common interest.
- **Controlling performance** – identifying weaknesses and errors by checking performance against targets, policies and plans.

✓ The role of leadership *(AO2)*

Leaders need to win the 'hearts and minds' of their followers to ensure their vision for the future is understood. Leadership is about behaviour, relying on less tangible and measurable factors like trust, inspiration, decision-making and personal character. Unlike managers, leaders instigate change, and are risk-takers and decision makers.

The Distinction between Managers and Leaders: Functions and Approach

Managers	Leaders
• Organise	• Innovate
• Plan	• Visionary
• Accept responsibility	• Seek responsibility
• Control employees and functions	• Creative
• Specialise	• Entrepreneurial
• Minimize risk	• Flexible
• Set goals	• Calculated risk taker
• Delegate cautiously	• Decision maker
• Motivate	• Set challenging goals
• Co-ordinate	• Seek followers
• Delegate	• Seek excitement

✓ Leadership styles *(AO3)*

Research on leadership has identified many styles, each of which possesses a central characteristic that influences the effectiveness of an organization and the satisfaction, or otherwise, of individuals or groups.

Characteristics of autocratic leadership style:

- Authoritarian with a clear chain of command.
- Decisions and objectives set independently and without involving others.
- Employees may lack motivation.
- One-way communication and no delegation of authority.
- Leadership based on personality.
- Formal systems backed-up by a strict code of conduct.
- Financial reward system linked to performance and targets. Those who meet targets are rewarded, while poor performance results in penalties.
- Although decision-making is efficient and quick, employees become dependent on the leader and unable to act on their own initiative. If the leader is absent, the organization can drift.

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Paternalistic leadership style

The **paternalistic, or 'kindly' autocrat**, sees the workforce as a 'family'. Close supervision is an attempt to gain respect and acceptance. The 'father figure' believes he is acting the workforce's best interests, even if the workforce does not always agree. Those who accept the style are rewarded, whilst those who do not are, at best, tolerated.

Case study

Sahara India Pariwar was founded by Subrata Roy, the son of a mill worker, in Northeast India with just 2,000 rupees. It now owns TV channels, an airline, retail outlets, a newspaper, real estate and employs 1.1 million people and attracts 32 million customers. Subrata Roy is a billionaire. Sahara is a private, family business with "no owner". The profits are re-invested or distributed to good causes. Sahara on its website states that, "Our employees are not employees; they are family members".

In an interview, Mr Roy told the Times of India:

"I believe I am the guardian of this family, who has the right to love and scold all members".

Democratic leadership style

Democratic or participative leaders ask employees for opinions before making decisions. Although, they consult, they make the final decision, because they are ultimately responsible and accountable. The important aspect is making the workforce feel part of the process

Participation should result in better decisions, higher commitment and improved motivation, but the process can be time-consuming and decisions may become ineffective compromises.

Laissez-faire leadership style

Some see the laissez-faire as an extreme version of democratic leadership, while others suggest it is *non-leadership,* as there is complete delegation of responsibility. The leader initially sets goals and parameters for the subordinate, but once established, drops the reigns of control and the employee is left unsupported, which may leave them floundering with little direction or motivation.

This style may work when the subordinate is willing *and able* to accept total responsibility. It may be appropriate with a team of highly skilled and expert people, such as university professors.

Situation leadership style

Situation leadership theory was developed by Hersey and Blanchard. They said leadership is a function of the situation, task or context, in which leaders operate. The success of leaders is not the result of their skills or characteristics alone, but because their style is appropriate for the situation. For instance, authoritarian war time leaders may not be so good in time of peace.

They argue there is no single "best" style of leadership. Successful leaders adapt their style to the situation and to the 'maturity level' of the individuals they are leading.

Factors that influence leadership styles:

- **The leader's personality** – if the business wants to change direction, it may need a new leader.
- **The leader's skills and abilities** – achievement rests on their skill and charisma.
- **Circumstances** – some rise during a crisis, while others are better in stable circumstances.
- **Corporate culture** – the established culture impacts on the most effective style.
- **Task** – the nature of the task determines who leads and how.
- **The workforce** – if it is prone to poor standards then a more dictatorial style may be needed.

✓ How ethical considerations and cultural differences influence leadership and management styles *(AO3)*

Ethical leadership

Leaders possess enormous power over their subordinates' futures, which makes employees reluctant to criticise or 'blow the whistle' on unethical behaviour. It is a leader's responsibility to develop honest and ethical approaches. The founder of the business can drive ethical credentials through a clear vision statement, aligned with the firm's ethics.

Ethical management

The role of management is more about meeting the targets of the organization, rather than behaviour. Managers may be offered incentives to reach operational milestones, including ethical goals.

Safeguarding

Leaders should implement rigorous checks to prevent unethical behaviour, including independent complaints procedures to protect employees who report ethical breaches. The organization needs to be regarded by stakeholders as approachable, trustworthy, listening and assertive when misdeeds are reported. Firms often publish ethical policies in company documents and on the firm's website.

Lockheed Martin
Our Values Statement: Do What's Right

Example

"We are committed to the highest standards of ethical conduct in all that we do. We believe that honesty and integrity engender trust, which is the cornerstone of our business. We abide by the laws of the United States and other countries in which we do business, we strive to be good citizens and we take responsibility for our actions."

Cultural differences

Leadership and management styles inevitably adapt to corporate and national cultures. When MNCs locate overseas, leaders and managers need to be sensitive to the values, norms and attitudes of their workforce. Different cultures and nationalities respect different leadership styles. Asian cultures, for example, tend to value group effort, responsibility and reward more than western cultures, where individual enterprise receives more respect.

2.4 Motivation

A crucial role of leaders and managers is to motivate their workforce to ensure they are productive and creative. Motivation influences individuals to behave in a certain way and, combined with individual skill and ability, results in performance. Motivation helps people:

- Achieve their goals
- Gain a positive perspective on their private and working lives
- Create the power to change
- Manage their own development
- Build positive self-esteem

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> *The heart of motivation is to give people what they really want most from work. The more you are able to provide what they want, the more you should expect what you really want, namely: productivity, quality and service.*

Twyla Dell: *How to Motivate People (1989)*

Motivation can be classified as *intrinsic* or *extrinsic*; employees are usually motivated by a combination of both.

Intrinsic motivation comes from within the person. People engage in an activity because they receive satisfaction from it, not because they are rewarded for doing it. Employees may be intrinsically motivated if:

- The job is challenging and interesting
- They see the result of their efforts
- They control the way they work
- They see their work helps others

Extrinsic motivation comes from outside of the person. Good performance is rewarded with benefits and recognition. Pay and bonuses are examples and may compensate for lack of satisfaction from the work itself.

✓ Motivation theories *(AO3)*

A theory of motivation is a general explanation of human behaviour which seeks to explain why human beings respond to stimuli in particular ways. There are two basic types:

- **Content theories** – *what* is it that motivates people?
- **Process theories** – *how* do you motivate another person?

✓ Content theories

Content theories focus on what motivates people, which is either intrinsic or extrinsic.

Frederick Winslow Taylor: Scientific Management

Taylor, an American engineer, sought to improve industrial efficiency. In *Principles of Scientific Management,* he developed 'scientific management' (*'Taylorism'*) that demanded rigorous analysis of input, output and costs.

- Each part of a job is analysed scientifically and the most efficient method of achieving it devised.
- The most suitable person to undertake the job is selected and is taught to do the job in the exact way devised.
- Managers cooperate with workers to ensure efficiency.
- There is a clear 'division' of work and responsibility between management and workforce.

Taylor equated men with machines, to be made efficient by removing wasted effort. Taylor had a low opinion of the quality of the workers, believing they were inherently lazy and motivated by greed.

Taylorism is associated with *mass production* and the *division of labour*. It relies on time and motion study to find the "one best method" to achieve a goal. At the Bethlehem Steel company, Taylor created ***control groups***, observed the behaviour of that group and showed that the size of a shovel and the amount lifted affected the efficiency of workers. The result was a reduction in the workforce from 600 to 140, but with remaining labourers awarded a 60% wage increase.

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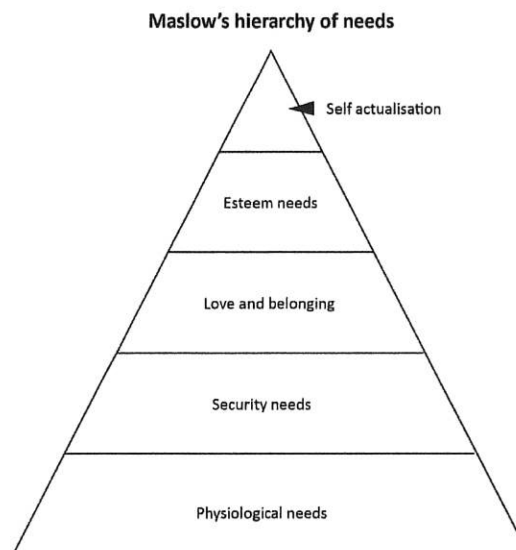
Whilst Taylor's principles are still used to improve efficiency, strict applications of scientific management may fail because the:

- Most efficient way of working for one person may be inefficient for another
- Economic interests of workers and management are rarely identical
- Difficulty of measuring and rewarding service-based employment, e.g. Nursing

Abraham Maslow: Hierarchy of Needs

Maslow's work was classified as part of the **Human Relations School.** Maslow's hypothesis was that *unsatisfied needs* act as motivators and that humans are influenced by a series of needs, some biological and others less tangible.

Maslow's **Hierarchy of Needs** includes a mixture of extrinsic and intrinsic needs. He identified five different levels of needs, represented as a triangle with the most basic needs at the base and the highest at the top. Most people can achieve the lowest level of needs, but few are able to satisfy higher order needs.



Maslow's hierarchy of needs

- **Physiological needs**, e.g. food and shelter, can be satisfied by acceptable wages and decent working conditions.
- **Security or safety needs** include the desire to be free of anxiety at work. These were refined to include job security, a pension and a contract of employment.
- **Social needs** of **friendship and belonging** means working in teams, participating in social events, and the opportunity to celebrate success.
- **Self-esteem or ego needs** and the need to feel positive about oneself. This can be achieved by good feedback on performance linked to promotion.
- **Self-actualisation** or **self-realisation needs** are the satisfaction of achieving one's innermost desires by seeking new challenges, and by applying creativity and imagination to new problems.

It is important to understand that when one level of needs is satisfied, ***it no longer motivates***. Firms need to offer higher levels of needs to motivate further.

Criticism of Maslow's theory:

- Humans have diverse needs.
- People place different importance on different needs.
- People move through the hierarchy at different rates.
- It is possible to experience several needs together.
- Money may be used to purchase higher order needs like ego possessions.
- Can anybody's needs be fully satisfied? Should the top of the hierarchy be open, suggesting limitless desire for achievement?

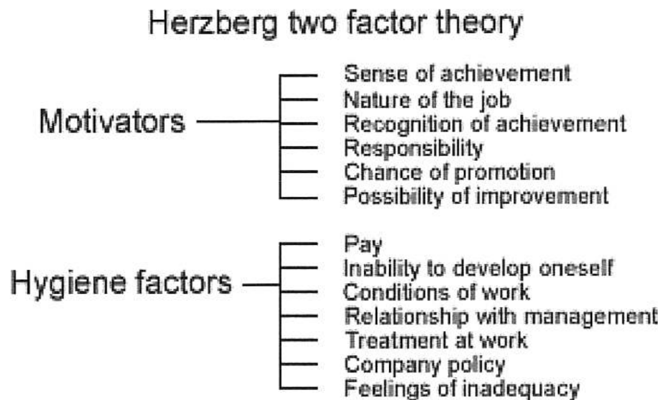
Herzberg: Motivation-Hygiene or 'two factor' theory

Frederick Herzberg's developed Maslow's analysis. His hypothesis is that *removing workplace dissatisfaction does not automatically cause satisfaction*; employers need to seek out factors that positively increase satisfaction. Satisfaction is associated with the work itself, such recognition for a job well done, rather than from extrinsic factors, such as salary or promotion. Herzberg proposed that humans have two sets of needs:

- Lower level needs as an animal to avoid pain and deprivation (***hygiene factors***)
- Higher level needs as a human being to grow psychologically ***(motivators)***

Hygiene factors can lead to dissatisfaction, so firms need to improve factors, such as salary, working conditions and company policies.

Motivators or **growth factors** offer job satisfaction. An increase in motivators is required to improve job satisfaction as these satisfy *psychological needs*. **Motivators** centre on recognition, responsibility, the nature of the work and promotion opportunities; improving these increases motivation.



The ***combination*** of hygiene and motivation factors creates four conditions:

- ***High Hygiene / High Motivation***: The ideal as employees are highly motivated with few complaints.
- ***High Hygiene / Low Motivation***: Employees have few complaints, but are not highly motivated.
- ***Low Hygiene / High Motivation***: Employees are motivated, but have many complaints. The job is exciting and challenging, but salaries and work conditions are unacceptable.
- ***Low Hygiene / Low Motivation***: The worst situation as employees are unmotivated with many complaints.

John Stacey Adams equity theory

Adams' Equity Theory has similarities with Maslow and Herzberg. His theory emphasises 'what is fair and reasonable'. Individuals seek a fair balance between what they put into our job ***(inputs)***, and what they get out of it ***(outputs)***.

Individuals form perceptions of what constitutes a ***fair balance,*** by comparing their situation with **'referent' others,** including colleagues and friends. Equity does not depend on the input-to-output ratio alone, but also on comparison between an individual's ratio and the ratio of referent others, which creates their own sense of fairness in their work situations.

Inputs		Outputs
Inputs are typically: effort, loyalty, hard work, skill, adaptability, flexibility, etc.	People need to feel that there is a fair balance between inputs and outputs.	Outputs are typically financial rewards - pay, salary, bonus and commission - plus intangibles - recognition, praise, promotion, etc.

If employees feel that:

- Inputs are fairly and adequately rewarded by outputs, they are happy and motivated.
- Inputs out-weigh outputs, they become demotivated and may feel a sense of injustice.

Daniel Pink

Pink believes that the scientific management works well with routine, unchallenging and controlled tasks, where rewards can motivate. However, 21st century jobs are more complex, more interesting and more self-directed, requiring creativity and imagination; skills that are difficult to measure and reward directly. He argues that traditional rewards can actually lead to:

- Diminished intrinsic motivation
- Lower performance
- Less creativity
- Unethical behaviour
- Short-term thinking

A new theory of motivation

Pink proposes a revised approach to motivation that fits more closely with modern business, one based on self-determination theory (SDT) that recognises that human beings:

- Have an innate drive to be autonomous
- Are self-determined and connected to one another
- When liberated, achieve more and live richer lives

Organizations should focus on offering employees:

1. **Autonomy** over the four main aspects of work:
   - When they do it (time)
   - How they do it (technique)
   - Whom they do it with (team)
   - What they do (task)

2. **Mastery** at something that matters to them, fostering a learning environment.

3. **Purpose**, by taking steps to fulfil employees' natural desire to contribute to a 'greater' cause. Organizations should ensure that employees understand the organization's vision, and how their individual roles contribute to this.

Pink's conclusion is that *firms can only increase employee satisfaction through intrinsic motivational methods.*

✓ Motivation in practice *(AO2)*

Employee Reward is a broader concept than *pay*. It is a portfolio of financial and non-financial benefits that provide a competitive package to motivate staff, improve retention and performance.

Employee reward combines:

- **Basic pay** expressed as an annual salary, weekly wage or an hourly rate.
- **Additions to basic pay,** e.g. bonuses.
- **Employee benefits,** e.g. pensions.
- **Non-financial rewards,** e.g. recognition and opportunities for achievement.

Financial rewards are classified into two categories:

1. **Payment systems** – providing the basic pay for a job.
2. **Incentive schemes** – rewards to recruit, retain and motivate.

✓ Motivation in practice: financial motivation

Remuneration is the entire package of rewards received by an employee, including basic pay, bonuses, pension, share options and other fringe benefits.

Payment systems

Salary

Salaried employees are paid a fixed sum for a year's work, but payable monthly. There is flexibility how work is organized and it is common for salaried staff to work longer than contractual hours. Herzberg argues that salaries are the best form of payment, because they offer firms the opportunity to satisfy employees' hygiene needs while concentrating on higher level motivators.

Wages (time-rates)

Employees receive a basic rate of pay per time period that they work, but not for their productivity (e.g. $5 per hour, $50 per day). If the employee works more than the agreed hours they can claim overtime payments e.g. $7.50 per hour instead of $5 per hour ('time and a half'). 'Employees may 'clock in' and 'clock out' to record hours worked.

The hourly rate depends on factors such as age, experience and responsibilities. Wages allow workers to concentrate on quality, because they are not pressured to complete a set output. However, wages may not *motivate, because employees are rewarded for their time, not the quality of their output.*

Wages (piece-rates)

Employees are paid per unit, or 'piece', they produce, linking reward to productivity. There is no guaranteed level of basic pay. Employees may reduce the quality of their output in order to boost the quantity they produce, and may only be suitable for standardised output that can be attributed to an individual employee.

Commission

The employee, e.g. sales representatives, receives a percentage of the value of the goods or services they sell in a period of time. This incentivises staff to work harder to make sales, but can lead to aggressive sales techniques. Commission does not offer the security of a guaranteed income, so many firms offer a package combining basic pay with commission.

Profit-related pay

Employee receives a share of the profits of the business each year. The better the firm performs, the more the employees should earn (subject to a maximum amount). Conversely, low profits or losses result in reduced reward.

Performance-related pay (PRP)

Paid in addition to the individual's basic pay, PRP payments are based on an employee achieving set targets over the year that forms part of an appraisal review. This rewards the 'output' of managers. Some PRP schemes reward successful and well performing teams. PRP may include a:

- *Performance bonus* for achieving, or exceeding, identified targets
- *Pay increase* for achieving, or exceeding, identified targets (this becomes a permanent part of the employees' pay package)
- *Loyalty bonus* for employees, who have been with the organization for a long period

Share ownership/options

Employee may receive part of their salary in shares, normally at less than current market prices. This is really a savings-plan for the employee. They can sell their shares after an agreed period of time. Employees should feel a desire to work harder to boost profits and dividends.

Share options are a common incentive for senior managers. Option holders have the right to buy their shares at a specified price and by a specified date. There is no obligation to take up the option, but the price is normally below the market price. On the agreed date the employee will be able to 'exercise' the option and sell the shares at a higher price. Share options:

- Attract and keep skilled employees by going beyond a fixed salary
- Make employees feel like partners in the business

Fringe benefits ('*perks*')

Fringe benefits are in addition to employees' wages or salary. These benefits can help increase motivation and retain staff. The most common include:

- Company cars
- Pension contributions
- Discounts on company products
- Membership of leisure clubs
- Subsidised food
- Private medical cover
- Housing allowance
- Flexible hours

Fringe benefits are an important part of the total remuneration package, particularly for senior management. They offer 'esteem' needs by conferring recognition and status. However, they can quickly become an 'expected' right, diminishing their motivational effect.

John Lewis Partnership

Example

The John Lewis Partnership in the UK has long used this PRP to motivate its staff as well as a number of fringe benefits.

✓ Motivation in practice: non-financial rewards *(AO2)*

According to Maslow, Herzberg and Pink, financial rewards by themselves are not enough to motivate. Employees are more motivated by satisfaction of higher order needs, such as self-esteem and self-actualisation, which may be achieved through methods of ***job redesign***.

Job rotation

Employees move between two or more jobs in a planned manner, offering a range of work experiences requiring a variety of skills, but at the same level of difficulty and complexity (***'horizontal loading')***. In a restaurant, for example, employees may serve meals or operate the till.

This may increase skills and job satisfaction, but the employee may do the new jobs poorly and unless more challenging, they may feel they are doing 'more of the same'.

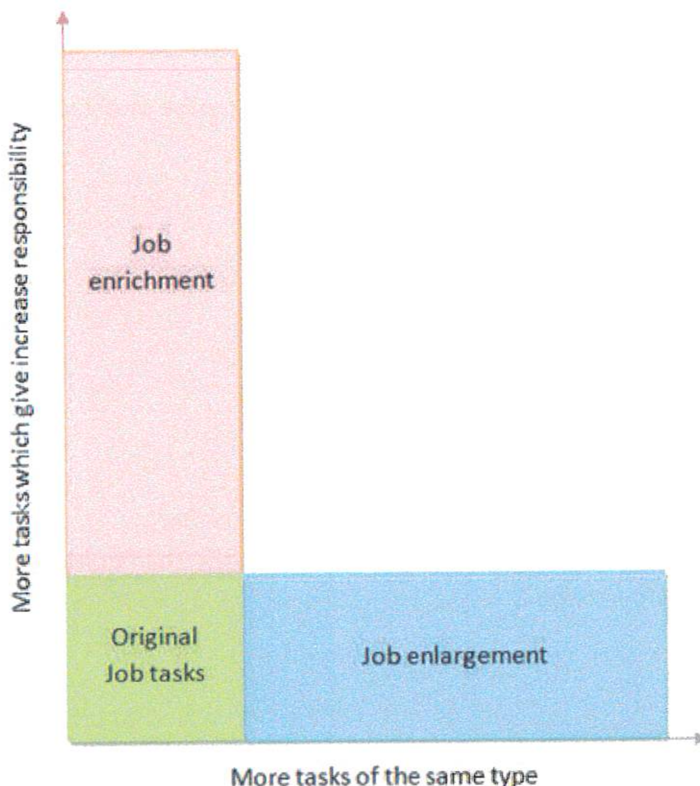
Job enlargement

Job enlargement means extending the range of employee's duties and responsibilities ***('horizontal expansion')***, contrary to the principles of specialisation. It involves the addition of tasks at the same level of skill and responsibility, motivating employees through greater variety.

Job enrichment

Job enrichment build a higher sense of challenge and achievement ***('vertical loading')*** and attempts to satisfy higher order needs. An enriched job should ideally contain:

- A range of tasks and challenges of varying difficulties (physical or mental)
- A complete unit of work - a meaningful task
- Feedback, encouragement and communication
- Training



Empowerment

Employees are given increased participation and the decision-making powers to encourage initiative and entrepreneurial spirit. Empowerment is one stage beyond delegation, because the individual is not only given a task, but the authority to carry it out independently. It provides opportunities for promotion.

> *By empowering others, a leader does not decrease his power, he may increase it – especially if the whole organization performs better.*
>
> *Rosabeth Moss Kanter*

Purpose/the opportunity to make a difference

Employees can be most engaged and energised when they are working for a purpose, such as contributing to the overall success of the organization. Purpose-driven goals can be agreed through appraisal. These should not focus on profit, but on aligning individual and organization aims. This is easier in not-for-profit organizations, e.g. a charity.

Teamwork

Elton Mayo's 'Hawthorne experiments' identified the power of the working group and the importance of teamwork in motivation. Teamwork helps meet employees' social needs for interaction, as well as providing a sense of 'belonging'.

> *Individual commitment to a group effort - that is what makes a team work, a company work, a society work, a civilization work.* ***Vince Lombardi*** *American football coach*

A productive team contains people who share common goals and vision and have some level of interdependence. Many businesses look at teamwork skills when evaluating job applicants, particularly when the product manufactured requires a team with multiple skills.

Teamwork:

- Provides worker flexibility and co-operation
- Helps achieve cultural shifts within an organization
- Improves problem solving
- Taps the talents of everyone

✓ Cultural impacts on financial and non-financial rewards *(AO2)*

Managers face challenges when motivating employees with diverse cultural backgrounds. Some cultures:

- Emphasise competition, risk-taking and freedom
- Are more interested in the group and the sense of belonging
- Place greater value on reputation, family security and social recognition

Managers supervising employees from diverse backgrounds must consider the types, and desirability, of rewards offered for high levels of performance. Specific incentives, such as pay raises or career advancement, will not have the same motivational effect on all people in all situations.

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2.5 Organizational (corporate) culture

✓ Organizational culture *(AO1)*

Corporate, or organizational, culture is used to define the unique personality or character of a particular organization and includes such elements as core values, beliefs and ethics.

✓ Elements of organizational culture *(AO2)*

Corporate culture can be expressed in the mission statement, in the decor of offices, by what people wear and how people address each other.

Culture is the set of values, beliefs and attitudes of both employees and management that influences decision-making and guides behaviour, actions and feelings. Each organization has a unique culture that defines its 'personality'. Culture changes as personnel do, as the aims of the firm evolve or as competitive forces alter.

✓ Types of organizational culture *(AO2)*

Charles Handy

No culture or mix of cultures, is bad or wrong in itself, only inappropriate in the circumstances

In *Gods of Management: The Changing Work of Organizations* (1978), Handy linked culture to four personality types, represented by Greek gods.

Power or Zeus culture

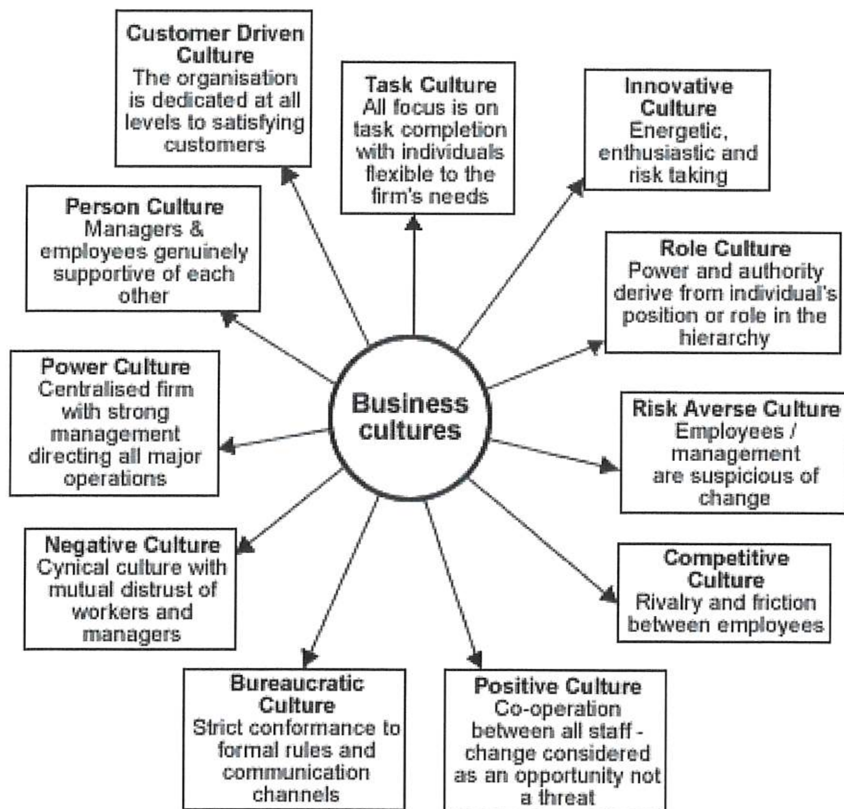
This revolves around one person and is frequently found in entrepreneurial organizations with few rules and procedures; where ends are more important than means. Decision making is quick, because there is little participation. This culture is centralized, top-down and based on power and influence, represented as a spider's web. The power comes from the spider – the web has no power without the spider.

Role or Apollo culture
This culture is bureaucratic with a tall, rigid hierarchy and slow decision-making and dominates large organizations, characterised by defined roles and procedures. It works best in stable, predictable markets and industries. Power stems from individual's roles in the hierarchy, rather than from their abilities and is represented by a temple, supported by strong columns, which are stable and long lasting.

Task or Athena culture
This culture is collaborative and task-based, drawing upon flexible teams of professionals who solve particular problems, and then move on. The emphasis is on getting the job done and is often organized as a matrix structure; characterised by empowerment. It works best in organizations like management consultancies, where expertise is applied in very specific ways.

Person (individual) or Dionysus culture
This exists where individuals within the organization believe they are superior to it and do what they want; laissez faire leadership predominates. It works best where individual talent is at a premium and employees work independently, meeting individual's self-actualisation needs.

A range of other business culture types are outlined below.



There is a link between corporate culture and organization structure.

- A power culture, strict control and centralized decision-making, leads to a tall structure with small spans of control.
- Innovative cultures, promoting the role of individuals, employ flatter hierarchies offering greater empowerment.

✓ Cultural clashes linked to mergers and acquisitions *(AO3)*

Cultures may change when organizations merge or when one organization is acquired by another. Mergers are driven by the desire to obtain synergies and economies of scale, but many fail in practice. If one organization with a role culture merges with another with a task culture, there may be problems with expectations and operations. Individuals may feel threatened, because their traditional authority is challenged, or if they are expected to take on new responsibilities and challenges. A new hybrid culture evolves and those who cannot adapt tend to leave. Alternatively, the business may crash spectacularly.

Case study

AOL-Time Warner

In 2001, the merger of AOL-Time Warner was hailed as vision for the future of global world entertainment using the World Wide Web. The $125 billion deal connected the magic of Hollywood films, the TV news of CNN and the technology of the internet as supplied by AOL. The merger bought together three billionaire entrepreneurs, Ted Turner of CNN, Steve Case of AOL and the movie maker Gerald Levin.

Two years later, the company reported losses of an astonishing $110 billion. Ted Turner was expelled from the Board of Directors. Mega-mergers almost never fulfil their promise. Research shows that more often than not, they destroy the value which comes with more focused management. By bringing together three different corporate cultures, the creativity was certain to result in a clash of empires and egos.

✓ How individuals influence organizational culture and how organizational culture influences individuals *(AO3)*

It is unlikely that individuals will satisfy their higher order needs in an organization where mistrust prevails. Senior managers may not appoint individuals perceived as threats to their positions, and training may be perceived as a waste of money if all major decisions are taken at the top.

Culture can be self-perpetuating. If autocratic management styles are expected, then even newly appointed managers may feel pressure to adapt to these expectations. However, as the external environment changes and markets become more competitive and global, managers are forced to delegate more and 'new blood' brings new ideas and methods.

2.6 Industrial/employee relations

✓ The role and responsibility of employee and employer representatives *(AO2)*

Managers balance the interests of the firm's stakeholders. The largest cost in any business is usually labour, so controlling pay levels may increase profits and reward shareholders through higher dividends. Conflict between employees and management risks these profits, so business success usually comes down to how skilfully employers negotiate the terms and conditions of employment.

Negotiations and collective bargaining

Negotiation is a bargaining process between two or more parties, each with its own viewpoints, and seeks to find common ground, reach agreements and resolve conflict.

Collective Bargaining is the process by which wages and conditions of employment are negotiated between employers, or associations of employers and workers' organizations.

Negotiating separate agreements with every employee would be time-consuming and inefficient. Agreements made on a collective basis are usually preferred by both sides. Individuals are in a weak bargaining position so may join a trade union to increase their strength. Employers may negotiate as a group at an industry level.

Collective bargaining is likely to centre on remuneration, including financial rewards, hours of work, working conditions and security of employment.

✓ Employer-employee relations – industrial relations *(AO3)*

Industrial relations describe the relationship between employers and employees and industrial disputes occur between trade unions and employer representatives. Neither have anything directly to do with 'industry'! Do not be confused by these terms.

Methods used by employees to achieve individual and group objectives

Employees are likely to have one, or a combination of, the following objectives:

- Increased pay rates and improved employment packages
- Better working conditions and job security

- Better training opportunities
- Recognition of trade union rights
- Protection from harassment at work
- Greater participation in decision making
- Flexible working practices

If employee representatives are unable to reach agreement with employers in negotiations, they may enter into an industrial dispute using a number of sanctions to pressurise employers.

- **Negotiations:** employees and employers may enter prolonged negotiations on pay and conditions.
- **Go slow**: employees deliberately work slower, reducing productivity and output, e.g. following every health and safety requirement.
- **Work to rule**: employees follow rules and procedures to the letter, e.g. refusing to undertake activities not directly specified in their contract.
- **Overtime bans**: workers refuse to do overtime. In some industries, such as transport, this is extremely disruptive as overtime is required to offer acceptable service levels.
- **Strikes**: employees withdraw their labour and refuse to work in response to the breakdown of collective bargaining. A strike may be:
    - For a fixed period e.g. One-day
    - Rolling (a sequence of strikes)
    - Full-time, until the dispute is resolved

Methods used by employers to achieve individual and group objectives

Employers are likely to have one, or a combination, of the following objectives:

- Improved levels of productivity
- Reductions in the costs
- Lower rates of absenteeism
- Job flexibility, e.g. Employees cover absent colleagues
- Reduction in union power
- Remuneration linked to performance

Employers often use highly skilled, specialist staff to conduct negotiations and can call on the additional specialists, such as lawyers, to prevent industrial action.

Employers use some of the following methods to put pressure on employees:

- **Negotiations**: employers seek to maximise their position using skilled negotiation techniques.
- **Public relations:** putting forward the firm's position through press releases and media interview.
- **Threat of redundancies:** threaten the workforce with compulsory redundancies if they do not agree with management proposals.
- **Changes of contract:** may not renew contracts unless employees accept different, and probably inferior, terms and conditions or employment.
- **Closure:** issue an ultimatum to employees to accept the employers' terms or stop strikes, or they will close the business, resulting in redundancies.
- **Lock-outs**: prevent employees from entering work premises - in effect, a strike by the management.

✓ Sources of conflict in the workplace *(AO2)*

Conflicts occur when people perceive there is a threat to their needs, interests or concerns. Conflict can be help force necessary changes within the work environment.

Source of conflict:

- **Poor communication** create a downward spiral of misunderstanding and hostility.
- **Personality-based conflict** where individuals simply do not like each other. Traditional management may create an 'us and them' situation, where employees view all management with suspicion.
- **Needs and wants:** stakeholders have conflicting objectives, particularly employees and management.
- **Power and control:** management may reassert their 'right to manage' and trade unions fight to support their members' interests.
- **Redundancy**: may cause conflict with those losing their jobs.
- **Change**: change needs to be managed appropriately to reduce resistance and conflict.
- **Values, beliefs and attitudes:** within any population there is discrimination of all forms, different political beliefs, cultural diversity and different religious affiliations. These are replicated at work.
- **Emotional differences:** the work environment cannot be completely detached from the personal environment. Problems in either are likely to affect behaviour and emotions in the other.
- **Power abuse:** some individuals abuse their power to victimise others in the workplace.

✓ Conflict resolution *(AO3)*

Conciliation (mediation) and arbitration

Conciliation and arbitration are methods of resolving collective disputes in industrial relations. Most countries have organizations (often government sponsored) that act as independent conciliators and arbitrators to resolve disputes.

The advantages of conciliation and arbitration are:

- Making negotiations less confrontational
- Improving communications between the parties
- Defusing disagreements as early as possible

Conciliation is *voluntary*. Sides to the dispute must agree to conciliation. The conciliator has no power to impose a solution, but aims to assist the parties to reach a settlement. With **arbitration** the disputing parties agree to the arbitrator's appointment and accept that the arbitrator's decision will be final and legally binding.

Employee participation and industrial democracy

Employee participation is a generic term for all forms of employee involvement in decision-making. Employee participation can take many forms:

- Project teams or quality circles in which employees work on projects or tasks with responsibility delegated to the team.
- Suggestion schemes give employees the opportunity to provide managers with new ideas and improvements.
- Multi-channel decision-making processes. Decisions result from communications upwards, sideways and in many other directions within the organization.
- *Kaizen* or continuous improvement programmes.

No-strike agreement

A no-strike agreement is an agreement that rules out the taking of industrial action. In its place is an agreed method of dispute resolution, such as arbitration.

Single union agreements

A single-union agreement gives one trade union sole bargaining rights in respect of **all employees** in an organization, which simplifies collective bargaining, because managers only have to negotiate with the representatives of that single union.

✓ Reasons for resistance to change in the workplace *(AO2)*

Rapid change may create resistance, because employees are more concerned with the implications for them, rather than the benefits the change brings to the organization. Some employees are happier with existing working practices. Fear of unemployment and increasing workloads cause resistance to change.

✓ Human resource strategies for reducing the impact of change and resistance to change *(AO3)*

Expecting resistance to change, and planning for it from the start of a change management programme, allows organizations to manage objections.

John Storey suggested approaches to managing change:

1. **A total imposed package**: senior management teams impose change without consultation. This creates rapid change, but with significant resistance.
2. **Imposed piecemeal initiatives:** change is still imposed by senior management, but in stages. Employees have more time to adapt and firms offer incentive payments to accept change.
3. **Negotiated total packages**: the aim is to agree the package through negotiation with the workforce. This significantly reduces the level of resistance.
4. **Negotiated piecemeal packages**: a gradual implementation negotiated at each stage, possibly linked to incentive payments.

Kurt Lewin's approach to change management is designed to break habits, challenge self-interest and 'unfreeze' the customs of work groups:

1. Unfreezing: overcoming resistance or inertia to change among employees using discussion groups and meetings.
2. Change: after change happens, employees gradually adopt a new mind-set, which is more open to accepting and implementing change.
3. Refreezing: institutionalising change and embedding it in the organization. New working patterns are built into job descriptions and changes in the organizational structure formalised.

✓ How innovation, ethical considerations and cultural differences influence employer–employee relations *(AO3)*

Innovation: Innovation creates new, unknown situations that may alienate a workforce and cause a climate of fear and resistance, e.g. the introduction of automated systems that replace human roles. Innovation requires retraining and re-evaluation of career paths and structures.
Ethical considerations: following periods of uncertainty and upheaval, such as a recessionary periods, firms should reconsider management styles and strategic objectives. Changes to the structure, nature and size of organizations must be handled sensitively and ethically.
Cultural differences: diverse workforces may approach change in different ways and with different expectations. Some cultures accept imposed change, while others see this as breaching their employment rights.

✓ Potential IB question on Unit Two topics for each assessment objective

AO1

- Outline the constraints and opportunities provided by demographic change
- Describe methods of recruitment, appraisal, training and dismissal

AO2

- Explain how non-financial rewards can affect job satisfaction, motivation and productivity
- Analyse the advantages and disadvantages of different methods of recruitment, appraisal and training
- Analyse methods of organizing human resources that are used by different organizations
- Analyse the dynamic nature of relationships between employees, employers and their representatives
- Explain the differences between crisis management and contingency planning

AO3

- Evaluate strategies for developing future human resources
- Discuss the effect of new technologies on the effectiveness of communication between organizations and their stakeholders
- Evaluate the effectiveness of various styles of leadership and their implications for organizations
- Compare and contrast the intrinsic and extrinsic needs that have to be satisfied at work and the rewards that motivate individuals
- Evaluate alternative financial reward packages and the impact of these on job satisfaction, motivation and productivity
- Examine the methods used by employees and their representatives in pursuit of their objectives
- Evaluate the costs and benefits of contingency planning
- Discuss how far it is possible to plan for a crisis

AO4

- Construct two different types of organization chart

Unit 3: Finance and accounts

3.1 Sources of finance

✓ Role of finance for businesses *(AO2)*

The source of finance needs to be related to its purpose. There are **two types** of expenditure:

Capital Expenditure

Capital expenditure (capital spending) is incurred when firms buy **fixed assets** or add to the value of an existing fixed asset, e.g. upgrading buildings.

Fixed assets are assets not intended for resale as they represent the productive capacity of the business.

Capital expenditures includes spending on:

1. Fixed assets such as equipment, buildings, machinery and vehicles
2. Improving existing assets
3. Restoring property or adapting it to a different use

Fixed assets tend to be expensive, so the finance will be of a medium- to long-term nature. Capital spending is not usually charged to just one year's accounts, but is spread over the life of the asset in the form of a ***depreciation charge*** to the profit and loss account.

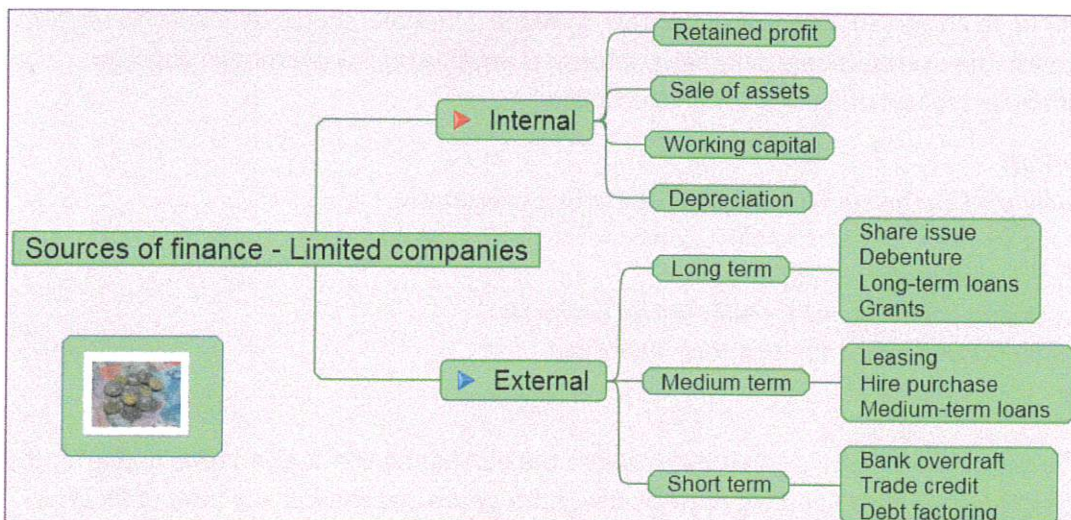
Revenue expenditure

Revenue expenditure (circulating capital) is short-term spending related to the day-to-day running of the business, e.g. administrative and selling expenses, including paying rent and salaries. Revenue expenditure does not add value to the business.

Three categories of revenue expenditure:

1. Single use consumables such as petrol for vehicles
2. Purchase of items used up within the current financial year e.g. Raw materials
3. Items used before they are paid for, e.g. Marketing expenditure

✓ Internal and external sources of finance *(AO2)*



Internal sources of finance

Personal funds

The most common source of funds for a sole trader is personal savings or borrowing from family and friends. Provided these are not loans, they are considered an internal source of initial capital.

Once the business is established there are several other forms of internal finance.

Retained profits

If a business makes a profit some of this will be taken by the government in tax and a proportion paid out in dividends. Remaining profit is retained in the business for investment. Ploughing retained profit back into the business is inexpensive and a significant source of expansion finance.

Sale of assets

An established business may sell buildings, machinery, or even subsidiaries to generate cash, if they are not fully used, or profitable. In addition, firms may sell assets they still need, but do not necessarily need to own, e.g. firms may sell expensive offices in city centres and then lease them back for an extended period (*'sale and leaseback'*). In a liquidity crisis firms may be forced to sell assets they do need.

An evaluation of internal sources of finance

Internal finance has no direct cost to the business and does not normally increase the liabilities of the business. However, relying on these alone to finance growth would limit the scale of expansion.

✓ Short-term and long-term external sources of finance *(AO1)*

Short-term sources

The short term is denotes a period of ***less than one year***. There are ***three*** main sources of short-term external finance:

1. Bank overdraft
2. Trade credit
3. Debt factoring

Bank Overdraft

A bank overdraft is a negative balance on the business bank account. The bank agrees to allow a firm to overdraw its account up to an agreed maximum limit. This is the most 'flexible' source of finance as the firm can increase or decrease the overdraft on a daily basis. Interest is payable on any overdrawn balance. Overdrafts are a short-term source of finance (a current liability).

Assessment of overdraft

- Interest is only paid on the amount, by which the firm is overdrawn
- Overdrafts are flexible - they can be paid off whenever the firm wishes
- Interest rates on overdrafts are high
- Some banks charge a flat rate fee for allowing an overdraft
- Overdrafts should not be used for long-term financing

Trade credit

Most transactions between firms are on a credit basis, where the purchasing firm is given time to pay for the items received – often three months. Choosing to delay paying for goods and services is a form of finance,

because the cash for the payment stays with the business. Indeed, the firm may sell the item it bought on credit before actually paying for it!

Debt factoring

Firms keep records of money owing to them in a 'Debtors Book'. Sometimes a firm raises finance by selling this book at less than its face value to a *factoring company*. The advantage is that the firm gets immediate liquidity, but loses a percentage of the value of its debts. The factoring company takes the risk of debts going 'bad'.

Medium-term sources

The medium-term is normally used to denote a ***one to five*** year time period. There are two main sources of medium-term external finance:

1. Leasing
2. Medium-term bank loan

Leasing

A lease is a contract that allows a firm to rent an asset in return for regular payments. Leasing does not actually bring in money, but allows firm to gain use of expensive assets, e.g. machinery, without large cash payments. When the lease ends, the firm can update the equipment, and is common in high technology industries.

Assessment of leasing

- Firms acquire expensive assets that would normally be unavailable
- Failure to make payments results in the lease being cancelled
- Repairs and maintenance are the responsibility of the firm that owns the asset
- May be more expensive than buying the assets outright, but improves short-term liquidity

Medium-term bank loan

A bank loan with repayment terms of between one and five year's repayment terms.

Long-term sources

The long-term denotes a time period of over five years. The two main choices are between debt or share (equity) finance. Sources of long-term external debt finance include:

1. Loan capital / long-term bank loan
2. Share capital / equity finance
3. Government grants and subsidies
4. Venture capital
5. Business angels

Loan capital / long-term bank loan

Loan capital borrowed from a bank is subject to regular interest payment. Interest can be variable or fixed. Variable interest rates offer less certainty as the percentage interest rate varies with the government base rate.

Loans can be secured or unsecured. A ***mortgage*** is a loan to buy property, secured against that property. The lender can reclaim the property used for security, if the firm cannot keep up with repayments.

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Assessment of loan capital

- All firms can borrow from banks with the necessary security
- Smaller firms are normally charged higher interest rates
- Loans must be repaid
- Lenders are unlikely to grant unsecured loans to small firms
- Lenders have no ownership rights
- Borrowing adversely affects the firm's gearing ratio

Governments may offer loans to new businesses.

Share capital / Equity finance

Limited companies issue shares to raise finance. Limited companies state their maximum authorised share capital in their *memorandum of association*. The value of the shares is shown in a company's balance sheet. Private Limited Companies are not allowed to sell shares to the general public and are restricted to raising finance from private sources; often family and friends.

Becoming a Public Limited Company allows the issue of shares on public stock exchanges. This is known as, ***'going public'*** a ***share flotation*** or an ***IPO*** (Initial Public Offering).

Assessment of share capital

Shares capital is permanent capital, because the funds are never paid back unless the company goes into voluntary liquidation. Unlike loans, share capital has no interest payments, so helping liquidity. The reward for holding shares is dividend payment based on a firm's profits decided by the directors. In a bad year, a firm may not pay a dividend.

A shareholder can only sell their shares if they find another investor prepared to buy them on the stock exchange. Additional sales of shares will dilute the control of the original owners of the business.

Additional sources of long-term finance

Government at the local, central or perhaps even supra-national (e.g. European Union) will sometimes provide financial assistance in the form of aid, grants and subsidies, sometimes with artificially low interest rates. Grants maybe given to firms if they are relocating, or expanding, in economically depressed areas.

Venture capital/industrial specialist

Specialist organizations provide funds for risky commercial ventures that banks refuse to finance. These include **venture capitalists**, looking for high returns. Venture capital is often used in a management buy-outs. ***Business angels*** are rich individuals prepared to put their money into business start-ups. They may work in syndicates, taking a minority shareholding in return for their investment.

Assessment of venture capital

- Only suitable for entrepreneurial business, as owners have to part with an equity stake
- No commitment to regular interest payments and the equity finance reduces gearing ratio
- Venture capitalist offers management skills and advice

Subsidy

A government benefit in the form of cash or tax reduction. It is granted to help business or an industry, such as farming, keep the price of a commodity or service low, keeping the firm in business and preserving jobs.

✓ The appropriateness of sources of finance for a given situation *(AO3)*

Considerations when selecting a source of finance

- **Cost:** administration or interest charges.
- **Time**: how long the finance is required.
- **Purpose**: revenue expenditure tends to be financed by short term finance, whereas capital expenditure is financed by long-term finance.
- **Amount** of finance required.
- **Financial situation**: firms suffering liquidity problems will find borrowing difficult and expensive.
- **Status and size**: small firms lack sources as they lack security.
- A business requires finance to build a new factory – this is a long-term project and requires long-term finance e.g. a mortgage.
- A small business has an unexpected expense requiring immediate payment, e.g. roof leaks - this requires short-term finance, e.g. an overdraft.

Examiner Tip!

The most important question when choosing a source of finance for an examination questions is:

Does the source of finance match the need e.g. term?

If the need is long term e.g. buying a property, then the source should be long term e.g. a mortgage, not short-term like an overdraft.

Specialist finance solutions

- ***Microcredit***: Microcredit schemes, often offered by NGO's, provide small amounts of credit to the poor in a developing country. Loans are targeted at the needs of borrowers and reflect their circumstances.
- ***Crowdfunding***: Crowdfunding platforms, such as *Kickstarter*, allow entrepreneurs to seek funding online by outlining the nature of their project through videos and images and a list of rewards per donation.
- ***Peer-to-peer lending:*** the lending of money to unrelated individuals without going through a traditional intermediary, such as a bank. Most peer-to-peer loans are unsecured personal loans and conducted online.

3.2 Costs and revenues

✓ Types of costs *(AO2)*

A cost is classified by its relationship with the level of business output. The following costs are defined in relation to how they change in value, as the level of output changes.

Fixed costs (FC)

These remain unchanged as the output level of firm changes. It does not matter what level of output the firm produces (even zero output), a fixed costs remains the same.

Examples of fixed costs:

- Rent
- Salaries
- Insurance
- Depreciation

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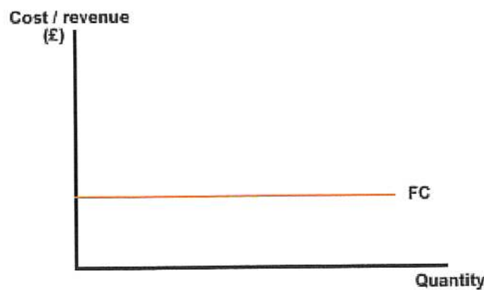
Fixed costs can be represented graphically:



Fixed costs

Fixed cost are only fixed *in the short-term,* e.g. in the long-term a firm may rent a second factory.

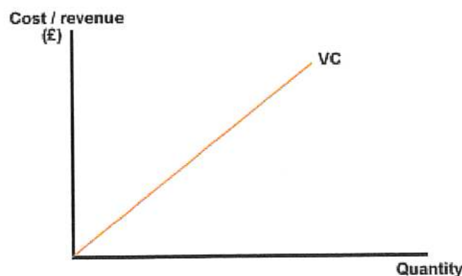
Variable costs (VC)

Costs which vary directly with the level of output: the total variable cost is totally dependent on the level of output. If output doubles, then variable cost will double. If halved, the variable costs would halve. At zero output, then are no variable costs.

Example of variable costs:

- Direct labour
- Raw materials
- Packaging
- Royalties

Variable costs can be represented graphically:



Variable costs

Semi-variable costs (SVC)

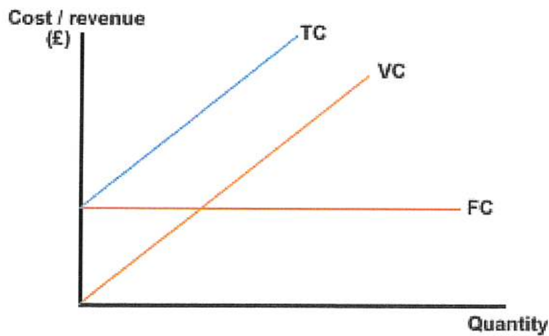
Most costs are not easily classified into either fixed or variable, falling between the two classifications and referred to as *semi-variable costs*, e.g. energy bills have a fixed standing charge and a variable element, depending on usage.

Total costs (TC)

Total cost are all costs totalled for any particular level of output. If the output level is zero, then total costs just consist of fixed costs. Total costs are the addition of fixed costs and total variable costs (where total variable cost is the variable cost per unit multiplied by the level of output).

- **Total variable costs = variable cost per unit x output level**
- **Total costs = fixed costs + variable costs**

Total costs can be represented graphically:



Total, fixed and variable costs

Direct costs (DC)

Direct cost is similar to variable cost, because it links cost to output. However, a direct cost is directly related to the output level of a particular product/department (cost centre); appropriate for firms making more than product.

Indirect costs / overhead costs (IC)

Costs that cannot be linked with the output of any particular product are called **overheads**. They are related to the level of output of the firm, but not directly, e.g.

- Utilities like gas
- Rent
- General administration
- Warehouse fees

✓ Total revenue (TR) and revenue streams *(AO2)*

Total Revenue is the total amount of money that a company receives from its ordinary activities in a given period, mostly from sales of products and/or services to customers.

- **Total Revenue = price per unit x quantity sold**

  TR = P x Q

Revenue streams

There are a number of sources of revenue. These include:

- Cash sales
- Credit sales (goods sold to customers, who are yet to pay)
- Interest
- Royalties
- Dividends on business investments

Profit or Loss

Profit or loss can be calculated using the formula:

- **Profit / Loss = Total Revenue (TR) – Total costs (TC)**

Provided Total Revenue is greater than Total Cost, the firm makes a profit.

***Example*:**

- **Profit = TR – TC**

= $20,000 - $15,000 = $5,000

If total costs are higher than total revenues, the firm makes a loss.

- **Loss = TR – TC**

= $15,000 - $20,000 = - $5,000

In accounts, a loss is shown by placing the figure in brackets:

Loss = TR – TC

= $15,000 - $20,000 = ($5,000)

3.3 Break-even analysis

✓ Contribution *(AO2)*

Contribution is the difference between price and the direct, or variable costs, of a product or service.

Contribution per unit

Contribution per unit = price per unit - variable cost per unit

For example, if a firm bought a pack of noodles for $2 and then sold the pack $10, the contribution per pack is $8. Contribution per unit is the amount that each unit of a good 'contributes' to paying the fixed costs or overheads of the firm.

Total contribution

Total contribution is calculated in two ways:

- **Total contribution = total revenue – total variable cost** *or*:
- **Total contribution = contribution per unit x total number of units sold**

	Noodles	Rice	Wok	
	$	$	$	$
Price	10.00	7.00	50.00	
Variable cost	2.00	4.00	55.00	
Contribution per unit	8.00	3.00	-5.00	
Sales	1000	300	100	
Total contribution	8,000	900	-500	**8,400**
***Less* Fixed costs**				5,000
Profit				**3,400**

Firms are concerned with the difference between costs and revenue and want to know the level of output at which they will start making a profit.

- When costs **are greater than** revenue the firm makes a loss
- When costs **are less than** revenue the firm will make a profit

Examiner Tip!

Do not confuse contribution with profit. Contribution only accounts for variable costs. Fixed costs must be paid before a firm calculates its profit.

At the break-even point the revenue obtained from the sale of a number of items, equals all the costs paid out in making and selling them:

- **Total costs = Total revenue**

Break-even analysis works out the minimum level of sales necessary for a firm to just start making a profit.

✓ Building a break-even chart *(AO2/AO4)*

Break-even chart: A diagram showing how total costs and revenue change with increasing production / sales.
Break-even quantity (BEQ): The level of sales or output, where costs equal revenue and the firm is making neither a loss nor a profit.

Break-even revenue (BER): The level of sales revenue earned by the firm at the break-even level of output (where sales revenue equals the costs of production).
Break-even point (BEP): Where TC and TR lines cross.
Margin of safety: The difference between planned or actual level of production/sales and the break-even quantity.

Finding the break-even point

Break-even can be found by constructing a diagram or using the following formula:

$$\text{Break-even quantity (BEQ)} = \frac{\text{total fixed costs}}{\text{contribution per unit}}$$

A firm breaks even when: total revenue = total costs.

Total costs = total variable costs + total fixed costs

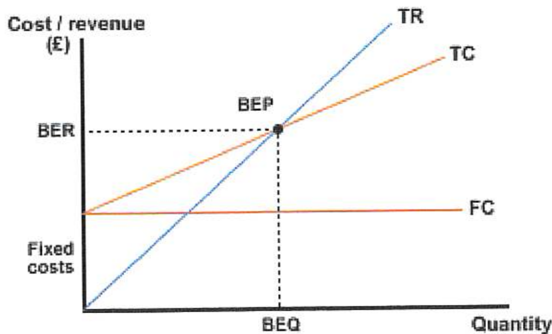
Contribution takes account of *variable costs*, but *not* fixed costs. It is the amount that each unit of a good 'contributes' to paying the fixed costs. So, if each product sold contributes $10 to total fixed costs of $1000, it is easy to work out how many products need to be sold to cover all fixed costs:

$$\text{Break-even quantity (BEQ)} = \frac{\$1000}{\$10} = 100 \text{ units}$$

When 100 units are sold all the variable costs and fixed costs have been paid, but no profit made. The sale of one more unit adds an additional $10, which is profit.

Drafting a break-even diagram

You must be able to draw the following diagram from given information.



Break-even diagram

Constructing a break-even chart

Step 1 Extract the data
Extract the data required from the question or text:

- FC per period of time
- Price per unit
- VC per unit.

Assume you have extracted the following information:

- FC $480,000 per month.
- VC: $60 per unit
- Price: $120 per unit

Step 2 Calculate the BEQ

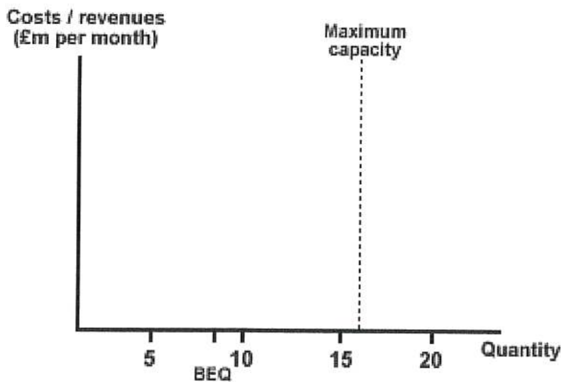
- Contribution = $120 - $60 = $60

$$\text{Break-even quantity (BEQ)} = \frac{\$480{,}000}{\$60} = 8000 \text{ units per month}$$

Knowing that BEQ is 8,000 units per month will help decide on the axes units, and where the TR and TC lines should cross on the graph.

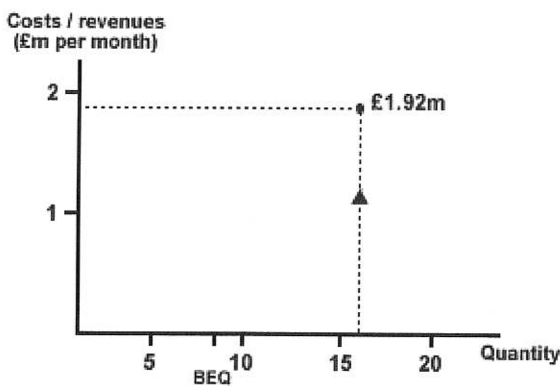
Step 3 Draw the X axis (capacity)

If given *a maximum capacity*, use that figure. If not, doubling the break-even quantity is a good guide, e.g. 16,000 units.



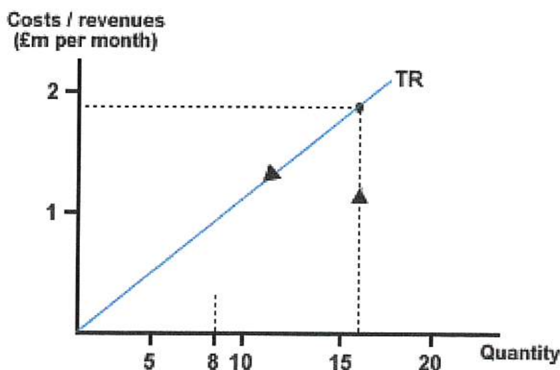
Step 4 Draw the Y axis (revenue and costs)

Revenue is usually the greatest figure. In this case, the maximum revenue is 16,000 x $120 = $1.92 million (price per unit x maximum sales).



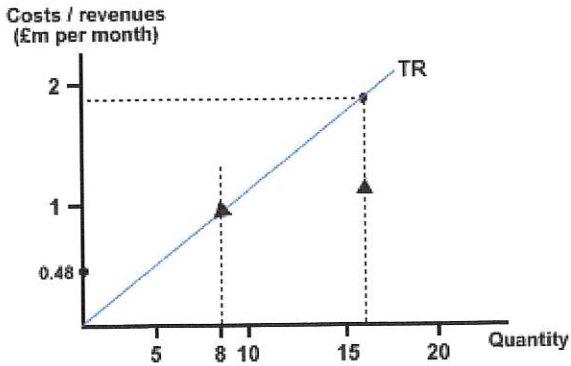
Step 5 Plot the TR axis

This passes through the origin, since there is no revenue, if there are no sales. You know TR = $1.92 million when sales = 16,000, and that TR is a straight line.



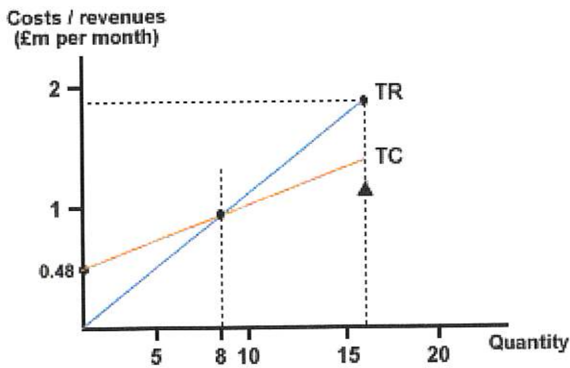
Step 6 Add the FC point

Fixed costs are the same, irrespective of output. So mark on the Y axis the value of the FC. In this case it is $480,000. Fixed costs are the costs of producing at 'output zero'.



Step 7 Add the TC Line

You know that this crosses the TR line at the BEQ, and that it starts at the FC at output zero.



You also know that the TC at maximum output of 16,000 units is:

$480,000 + 16,000 ($60) = $1.44 million.

Remember to label the axes and to give the chart a title

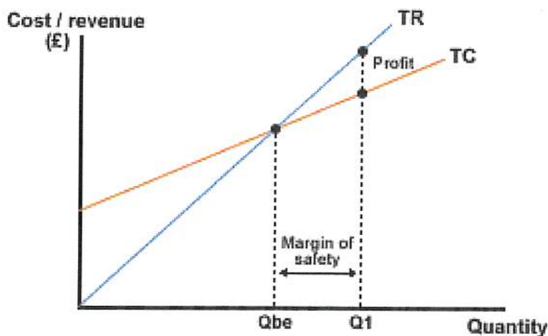
Margin of safety

Most firms seek a profit and want to operate at a position as far to the right of the break-even quantity as possible.

The **margin of safety** (units) is the difference between the planned or actual level of sales achieved by a company, and its break-even quantity. The higher the margin of safety the better.

- **Margin of safety = actual sales – break-even output**

The margin of safety can be negative if the actual production is below the break-even point.



Margin of safety

Cobra Motors

Example

Cobra Motors plan to produce 200 cars each week. They have previously calculated that their break-even quantity is 150 cars per week.

Margin of safety = 200 – 150 = 50 cars per week (based on actual sales)

Target profit output and target profit

The break-even quantity formula can be adapted to calculate the level of output required to earn a given level of profit.

$$\text{target profit output} = \frac{\text{fixed costs + target profit}}{\text{contribution per unit}}$$

Example: target profit output:

- *Target profit = $50,000*
- *Fixed costs = $200,000*
- *Contribution per unit = $50*

$$\text{Target profit output} = \frac{\$200{,}000 + \$50{,}000}{\$50}$$

$$\frac{\$250{,}000}{\$50} = \textbf{5,000 units}$$

Target price

The target profit output formula can be used to calculate target price at the target price output.

Example: target price:

- *Target profit = $50,000*
- *Target profit output = 5,000 units*
- *Fixed costs = $200,000*
- *Variable costs = $20*

$$\text{Target profit output} = \frac{\text{fixed costs + target profit}}{\text{target price} - \text{variable cost}}$$

$$5{,}000 = \frac{\$200{,}000 + \$50{,}000}{\text{target price} - \$20}$$

$$5{,}000\ (\text{target price} - \$20) = \$250{,}000$$

$$5{,}000\ (\text{target price}) - \$100{,}000 = \$250{,}000$$

$$\text{Target price} = \frac{\$350{,}000}{5{,}000} = \underline{\$70 \text{ per unit}}$$

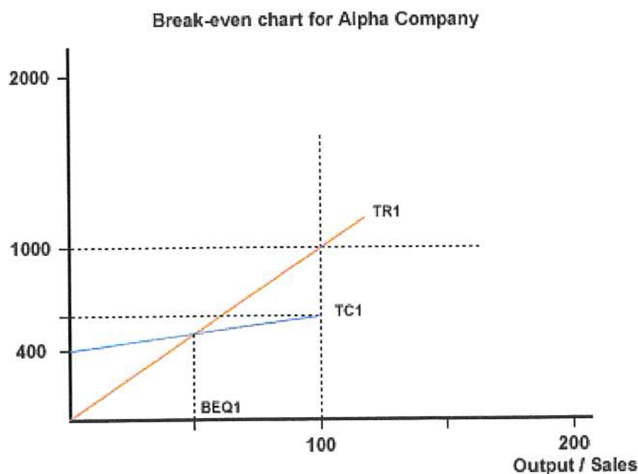
To reach the target profit of $50,000 at a target profit output of 5,000 units, the manufacturer needs to sell each unit for $70.

✓ Modifying a break-even chart, e.g. price or output *(AO2/AO4)*

Changes in costs or revenues affect the slopes of the revenue and cost lines changing the break-even output, e.g.

The Alpha Company produces paperweights:

- Price $100 each
- Fixed costs $400 per month
- Variable costs $2.00 per unit



The company plans to double its capacity by installing new equipment, and hiring more staff. This impacts on costs and price.

New costs and price

- Fixed costs increase from $400 to $700 each month
- Variable costs fall $2.00 to $1.50 per unit, because of purchasing economies of scale
- Alpha decides to lower prices by 10% to increase sales

Revised break-even chart

Costs

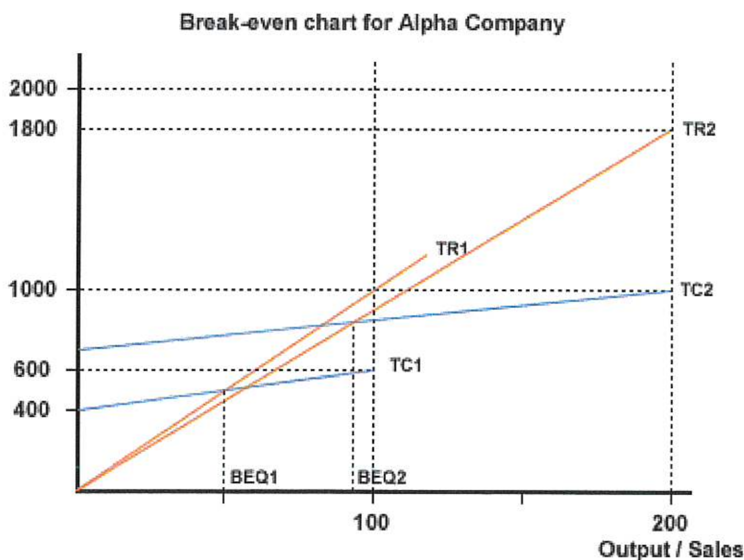
Fixed costs have risen, but variable costs have fallen. The total cost line starts higher up the Y Axis (at $700), but its slope is less.

- The total cost line moves upwards from TC^1 to TR^2
- The total cost at maximum output = 700 + 200 (1.5) = $1000

Revenue

The total revenue line changes from TR^1 to TR^2. Although it still starts at the origin, it slopes upwards *less steeply* because of the price reduction

Total revenue at 200 = 200(90) = $1800.



Alpha Company – new break-even chart

Implications of the change in break-even

- The capacity of the factory has risen from 100 to 200 units.
- The BEQ has risen from approximately 55 to about 95.
- Unless sales increase from their present level, it will make a loss, e.g. from 80 to 105 to break even - an increase of 44% on present level.
- Sales will have to increase to about 150 to make the same amount of profit as they do now.

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Benefits of break-even analysis *(AO3)*

- Relatively easy to draw, providing a visual way of analysing a firm's revenues, costs, profit and loss at different levels of output
- Explains the relationship between cost, production and returns
- Indicates the lowest amount of output necessary to prevent losses
- Useful for calculating resource requirements
- Supports investment appraisal when choosing between competing products
- Shows how changes in costs impact on profit levels and break-even quantity

Limitations of break-even analysis:

- Ignores the use of stocks
- Assumes all products made are sold
- Assumes all relationships are linear (straight lines)
- Assumes all variables can be changed independently
- Is a static model, but the environment is dynamic
- Results are only as accurate as the data it is based on
- Ignores all factors other than costs and revenues, e.g. The availability of finance

3.4 Final accounts

Accounting is the systematic process of identifying, recording, measuring, classifying, interpreting and communicating financial information about a business. It provides information on the resources available to the business, the means employed to finance those resources, and the results achieved through their use. It reports on the profit or loss for a given period and the value and nature of a firm's assets, liabilities and owners' equity.

All companies must provide a set of final accounts including *three major accounting statements:*

1. The **profit and loss account** (the **income statement)**
2. The **balance sheet**
3. The **cash flow (funds flow) statement**

✓ The purpose of accounts to different stakeholders *(AO3)*

The various stakeholders in a business look at the accounts for different reasons:

- **Managers** use the 'numbers' to analyse performance against targets.
- **Employees** look for security of employment.
- **Shareholders** analyse the accounts to check management's performance and efficiencies.
- **Potential investors** look at figures before investing to check likely return.
- **Creditors** and **suppliers** (those owed money) examine the accounts to check on security of payment.
- The **government** to check firms are paying the correct tax.
- **Customers** want to be sure of a reliable supply of goods/services.
- **Competitors** will want to compare their performance with other firms.

✓ The principles and ethics of accounting practice *(AO3)*

All firms are required to have their accounts audited by independent companies to ensure that they present a **'true and fair view'** of the financial position of the firm.

However, it is common for firms to '***window dress***' their accounts, by presenting them in the best possible, or most, flattering way. In public companies, this "creative accounting" can amount to fraud. Even if accounts are presented according to codes of practices, window dressing can be unethical, as they misrepresent performance.

✓ Final accounts *(AO2/AO4)*

Trading and profit and loss account (income statement)

The profit and loss account is shorthand for the full title of the trading and profit and loss account. This summarises a firm's trading results for a specific year and shows how the profits were used, or the losses were financed. It is sometimes compared to ***a video*** of the year's activities.

The Format of the Trading and Profit and Loss account

The trading and profit and loss is divided into three distinct sections:

(a) The trading account
(b) The profit and loss account
(c) The appropriation account

(a) The trading account

The trading account reveals the ***gross profit*** of the business, defined as the difference between ***sales revenue*** and the direct ***costs of the goods sold*** (or ***cost of sales***).

Gross profit = Sales revenue – cost of goods sold

The cost of goods sold (COGS) is the cost of producing or purchasing the products sold during that trading period. The cost of goods not sold are carried forward to the period when they are sold.

Cost of sales = opening stock + purchases – Closing stock

Gross profit can be improved by increasing the level of sales revenue and/or reducing the cost of goods sold, e.g. finding cheaper suppliers.

(b) The profit and loss account

This section of the account shows the ***net profit*** of the business, defined as the difference between gross profit (plus *non-operating income*) for the trading period and the corresponding expenses incurred. Non trading income may come from selling assets or receiving dividends.

Net profit	=	Gross profit	–	Expenses

Expenses (overheads) include the following:

- Marketing costs
- Administration expenses
- Interest on loans
- Rent
- Local taxes
- Depreciation charges

(c) The appropriation account

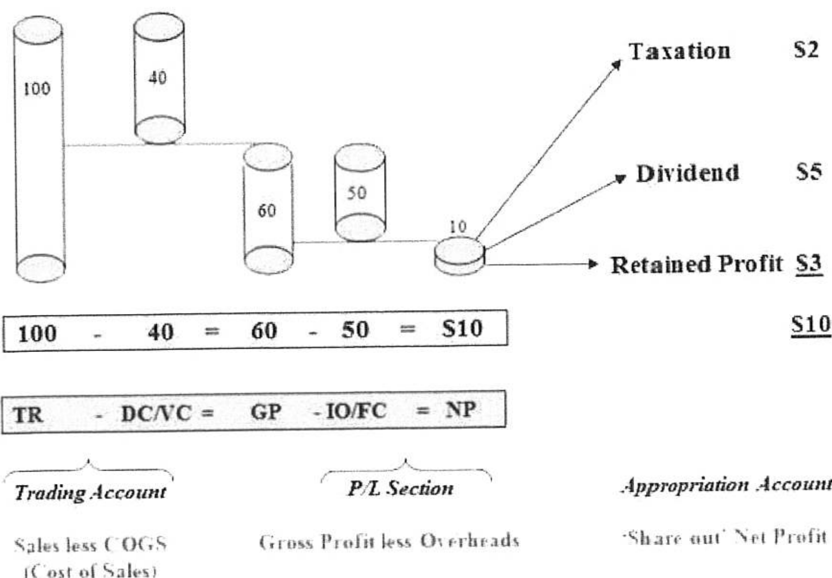
This records how the net profit is distributed (or appropriated). There are three possible uses of net profit:

1. **Taxation** – the government claims *corporation tax.*
2. **Dividends –** the shareholders receive a share of the profits determined by the board of directors.
3. **Retained profit** – what remains after tax and dividends are paid. Used to fund future expansion.

It is unlikely that these will be paid in the current year so they are transferred to the end of year balance sheet. Tax and dividends become *current liabilities* and retained profit is added to the *capital and reserves* section.

The meaning of profit

When discussing profit, an important question to ask is - which profit? The profit and loss account identifies



three types of profit:

Gross profit

This is simply 'sales *less* cost of goods sold' and is the difference between the buying in price and the selling price.

Net profit before interest and tax (NPBIT)

NPBIT is gross profit after deducting the costs of running the business, such as the costs of labour etc., but not interest or taxation. This is used for performance ratios, because management has no control over interest and taxation. If tax was 100% there would be no profit, which would not be management's fault.

Net profit after interest and tax (NPAIT)

Tax and interest have been deducted, leaving a figure of interest to the shareholder, because this is the pot from which dividend is paid.

The IB required format for the profit and loss account

Arben Ltd

Profit and loss account for Arben Ltd for the year ended 31 May 20**

	$m
Sales revenue	950
Cost of goods sold	350
Gross profit	600
Expenses	200
Net profit before interest and tax	400
Interest	10
Net profit before tax	390
Tax	30
Net profit after interest and tax	360
Dividends	160
Retained profit	200

The Balance Sheet

Like a ***still photograph***, the balance sheet is a financial snapshot of a business at a point in time. This could be misleading as the financial position may be different a week later. The real meaning is not evident unless compared with previous years' balance sheets (showing changes in the firm's financial position over time) or with the balance sheets of similar and/or competing firms.

A balance sheet provides two 'photographs' separated by 12 months. The final figures from the previous year's balance sheet acts as the starting point for the current year and the current balance sheet figures represent the end point. This may show some significant differences, but like the first and last pages of a book it leaves out quite a lot of action in between!

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What the balance sheet shows

A balance sheet shows:

- The value of the capital a firm is using
- Where the firm obtained its funds – its *sources*
- Where these funds were spent – its *uses*

Any transaction involves a 'giving' and a 'receiving'. If you spend $1 on an ice-cream, you give $1 and receive a good in return worth $1. If you draw up an account to record this transaction the value of the 'giving' side of the account will equal the 'receiving' side of the account. The balance sheet works on the same principle. It shows where the firm obtains all of its funds (sources) and where these funds went (uses). It must, therefore, balance!

The balance sheet represents a valuation of the firm's ***assets*** and ***liabilities*** at a particular time - a *snapshot* of the business's wealth.

Assets are anything, tangible or intangible, that is capable of being owned by, or owed to, a business. Assets produce value and have a positive economic value, as they can be converted into cash (also an asset). Tangible assets include current assets and fixed assets.

Examples: land, buildings and stock.

The firm obtains its funds from shareholders (***shareholder capital***) or borrows them from external organizations such as banks (***liabilities***). It uses these funds to purchase the *factors of production* required to produce goods and/or services.

Liabilities are financial obligations, debt or claims on the business. These are anything owed by the business when the balance sheet is prepared. Liabilities can be classified as long-term or current.

Examples: mortgages, bank loans and creditors.

Net assets are the value of the total assets less current liabilities. The word net is used always to refer to something *less* something else. Net assets measure the value of the assets after liabilities have been paid.

Sources of finance – explains where the money to fund **Net Assets** has been sourced, e.g. share capital and retained profits.

Assets

Fixed assets are things the firm owns, that have a lasting value and are not intended for sale. They have a life lasting for more than one year, e.g. land, buildings, equipment, furniture and fittings and vehicles. These are presented in order of permanence.

Current assets are things do not have a lasting value and a short life as they will normally be turned into cash within a year, e.g. stock, debtors and cash. These are presented in *order of liquidity*.

- **Cash** does not literally mean coins and notes, but any credit balances, e.g. cash in hand or cash in the bank.
- **Debtors** represents a debt owed to the business, because customers have bought goods or services on credit.
- **Stock** e.g. unprocessed stock, such as raw materials, semi-processed goods (work-in-progress) and finished items.

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Liabilities

Current liabilities - short-term liabilities that are paid quickly; usually within one year, e.g. creditors, overdrafts, short-term loans and debentures:

- An **overdraft** is a borrowing **facility** granted by a bank. The firm can overdraw up to an **agreed limit** over a period of time. Interest is charged on any overdrawn amount.
- **Creditors** are people and firms to whom the business owes money, e.g. suppliers.
- **Short-term loans** are expected to be repaid within a year.
- **Net current assets or working capital** - WC (NCA) = CA - CL.

Working capital is liquid funds used for day-to-day requirements, e.g. for paying bills and wages.

Long term liabilities (debt) – Debts or loans that are repaid in more than a year, e.g. bank loans or debentures.

Net Assets - calculated as total assets (fixed assets + current assets) minus current liabilities.

FA + (CA – CL)

Represents the **net** value of all the assets the firm owns.

Financed by - where the company got the funds to purchase its net assets, e.g. shareholders' funds (share capital and retained profits) and long-term loans (debt).

- **Share capital** – face value of the shares that have been sold - the original owner paid to the company (not the market price for the shares).
- **Retained profit** – profit made that has not been paid out as tax or dividends, but reinvested to fund growth. This belongs to the shareholders.

The following equation describes how a balance sheet 'works'. Once you know, and understand this, you are on the way to understanding balance sheets.

FA + [CA – CL] - LTL = SF

Fixed assets + [current assets – current liabilities] (net assets) - Long term liabilities = shareholder's funds + reserves (capital employed)

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The IB required format for the balance sheet

Arben Ltd: Balance sheet as of May 20**	$m	$m
Fixed assets		
Fixed assets	700	
Accumulated depreciation	40	
Net fixed assets		660
Current assets		
Cash	20	
Debtors	25	
Stock	60	
Total current assets	105	
Current liabilities		
Overdraft	15	
Creditors	32	
Short-term loans	18	
Total current liabilities	65	
Net current assets (working capital)		40
Total assets less current liabilities		700
Long-term liabilities (debt)	450	
Net assets		250
Financed by:		
• share capital	180	
• retained profit	70	
Equity		250

✓ Intangible assets *(AO1)*

Assets are things of value. The treatment of intangible assets in balance sheets is more difficult.

Tangible assets are real and touchable and have a market value that can be generally agreed, e.g. land and buildings.

Intangible assets are non-physical assets, but have value; indeed they may be the most valuable asset a firm possesses, e.g. the Coca Cola brand is virtually priceless. Putting an exact value on an intangible asset is difficult and may not be established until sold.

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Intangible assets appear in the balance sheet in the Fixed Asset section. They include:

- **Goodwill**. The good name and reputation of the business, its public image and customer base and its existing products. Goodwill only arises when a business is sold and its value is what the buyer is pays, over and above the value of its other assets.
- **Patents and copyrights**. *Patents* are legal documents designed to protect an invention against copying by other businesses for up to 20 years. *Copyrights* protect the *ideas* of authors, artists and composers. The value of patents and copyrights should be recorded in the balance sheet.
- **Trademarks and brand names**. Trademarks representation the firm in the form of symbols, images and logos, which are instantly recognisable and provide a shorthand identity for a firm, such as the 'Golden Arches' of McDonalds. They generate significant sales, so firms protect trademarks by registering them. Brand names have a similar value and function.

✓ Depreciation *(AO2/AO4)*

Depreciation is a non-cash expense that reduces the value of an asset as a result of *wear and tear* or *obsolescence*. Most assets lose their value over time (depreciate), and must be replaced at the end of their useful life. Depreciation lowers the company's reported earnings, but it does not involve a cash outflow in the way other expenses do. Depreciation is an allowance and is effectively subtracted from the balance sheet and added to the profit and loss account as a cost or expense. No money actually moves; it is merely an accounting entry.

Not all fixed assets are depreciated. Property is likely to *increase* in value or ***appreciate***. Firms periodically revaluing these assets in the balance sheet to reflect market value.

Main methods to calculate the depreciation of fixed assets:

- *Straight line method*
- *Reducing balance method*

Straight-line depreciation (SLD)

SLD is most commonly used as it is easy to calculate. Once the annual depreciation provision is calculated, it remains the same for each year. The formula is:

$$\text{SLD} = \frac{\text{Historic Cost} - \text{residual (scrap) value}}{\text{Estimated life of the asset}}$$

Example

The scrap value (residual value) is an estimate.

A delivery vehicle was bought for $25,000. The firm plans to keep it for five years and then trade it in for $3,000 (in effect the scrap value).

***Depreciation charge*:**

$$\frac{\text{Cost (\$25,000)} - \text{Scrap value (\$3,000)}}{\text{Lifespan in years (5)}} = \frac{\$22,000}{5} = \$4,400 \text{ each year for 5 years}$$

This charge appears in *the profit and loss account* as an expense reducing the profit for five years running. The *balance sheet value* would reduce by the depreciation provision each of the five years – the asset's value falls each year by $5,000 for five years until the assets has no value.

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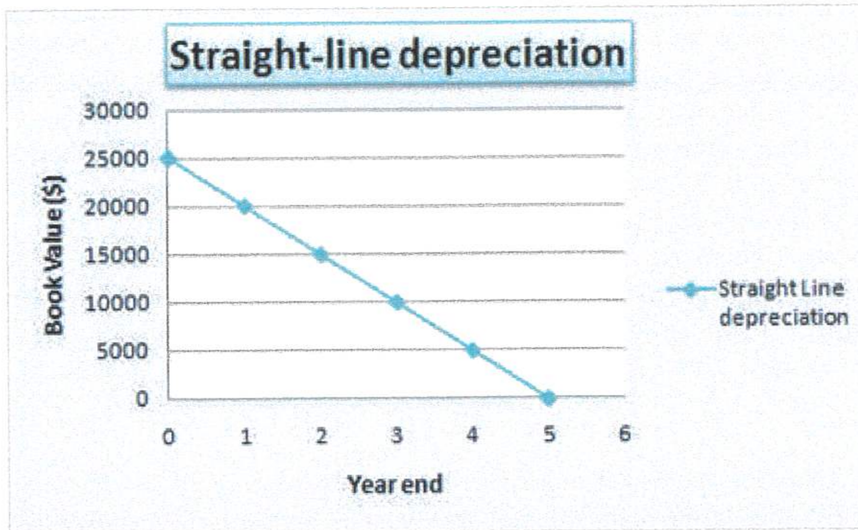


Straight-line as a percentage

It is common to express straight-line depreciation as a percentage showing how long the asset is expected to last, e.g.

- 10% - 10 years
- 20% - 5 years

Reducing (declining) balance method

The annual depreciation is based on a percentage of the ***asset's net book value*** (i.e. what the asset is worth in the firm's accounts), calculated as follows:

- *Net book value = original cost – accumulated depreciation*

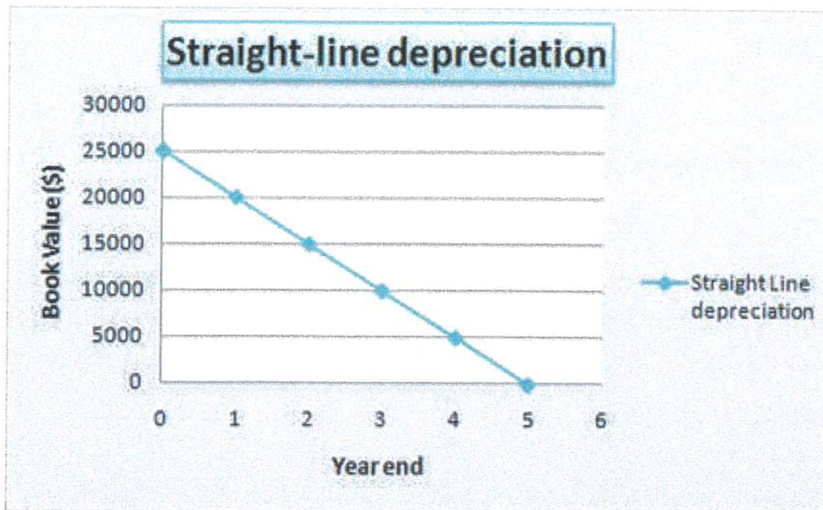
As the depreciation charged against an asset builds up over time, the net book value decreases. Although the percentage used remains constant, the depreciation charge (in $) will become smaller over time. This method is also known as the *diminishing* or *declining balance* method.

Example

Equipment is bought for $40,000 with a residual value of $6500. The depreciation is to be charged at approximately 30% per annum. The calculations for the first three years are as follows:

	$
Cost	40,000
First year depreciation (30% x $40,000)	12,000
Net book value after first year	28,000
Second year depreciation (30% of $28,000)	8,400
Net book value after second year	19,600
Third year: depreciation (30% x $19,600)	5,880
Net book value after third year	13,720
Fourth year depreciation (30% of $13,720)	4,116
Net book value after fourth year	9,604
Fifth year: depreciation (30% x $9,604)	2,881
Net book value after fifth year	6,723

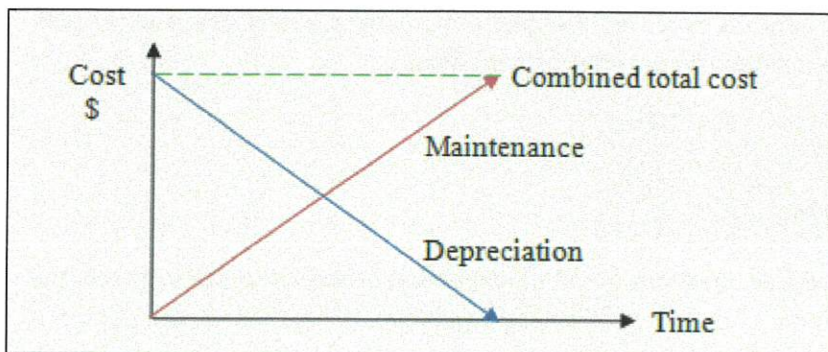
The depreciation is charged until the asset loses all of value. *If there is a scrap value, this method depreciates the value down to the scrap value, rather than to zero.*



✓ Choice of method: strengths and weaknesses *(AO2)*

With the reducing balance, the depreciation provision per year starts off relatively large and becomes gradually smaller. It is a more realistic asset valuations – assets do lose more of their value in the earlier, rather than the later years.

The cost of a machine or vehicle is made up not just of the purchase price, but also the maintenance costs. When the asset is new, maintenance costs are low, but depreciation charge is high. When the asset is older, maintenance costs tend to increase, but depreciation charges fall. The combined value of depreciation *plus* maintenance is relatively constant using reducing balance.



3.5 Profitability and liquidity ratio analysis

A ratio is a mathematical relationship between one figure and another. Financial ratios are relationships between quantities taken from the accounts.

If sales this year are $20m and profits $5m, this information has limited meaning. What is required is a relative comparison. Financial ratios do this, but are only significant when ***compared to other ratios***. Single balance sheets and profit and loss accounts tell us very little. In practice, comparison is between *different years* and *between* the *firm and its competitors* or *industry averages* (***inter-firm comparisons***).

✓ Profitability and efficiency ratios *(AO2/AO3/AO4)*

Profitability ratios

Profitability measures performance and effectiveness, comparing profit to something else, telling the stakeholder if profit is sufficient or adequate.

Profit margins

We compare profits with sales revenue in ***two main*** ways:

Gross profit margin

This ratio compares a firm's gross profit to its sales revenue; in other words the percentage of the selling price that is gross profit and available to pay the firm's overheads. 20% is a benchmark for many industries. Gross profit margin is the firm's *mark up* on the items it buys in.

$$\text{Gross profit margin} = \frac{\text{Gross profit}}{\text{Sales revenue}} \times 100$$

Firms that turn stock over quickly may operate with relatively low gross profit margins. In a hypermarket, the gross profit margin on clothing is higher than on food.

If the ratio is falling, it might mean higher cost of sales have not been passed on to customers in higher prices. A firm may improve its margin by *reducing the direct costs of sales* (changing suppliers) or by *increasing price.* Increasing prices may lead to lower sales if customers are price sensitive.

Net profit margin

This ratio calculates the percentage of a product's selling price that is net profit, expressed as a percentage. It is a better measure of a firm's performance than gross profit margin, as it includes all operating expenses and measures how successfully the firm controls expenses. A higher percentage is preferable, and may be achieved by raising sales revenue, while maintaining or reducing expenses.

$$\text{Net profit margin} = \frac{\text{Net profit}}{\text{Sales revenue}} \times 100$$

A comparison of the two profit margins raises questions about management efficiency. If, for instance, the gross profit was improving at the same time as the net profit margin declined, this points to poor control of expenses (increasing overhead costs).

Efficiency ratios

Efficiency ratios tell shareholders how effectively the firm is using their money. Firms try to get as much turnover from its assets as possible.

Return on capital employed (ROCE)

Known also as the **primary efficiency ratio,** this is regarded as the most important ratio.

$$\text{ROCE} = \frac{\text{Net profit before interest and tax}}{\text{Total capital employed}} \times 100$$

The ratio uses *net profit before interest and tax* (NPBIT), because this value is controllable by the management, unlike profit after interest and tax.

Total capital employed is given by the formula:

- **Shareholders' funds *plus* long-term liabilities**

The higher the ratio the better, as ROCE measures profitability. If the ROCE is less than interest rates, shareholders are better leaving their money in the bank.

In manufacturing, a benchmark ROCE is in excess of 10% and in retail, lower figures would be experienced, ranging between 5% and 15%. However, it will depend on a number of factors, such as the:

- Industry
- State of the economy
- Interest rate
- Size and age of the firm
- Requirements of the firm

Like other ratios, ROCE should be compared over time. A ROCE of 20% appears acceptable, but if the firm historically achieves over 30%, it would not.

If the ROCE is falling, the firm may:

- Increase profit generated using the same level of capital, by increasing efficiency
- Maintain the profits generated using less capital

Examiner Tip!

The ROCE can also be considered to be a *profitability ratio*, because it measures the efficiency with which the firm generates *profit* from the funds invested.

✓ Liquidity ratios *(AO2/AO4)*

Liquidity is the ability of a firm to meet its liabilities and pay its bills. A firm is liquid if it can pay its bills, illiquid if it cannot. Liquidity ratios measure the short term *financial health* of the business.

Working capital is the *lifeblood* of an organization:

- Too little and the firm may not be able to pay its debts, which may end in closure
- Too much shows the business is not using financial resources efficiently

There are **two liquidity ratios:**

1. Current ratio
2. Acid test ratio

Current ratio

The current ratio reflects the firm's working capital position and its ability to pay its short-term creditors from the realisation of its current assets without selling any fixed assets.

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The current ratio is simply the ratio of all current assets to current liabilities:

(Stock + debtors + cash) / (Creditors + overdrafts + short-term loans)

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} \times 100$$

Ideally the figure should be greater than 1, indicating sufficient assets to pay liabilities. The rule of thumb is between 1.5 and 2.0. In other words, for every $1 of debts the firm will have between $1.50 and $2 in current assets to pay for these. The higher the figure, the more liquid the business, but too high a figure indicates it may not be investing sufficiently in higher earning assets.

The current ratio includes stock, which may include redundant stock. It is best to ignore stocks, when looking at liquidity.

Acid test ratio

The acid test ratio is the strictest test of liquidity.

$$\text{Acid test ratio} = \frac{\text{Current assets less stock}}{\text{Current liabilities}} \times 100$$

OR

$$\text{Acid test ratio} = \frac{\text{Cash plus debtors}}{\text{Current liabilities}} \times 100$$

This ratio measures the risk of bankruptcy, which increases as the value of the ratio falls. A value of 1.0 is considered satisfactory, because the firm has sufficient liquid assets to meet its liabilities. Much below 1.0 is generally dangerous, whilst ratios above 1.0 may be a sign of poor cash management.

This ratio is industry dependant. Major supermarket may have seemingly 'poor 'acid test scores, but quick stock turn and good credit terms ensure adequate liquidity.

✓ How can a firm improve its liquidity ratios? *(AO3)*

To increase a liquidity ratio, a firm must increase its current assets other than stock; reduce its current liabilities, or both.

- **Increase current assets** – current assets are stock, debtors and cash. Increasing cash levels may be achieved by higher overdraft levels, loans, share issues or selling assets.
  Current assets should be made as liquid as possible, e.g. customers are pressed to pay outstanding accounts.
  To improve the acid-test ratio, stock should be reduced and sold for cash. The firm may implement a just-in-time stock control system.

- **Decrease current liabilities** – short-term loans and overdrafts may be rescheduled and converted into long-term loans, dividends may be cut and creditors' payment terms re-organized.

3.6 Efficiency ratio analysis

✓ The following ratios are measure of efficiency *(AO2/AO4)*

Inventory/stock turnover

This ratio measures a firm's success in converting stock into sales. The ratio uses the cost of goods sold (cost of sales), without any profit margin. If the firm makes a profit on each sale then the faster it sells stock, the greater the profit it earns.

Too high a stock turn may indicate that a firm cannot match customer demand, which may lead to dissatisfaction and lost sales.

Stock turnover levels vary between companies and industries. A fruit seller may sell total stock every one or two days – approximately 110 times per year. A plane manufacturer will have lower stock turn, but the profit on one plane is far higher than on one apple!

$$\text{Stock turnover} = \frac{\text{Cost of goods sold (COGS)}}{\text{Average stock}} = \text{times}$$

OR

$$\text{Stock turnover} = \frac{\text{Average stock}}{\text{Cost of goods sold}} \times 365 = \text{days}$$

The first equation measures how many times in a period (usually the financial year) the firm turns over its stock. If you imagine a cupboard full of products, then stock turn is the number of times the entire contents of the cupboard is sold.

The second equation shows the time, in days, to turn over the total stock – or to the time taken to sell the content of that stock cupboard. Firms only earn profit when they sell goods, so firms want the lowest possible figure, allowing it to restock and sell again. The ratio can be improved by holding less stock or by increasing sales.

Debtor days

Debtors are customers, who owe the firm money for products bought on credit. Debtors have the firm's products, but are yet to pay, so should be carefully controlled. However, better credit terms may result in higher market share.

This ratio represents the average time, in days, taken to collect trade debts and provides feedback on debt management. If debtors take too long to pay, the firm may experience difficulty paying its debts.

$$\text{Debtor days} = \frac{\text{Debtors}}{\text{Sales revenue}} \times 365 = \text{days}$$

Some debtors will never pay, so are 'written off'. This 'improves' the ratio, but reduces the asset value of the firm.

Creditor days

This ratio measures the length of time it takes the firm to pay its creditors. In general, the firm should maximise the period it takes to pay its debts. In this way, it has the products required, but still has the money for these in its bank account gaining interest.

$$\text{Creditor days} = \frac{\text{Creditors}}{\text{Total credit purchases}} \times 365 = \text{days}$$

A high creditor days figure may indicate that the firm is losing out on discounts for early repayment. It is important to place this ratio in the context of the industry in which it operates, e.g. food retailers have lower creditor days' ratios than manufacturers.

Note: *There should be a link between debtors' days and creditors' days. Creditors' days should be at least as long (or short) as the debtor's days. One can finance the other.*

Gearing ratio

Once operating, businesses have two main sources of funds for investment:

1. **Loans** capital from banks, and other institutions **(Debt)**
2. **Share capital** and **reserves,** including **retained profit (Equity)**

Most firms use a mix of borrowed capital and their own finance. There are advantages and disadvantages to both sources.

	Advantages	Disadvantages
Loan capital	Once repaid, still have the assets bought with no more charges to be met.	Have to pay interest, even if there is no profit. Interest payments reduce profit.
Share capital	No interest. Dividends optional.	Share issues to raise capital can be costly. The number of shares that can be sold is limited.

Share capital and retained profits are free of fixed charges; only dividends need to be paid. However, this form of capital is restricted and relying on it alone may slow growth.

The balance between loans and share capital is important. Gearing measures the proportion of *capital employed* that is provided by long-term lenders.

The gearing ratio is sometimes known as ***the debt equity ratio***.

$$\text{Gearing ratio} = \frac{\text{Loan capital}}{\text{Total capital employed}} \times 100$$

Loan capital is all monies that have been borrowed and where interest must be paid. It does not include debtors or creditors; they are interest free.

The gearing ratio value can vary between 0 and 100%. What do individual results mean?

Value	Meaning
0 – 25%	Probably too low. Growth may be being slowed by a lack of capital.
25 – 75%	Acceptable range
75% +	Possibly too high. Any rise in interest rates could increase interest payments significantly and lead to liquidation.

A firm is ***highly geared*** if the gearing ratio is ***over 50%*** - loans represent more than 50% of capital employed. The higher the gearing ratio: the higher the ***degree of risk***.

A lower geared company offers lower risk investment and can negotiate additional loans more easily and at a lower interest rate.

✓ Possible strategies to improve these efficiency ratios *(AO3)*

Ratios are like symptoms of a disease (or of health). If the business is improved, the ratio values will reflect this improvement.

- **Asset turnover**: get sales up, assets down, or a combination of both.
- **Stock turnover:** get sales up, stock down, or a combination of both.
- **Debtor days:** get debtors down, sales up, or a combination of both.
- **Gearing:** if too low, borrow more money provided there is a suitable investment. If too high, attempt to pay off some loans or raise more share capital.

3.7 Cash flow

✓ The difference between profit and cash flow *(AO2)*

Profit is the positive difference between a firm's sale's revenue and its total costs of production. The fact that a company is profitable does not guarantee it will be solvent and it may still run out of cash. It is often assumed that at the end of the year, a sum equal to the firm's profit, is in the bank account and can be used to pay bills. In practice, profits are usually tied up in the firm and in some other form of asset other than cash.

A firm may be profitable, but short of cash because:

- Sales are on credit shown in the profits, but the cash may not appear for months.
- The firm may have invested heavily in high-cost capital items, impacting negatively on the cash position.
- The firm may have invested in stocks, with cash outflow occurring when purchased.
- Some items are paid for in advance, but do not appear as a cost until later.

Examiner Tip!

Cash is **not** the same as profit. A firm may be making losses, but is 'cash rich' or alternatively may be very profitable, but suffering from liquidity problems.

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Case study

Body Shop and Bowater Scott

Body Shop expanding rapidly through the use of franchising. Every new franchise required training, new equipment, marketing and supplying. Body Shop was very *profitable,* but suffered a *cash flow* problem as cash was tied up in new franchises.

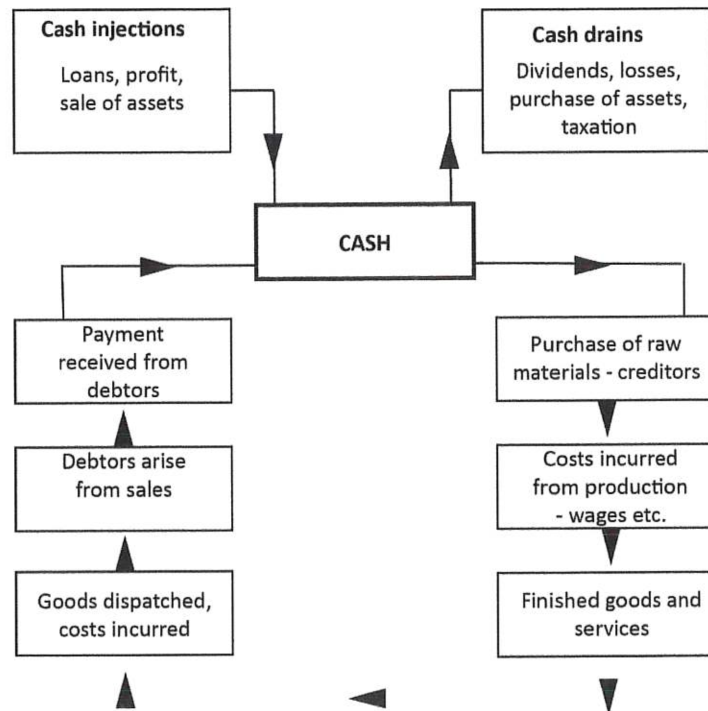
Bowater Scott, a paper manufacturer made heavy *losses* and decided to sell loss-making divisions, resulted in a large *pile of cash*, despite its losses.

✓ The working capital cycle *(AO2)*

The accounting definition of working capital is:

Working capital = Current assets – current liabilities **Stock + debtors + cash** **minus** **Creditors + overdrafts + short-term loans**

There is often a significant delay between paying out for raw materials and labour to produce the goods or services and the receipt of cash from the sale of those goods. This means that working capital (net current assets) needs to be carefully managed. This time lag between paying out cash and receiving cash from sales is termed the working capital cycle and is shown in figure below.



Working capital cycle

At the top are cash injections and drains to the business. Cash may come in from loans, overdrafts, and profit or perhaps from the sale of assets. However, cash can be lost to government (taxation), shareholders (payment of dividends) or the purchase of assets. These cash drains and injections are shown separately, as they are independent of production and sale.

To produce, the firm has to buy raw materials, so cash is lost to suppliers, depending on the credit period offered. Further cash is lost to workers pay, productions costs and the distribution of goods. Even when goods are sold, cash will not come in immediately, as they may be sold on credit terms creating debtors, but not cash. Only when debtors pay is the cycle complete and cash returned.

This time lag between cash going out and coming in needs careful management to prevent insolvency.

✓ Cash flow forecasts *(AO2 / AO4)*

Firms usually exist to make a profit, but they must monitor their cash flow position to ensure they can pay bills, supplier costs and wages.

KEY TERMS

A cash flow forecast is an estimate of the timing and amounts of cash inflows and outflows into an organization over a specific period, usually one year.

A **cash forecast** contains three main elements:

1. **Cash inflows** from cash sales, debtor payments, interest received, bank loans, rent payments and disposal of assets.
2. **Cash outflows** occur when the organization pays creditors, makes cash purchases, buys assets, pays taxes, wages and rent and any other cash expenses.
3. **Net cash flow** is the difference between cash inflows and cash outflows. Ideally, this should be positive, although organizations can survive negative cash flows if they find alternative cash sources, e.g. an overdraft.

A profitable business may run out of cash – this is called *insolvency*, e.g. by selling output with long credit periods or tying up funds in new assets. Many business failures result from lack of cash, especially new businesses. Too little cash results in the following:

- Non-payment of suppliers
- Discounts lost for late payment
- Wages and salaries delayed causing poor motivation, high labour turnover and absenteeism
- New capital assets unaffordable
- Unpaid taxes

Examiner Tip!

A positive cash flow is ***not*** profit and a negative cash flow is ***not*** a loss. Do not use these terms interchangeably.

Managing cash flow

To manage cash flow, a firm should assess:

- The size and timing of cash flows into the business
- The size and timings of cash flows out of the business
- Additional sources of finance to cover short term cash needs

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Cash-flow forecast

A cash-flow forecast is an attempt by management to prevent future liquidity problems. Each month a firm estimates the amount of cash entering and leaving the business and whether this will result in a cash deficit (overdraft) or surplus. If an overdraft is predicted, the managers will have to consider solutions. These could include:

- Arranging an overdraft
- Arranging a longer term loan
- Rescheduling payments or considering alternative purchase solutions, e.g. Hire purchase
- Selling assets or postponing purchases
- Finding cheaper suppliers
- Reducing credit terms for customers or lengthening credit terms with suppliers

Some businesses are highly seasonal, e.g. tourism, so firms in these industries may experience cash-flow problems. Making arrangements with banks to cover these periods will reduce insolvency risks.

Key terms in a cash flow forecast:

- Opening cash balance[1] for each month is the closing cash balance for the previous month.
- Total cash inflows[2]: are all the cash inflows for a particular month.
- Total cash outflows[3] are the sum of all the cash outflows for a particular month.
- Net cash flow[4] is the difference between the total cash inflows and the total cash outflows.
- Closing cash balance[5] is calculated by adding the net cash flow of a particular month to its opening balance.

Example

A typical cash-flow forecast

New Horizon Holidays

Cash flow forecast year ($000s)

Month	Jan.	Feb.	Mar.	Apr.	May	June	July
Receipts/inflows							
Cash sales	100	120	240	280	430	500	**540**
Payments from debtors	50	100	100	140	200	340	**450**
Other (loan received)					80		
Total cash inflows[2]	150	220	340	420	710	840	**990**
Payments/outflows							
Labour	20	40	50	60	100	180	**200**
Flights	40	75	90	100	180	190	**210**
Hotel bookings	30	80	120	140	250	260	**300**
Interest		20			20		
Advertising	5	30	30				
Electricity	15			15			**15**
Rent	50			50			**50**
Salaries	50	50	50	50	50	50	**50**
Purchase of fixed assets				60			
Total cash outflows[3]	210	295	340	475	600	680	**825**
Net cash flow[4]	(60)	(75)	(0)	(55)	110	160	**165**
Opening cash balance[1]	70*	10	(65)	(65)	(120)	(10)	**150**
Closing cash balance[5]	**10**	**(65)**	**(65)**	**(120)**	**(10)**	**150**	**315**

* January's opening balance of $70,000 is the closing cash balance from December, and January's closing balance of $10,000 becomes the opening balance of February

Examiner Tip!

Examiners like to add complications to cash flows. The most common are:

- It is common practice for firms to buy and sell products on credit. The examination question may give a table of sales or purchases, but say that the credit term is one month, so the cash inflow occurs one month later, e.g. goods received in January are paid in February:

	Jan	Feb	March	April	May	June	July
Good received ($000)	20	30	30	25	40	50	
Payment - cash outflow		20	30	30	25	40	50

- Asset purchases made in instalments
- Payments, such as electricity, payable every quarter

Figures in brackets are negative, i.e. negative cash flow.

✓ The relationship between investment, profit and cash flow *(AO2)*

A liquidity crisis

A *liquidity crisis* may be caused by a number of factors:

- **Overstocking** which ties up liquid funds.
- **Over borrowing** creating significant interest payments.
- **Unexpected changes in the external environment,** e.g. seasonal variations.
- **Poor credit control** causing liquidity issues, especially when debts 'go bad'
- **Overtrading** when a firm expands without securing the necessary long-term finance. Although profitable when sold, production ties up liquid funds in assets such as work-in-progress and storage, as well as production expenses. A liquidity crisis may prevent completion of the order.

✓ Strategies for dealing with cash flow problems *(AO3)*

There are four ways to improve liquidity:

1. Improve cash inflow
2. Reduce cash outflow
3. A combination of both improved cash inflows and reduced cash outflows
4. Alternative sources of finance

Increasing/speeding up cash inflow

- **Control credit** – reduce the amount of credit and repayment period. However, customers may simply change supplier. Alternatively, the firm may offer improved discounts for early repayment.
- **Improve marketing** – any change in the marketing mix, such as lower prices or increased advertising may lead to increased sales and/or reduced stock levels and improved cash inflows. The disadvantage is that profit margins will fall and it requires customers to be price sensitive.

- **Credit management** – a specialist department monitors debts and ensures they are paid promptly by sending out reminder letters and taking legal action if necessary.
- **Factor debts** – a firm sell its debt book to a factor company that pays up to 85% of its value. This improves liquidity, but reduces potential profit.

Decrease/delaying cash outflows

- **Negotiating longer credit periods** from existing suppliers or changing to new suppliers offering better terms.
- **Delaying payment of debts** - the disadvantage is possible legal action by suppliers, which affects the firm's reputation reduces the number of suppliers willing to supply.
- **Leasing equipment** or buying it on **hire purchase**, rather than purchasing it outright thus spreading costs over a longer period.
- **Renting property** rather than buying it.
- **Better stock control** by introducing just-in-time production when raw materials are delivered as required.
- **Reduce costs and/or postpone expenditure** – eliminate waste and delay replacement of assets, such as vehicles.

Additional sources of finance

- **Sale and leaseback** – the firm sells an asset, such as its headquarters, to a company that then leases it back. This releases cash from the asset, but increases future costs.
- **Overdraft facility** – the firm arranges an overdraft to cover periods of poor liquidity. Common in seasonal industries.
- **Sales of fixed assets** – the firm sell assets to pay bills, reducing operational capacity. Alternatively, it sells assets surplus to requirement.
- **Short term bank loans** – the firm negotiates short-term loans to reduce the cost of running expensive overdrafts.

3.8 Investment appraisal

KEY TERMS

Investment means postponing present consumption to increase future returns. In a business sense this involves the purchase of capital equipment, such as machinery, with the objective of increasing future output, sales revenue and profit.

Finance available to firms is limited and they must choose how to spend this finance to obtain the best return on investment. They may have to choose between:

- Launching one product or another
- Between different locations
- Buying one piece of equipment or another

Investment appraisal is a quantitative technique used to avoid relying on 'hunch' decision making. Not only is it used to choose between projects, but also to rank investments in terms of financial returns.

Investment appraisal requires two main pieces of information:

1. The **capital cost** of the project
2. The **value of the project** (what cash will it bring in?)

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Like other tools in the business management toolbox, investment appraisal should be used in combination with other tools. Non-financial information may be as important in decision making as financial outcomes.

✓ Investment appraisal techniques (*AO3/AO4)*

Example

Investment appraisal

Student Computers plc are trying to decide between two expansion projects. It has the following data available from the projects department. All units are $000's.

	Net cash inflow ($000)	
Project A		Project B
50	Year 1	100
100	Year 2	300
150	Year 3	500
200	Year 4	300
100	Year 5	200

Project A has a capital cost (in year 0) of $400k
Project B has a capital cost (in year 0) of $700k

Which project is best, or should Student Computers decide to do neither?

✓ Payback period (AO3/AO4)

KEY TERMS

Payback period is a method of investment appraisal that estimates the time period taken to recover the initial cash outlay on an investment. Although simplistic, it is the most popular method of investment decision making.

Payback is calculated using the formula:

$$\textbf{Payback period} = \frac{\textbf{Initial investment cost}}{\textbf{Annual cash flow from investment}}$$

This can be used when the annual return is the same each year:

A distribution company plans to invest $100,000 in a new lorry, which will generate an additional $25,000 per annum in cash flow.

$$\textbf{Payback period} = \frac{\$100{,}000}{\$25{,}000} = 4 \text{ years}$$

An investment may generate varying annual cash inflows. Here, the firm uses a cumulative technique to calculate payback.

Cumulative cash flow method of payback

Cumulative data is generated by adding up the annual returns.

Project A ($000)
50
100
150
200
100

So the ***cumulative returns*** at the end of each year are:

Year Cumulative

$000

1 50

2 150 (50 + 100)

3 300 (50 + 100 + 150)

4 500 (50 + 100 + 150 + 200)

5 600 (50 + 100 + 150 + 200 + 100)

Payback period method – this converts the net cash flow data to cumulative net cash flow and establishes when cumulative net cash flow is the same as the capital cost - when the project repays the capital cost.

Project A			Project B	
Cost: 400	Payback reached?	Capital cost ($000)	Cost: 700	Payback reached?
		Cumulative net cash inflow ($000)		
50	No	Year 1	100	No
150	No	Year 2	400	No
300	No	Year 3	900	Yes
500	Yes	Year 4	1200	
600		Year 5	1400	

The cost of project A is covered by the end of year 4, and Project B cost covered by the end of year 3. We then calculate when the payback occurs within the year.

- **Project A** pays back between 3 and 4 years. At the end of the third year Student Computers need an additional $100 000 to payback their investment. A total of $200 000 in cash inflows are expected in the fourth year, so:

  Payback period = 3 + 100/200 = 3.5 years (i.e. 3 years and 6 months)

- **Project B** pays back between years 2 and 3. At the end of the second year, Student computers need an additional $300 000 to payback their investment. A total of $500 000 in cash inflows are expected in the third year, so:

  Payback period = 2 + 300/500 = 2.6 years (i.e. 2 years and 7.2 months)

Firms will often set ***criteria*** in advance for undertaking a project. For instance, Student Computers may state that only projects paying back within 3 years are undertaken - only Project B would be acceptable.

On a financial basis, Project B is preferable as it pays back quickest, but it may also consider non-financial factors or liquidity issues. If the firm's cash flow is poor, it may select the project that pays back the quickest, even if other factors suggest it is not the best in the long-run.

Benefits of payback method

- Easy to calculate and understand
- Includes the cost of the investment
- Focuses on short-term cash flow

Limitations of payback period

- Not a measure of profit
- Ignores all cash flows after the payback point
- Ignores the pattern of cash flow
- Ignores the 'time value' of money
- Encourages a short-term view

✓ Average rate of return (ARR) *(AO3/AO4)*

The **average rate of return (ARR),** or *accounting rate of return*, method of investment appraisal ***measures the annual income of a project as a percentage of the total investment cost***, which payback does not. It measures average profit, expressed as a percentage. The result is compared with returns from alternative uses of funds, e.g. interest rates.

The firm usually sets an investment criterion, e.g. any project with less than 5% return is rejected.

ARR – The three main steps

The net return is measured each year as a percentage of the initial cost of the investment.

$$\text{Average rate of return (\%)} = \frac{\text{Net return (profit) per annum}}{\text{Capital outlay}} \times 100$$

Three projects have the following costs and expected income:

	Project A ($)	Project B ($)	Project C ($)
Cost	50,000	40,000	90,000
Return			
Yr 1	10,000	10,000	20,000
Yr 2	10,000	10,000	20,000
Yr 3	15,000	10,000	30,000
Yr 4	15,000	15,000	30,000
Yr 5	20,000	15,000	30,000
Total	70,000	60,000	130,000

STEP 1. Calculate the total net profit from each project by subtracting the total return of the project from its cost.

i.e. $70,000 - $50,000 = $20,000 for project A.

STEP 2. Calculate the net profit per annum by dividing the total net profit by the number of years the project runs for.

i.e. $20,000 ÷ 5 = $4,000 for project A.

STEP 3. Calculate the ARR using the following formula:

$$\textbf{ARR (project A)} = \frac{\$4,000}{\$50,000} \times 100$$

$$= 8\%$$

Benefits of ARR

- Measures profitability
- Uses all cash flows
- Easy to understand
- Easy to compare percentage returns with other investment opportunities

Limitations of ARR

- Ignores the pattern of cash flow
- Later cash flows are unlikely to be accurate as they are forecasts
- Length of the project or life span of a machine are estimated
- Ignores the timing of cash flows
- Ignores the 'time value' of money
- Ignores the risk factors associated with a long payback period on liquidity

✓ Investment opportunities using net present value (NPV) *(AO3/AO4)*

Discounted cash flow (DCF) and net present value (NPV)

KEY TERMS

Discounted cash flow (DCF) analysis is a method of valuing a project, company, or asset using the concepts of the ***time value of money***. DCF is used to calculate the value of future cash flows in terms of an equivalent value today. All future cash flows are estimated and discounted to give their present values (PVs).

What is the time value of money?

You have probably looked at compound interest in mathematics and asked simple questions such as:

If you had $100 and put it in the bank at 10% interest how much would you have at the end of:
Year 1?
Year 2?
Year 3? and so on...

The answers are:

Year 1 $110 ($100 + $100 x 10 per cent) or ($100 x 1.1).
Year 2 $121 ($110 + $110 x 10 per cent) or ($110 x 1.1).
Year 3 $133.1 ($110 + $110 x 10 per cent) or ($110 x 1.1).

N.B. Multiplying by 1.1 is the same as calculating 110%.

This is called *compound interest*, because you receive 10% interest on your original $100 deposit (*the principal*) ***plus*** 10% interest on any *previous interest*. So, in the case of year 2 to year 3, you receive 10% on your original $100 (which is $10) plus an additional 10% on your $21 interest (which is $2.1), receiving $12.1 interest added to your $121 to give $133.1.

KEY TERMS
Compound interest is calculated not only on the initial principal, but also on the accumulated interest of prior periods.

So, what is $110 earned in one year's time worth *today* (the **Present Value or PV**) if the interest rate is 10%? One way of thinking of this is *reverse compound interest*. The answer is obviously $100, as this could have been invested a year ago at 10% to earn $10 in interest giving $110. Therefore $100 is worth the same as $110 received in a year's time or $121 received in two years' time. This indicates the *time value of money.*

Discounted Cash Flow (**DCF**) deals with both **interest rates** and **time**. The return on an investment project is always in the future. Money paid in the future is worth less today, because of *reverse compound interest.*

$100 is worth the same as $110 received in a year's time or $121 received in two years' time, indicating the time value of money. So the **Present Value or PV** of $110 received in a year's time is $100, as this could have been invested today at 10% to earn $10 in interest giving $110 at the end of the year. $100 today is therefore exactly the same in financial terms, as $110 received at the end of the year.

If a business wishes to compare two possible investments, which deliver different returns in the future, it is impossible to compare the relative merits unless the business can compare 'like with like'. To achieve this, future returns are converted into ***present values (PV)*** by ***discounting***.

To evaluate the worth of an investment we calculate Net Present Value:

KEY TERMS
The ***Net Present Value*** (NPV) of a project is the ***return on the investment*** (the sum of the discounted cash flows), less ***the cost of the investment***.

If the NPV is larger than the initial cost (positive NPV), then the firm sees a return on its money. If it is less than the initial cost (negative NPV) the project is not worth pursuing.

Example

An investment project costing $100,000 yields an expected stream of income over a three year period of:

Year1 – $30,000
Year 2 – $40,000
Year 3 – $50,000

If the interest rate is 10%, the discount values (present values) can be found using a discount table. The extract of a table below shows the present value of $1 receivable for a 6 year period at an interest rate of 5% per cent (to two decimal places).

Present value of $1 receivable at the end of 6 years at 5 per cent

After	1 yr	2 yrs	3yrs	4 yrs	5 yrs	6 yrs
Present value of $1	$0.95	$0.90	$0.86	$0.82	$0.78	$0.75
Discount factor	0.95*	0.90	0.86	0.82	0.78	0.75

It is possible to calculate the present values of the yields using the correct discount factor:

Present value of income in year 1	=	$30,000	x	0.95*	=	$28,500
Present value of income in year 2	=	$40,000	x	0.90	=	$36,000
Present value of income in year 3	=	$50,000	x	0.86	=	$43,000
Total present value of all income	=					**$107,500**

This investment is now viable as the Total Present Value ($107,500) is greater than the cost ($100,000). **The NPV, therefore, is $7,500.**

Benefits of Discounting/NPV

- Considers all cash flows
- Accounts for the time value of money and considers the opportunity cost
- Scientific approach

Limitations of NPV

- Complex to calculate
- Npv will be wrong if the estimates of cost or net cash inflows are incorrect
- Selection of the discount factor is crucial, but is mostly guesswork
- Npv's look deceptively accurate
- Ignores non-financial factors

3.9 Budgets

✓ The importance of budgets for organizations *(AO2)*

KEY TERMS

A budget is an agreed plan setting out an organization's expected future income and expenditure over a defined period usually one year.

A budget is a financial plan predicting expected future flows of money in and out of the firm, and is a yardstick by which a manager's success or failure is measured. Normally, a budget will be prepared in advance of a period of time, usually a year but it could be monthly or quarterly.

Functions of budgets

Planning

Budgeting forces managers to plan for the future by evaluating courses of action, encouraging managers to anticipate and address problems before they arise. Budgeting produces better results than decisions made 'on the spot'.

Co-ordination

Without budgetary control, managers of different functions (e.g. production) may make decisions about the future that conflict with other departments. For example, the sales department may plan an advertising campaign to boost sales without the necessary finance. Effective budgeting requires managers to match budget allocations with the aims of the organization.

Control

Budgets maintain effective financial control of an organization, preventing the firm spending more than it earns. Comparisons of budgeted data and the actual data is called **variance analysis**. If an area of the business is continually overspending, action can be taken to see why. With budgets showing recorded and planned outflows of cash, it is harder for managers to spend money, which is not justified or identified.

Motivation

Involvement in the budgeting process empowers employees by giving them responsibility for their financial performance. Research shows individuals work better when they have achievable targets, satisfying some Maslow higher order needs, and helping boost productivity and reducing turnover.

Communication

The budgeting process encourages communication and interaction between managers and their departments, developing increased awareness of other department needs.

✓ Cost centres and profit centres *(AO1)*

KEY TERMS

A **profit centre** is a division, or part of a company that generates profit and where costs and revenues can be clearly isolated and recorded allowing profit generated to be determined.

A **cost centre** is a division or part of a company that generates costs but does not make profit, and where its costs can be isolated and recorded.

Profit and cost centres should be under the control, or responsibility, of one person.

All divisions of a company are potentially cost centres, e.g. transport. A few, may be profit centres as well, e.g. the sales department or individual brands. When setting up cost and profit centres a firm is creating a system of responsibility and accountability. Managers of cost or profit centres have the authority to make change and decisions, as well as being responsible if things going wrong.

✓ The roles of cost and profit centres *(AO2)*

Cost and profit centres have three uses:

1. **Financial accounting** - enabling a firm to see how it is performing compared to budgeted figures.
2. **Motivational** – targets and delegated authority ensure staff are motivated, because they are rewarded for good performance.
3. **Organizational** - breaking the firm down into manageable chunks, allows management to monitor performance and identify strong and weak areas.

Effective use of cost centres means that no part of a company is hidden. All overhead departments (staff functions) are recorded and accounted for, supporting cost savings and increased profits.

✓ Variance analysis *(AO2/AO4)*

A budget variance is the difference between the actual amount incurred, and the corresponding budgeted figure.

Variances can be adverse/unfavourable or favourable and positive or negative.

KEY TERMS

Adverse variances are unfavourable to the firm, e.g. sales below plan, costs above budget, and overtime payment more than forecast.

Favourable variances are beneficial to the business, e.g. sales ahead of plan, costs and wages below forecast.

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	Actual greater than budget	Actual lower than budget
Sales/turnover/income	Favourable	Adverse
Costs/expenses	Adverse	Favourable

Which of these are favourable and which adverse?

- Raw materials cost less than expected. The company saves money so increases profit. **Favourable**, in spite of the variance being **negative**. **Negative, favourable**.
- Sales less than predicted, so revenue falls. Profit is lost, so the variance in **adverse**, but is **negative**. **Negative, unfavourable**.
- Profits above the budgeted figure, so the company gains. **Favourable** and so, **positive**. **Positive, favourable**.
- Sales tax more than forecast. The company suffers, so an **unfavourable** variance, in spite of being **positive**. **Positive, unfavourable.**

The tests for variance

Actual greater than plan	**Positive** variance
Actual less than plan	**Negative** variance
Actual same as plan	No variance
Variance increases the firm's profit, or offers an advantage to the firm	**Positive/Favourable**
Variance decreases the firm's profit, or is a disadvantage to the firm	**Adverse/Unfavourable**

Management by exception

Management concentrate on abnormal performance as there is no point in wasting time monitoring systems working according to plan. Positive or negative variances should trigger investigation.

✓ Role of budgets and variances in strategic planning *(AO2)*

Budgets and variance analysis enhance performance and efficiency and improve financial control:

- Control and monitor costs and link costs to revenues
- Make individuals responsible for their performance
- Provide data for rewarding individuals
- Motivate individuals by setting challenging, but achievable targets
- Improve communication within, and between, departments
- Force managers to consider the business direction and the role of departments in reaching organizational aims and objectives

Limitations of budgets and variances in strategic planning

- Budgeting is not an exact tool since budgets are built on forecasts of revenues and costs. Inaccurate budgets demoralise budget holders held responsible for overspends.
- Powerful departments and individuals may set higher budgets to demonstrate their status.
- Budgets may encourage short-termism to meet unrealistic targets and promote a focus on financial targets at the expense of less tangible, important factors.
- Unless budgets are allowed to roll over to the next financial year, managers are encouraged to spend unnecessarily near the end of the financial year.
- Budgets may be set by adding an increment to the previous year's budget (*historical budgeting)* rather than meeting actual need.
- The process of setting, and updating, budgets takes time and is costly.

- Senior managers control spending by insisting on 'efficiency gains', so reducing departmental budgets to encourage productivity increases. The process may limit co-operation between departments as they fight to protect their self-interest.
- Setting fixed budget may not be suited to dynamic markets and external environments.

✓ Potential IB question on Unit Three topics for each assessment objective

AO1

- Define working capital

AO2

- Explain the working capital cycle
- Explain the purpose of accounts
- Use the ratios for XYZ plc to interpret and analyse financial statements from the perspective of the shareholders and the employees
- Explain the importance of budgeting for organizations
- Analyse the role of budgets and variances in strategic planning

AO3

- Examine the advantages and disadvantages of three sources of finance
- Compare and contrast three strategies for dealing with XYZ plc's liquidity problems
- Evaluate the importance of final accounts to each stakeholder group

AO4

- Calculate the payback period and ARR for XYZ plc's proposed investment
- Prepare a cash-flow forecast from the information given for XYZ plc.
- Construct and amend accounts XYZ plc's accounts using the information provided
- Calculate the gross profit and net profit margins for XYZ plc.
- Calculate and interpret variances
- Calculate depreciation using straight line and reducing balance methods
- Calculate the contribution of XYZ plc's new tablet computer to its fixed costs
- Use graphical and quantitative methods to calculate the break-even quantity, profit and margin of safety for XYZ's new tablet computer

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Unit 4: Marketing

4.1 The role of marketing

It is tempting to believe we know all about marketing as we are surrounded by it every day. However, firms are more scientific in their approach than we may assume. The psychology of marketing has been developed over many years and is highly influential on our purchasing behaviour.

As customers, our needs and wants evolve with economic circumstances and our stage of life. Marketing is about creating loyalty to the company, product and brand. Firms may persuade us to buy a product once through clever marketing, but if the buying process or the product is unsatisfactory, we may never buy the product again, nor recommend it. Firms only succeed by getting us to buy and buy again; this is referred to as ***repeat purchasing behaviour.***

Marketing is both a function of an organization and a business philosophy, stressing the achievement of business goals through customer satisfaction. The complex range of activities that define marketing are applicable to all firms, large or small, new or established and even applies to non-profit making organizations.

Marketing is the process of identifying a target market, defining what that target market needs and/or wants and organizing the firm to meet those needs and wants. Firms try to predict ***customer demand patterns***, so the better definitions of marketing focus on the satisfaction of customer needs.

KEY TERMS

> ***Marketing*** *is the management process responsible for identifying, anticipating and satisfying customer requirements profitably.*
>
> Chartered Institute of Marketing (CIM)

Examiner Tip!

It is important to be aware of what ***marketing is NOT***.

- **Marketing** is **not interchangeable** with **advertising**. Advertising is just one element of marketing.
- **Marketing** is **not interchangeable** with **selling**. Selling emphasises the needs of the seller, whereas marketing focuses on the needs of the buyer.

> *Selling tries to get the customer to want what the company has; marketing, on the other hand, tries to get the company to produce what the customer wants.*
>
> Theodore Leavitt

Every employee markets a firm in some way from the CEO to the receptionist and the marketing of the business extends outside of the workplace – a negative or positive statement about the firm made in a restaurant, may be overheard and passed on. Word-of-mouth is a powerful promotional tool.

Markets are increasingly fragmented with various social exchanges facilitated by technologies such the World Wide Web:

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AO3

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AO4

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Markets are increasingly fragmented with various social exchanges facilitated by technologies such the World Wide Web:

- B2B (***Business to Business***): commercial transactions between businesses, e.g. manufacturer and a wholesaler or wholesaler and retailer.
- B2C (***Business to Consumer***): the marketing of products and services by businesses to a consumer market that are not business related, e.g. food, clothes and personal services.
- C2C (***Consumer to Consumer***): Any informational or financial transactions between consumers, usually mediated through a business site, such as *eBay*.
- B2G (***Business to Government***): Often called "public sector marketing".

✓ Marketing and its relationship with other business functions *(AO1)*

> *Marketing is not only much broader than selling, it is not a specialized activity at all. It encompasses the entire business. It is the whole business seen from the point of view of the final result, that is, from the customer's point of view. Concern and responsibility for marketing must therefore permeate all areas of the enterprise.*

Marketing is a *business philosophy* and cannot be the sole responsibility of the marketing department. Marketing *thinking* must permeate the entire organization. Developing an effective marketing plan requires close links with other functional areas.

Marketing AND Operations Management/Production

The marketing department works closely with the production department to ensure that:

- Adequate research and development is planned to satisfy current and future customer needs
- The item can be manufactured to the quality and design desired by the consumer
- The volume of orders generated by marketing can be met within the time schedule

Marketers wish to get products to market as soon as possible to ensure competitive advantage, whereas production wants to test products fully to ensure low defect rates and meet legal requirements.

Marketing AND Finance

The marketing department will need to work closely with the finance department to ensure that:

- There is an adequate budget to meet the needs for research, promotion and distribution

The finance department's role is ensure that the business operates within its financial capabilities. The marketing department concentrates on sales volume and market share, while the finance department is more focused on cash flow, costs and paying back investment.

Marketing AND Human Resource Management

The marketing department will need to work closely with the HRM to ensure appropriate skills and staffing levels are in place to:

- Research and develop new product ideas
- Meet production targets
- Create a competent sales team

The HRM department has recruitment and training demands and needs to balance its obligations to marketing with those to other departments.

✓ The differences between marketing of goods and marketing of services *(AO2)*

In more economically developed countries most national income and wealth comes from the sale of services, rather than products.

A product (or good)

A product or a good is a **tangible** (or visible) item that can be seen, touched, felt, heard and smelled. When purchased, ownership of the product moves from the seller to the buyer.

Types of product

Consumer goods

Consumer goods are sold to the general public. They fall into the following categories:

- ***Convenience items*** - consumers search for the nearest shop for ***staples*** like milk, ***emergency*** items like plasters, ***impulse*** buys like sweets.
- ***Shopping/comparison goods*** - consumers compare prices and features before purchase e.g. washing machine.
- ***Specialty goods*** - unique or special goods.
- ***Consumer durable*** - bought by households and used many times e.g. TV.
- ***Consumer non-durables*** - goods consumed in use e.g. food/drink.

Industrial / capital goods

These are sold business to business ('B2B') and used in the production of other goods e.g. raw materials, manufactured parts and equipment.

A service

Features of a service:

- **Intangibility** (or invisible) item - purchasers buy skill and experience, which cannot be seen or touched, e.g. a haircut.
- **Inseparability** - the service cannot be separated from the person or the seller providing it.
- **Heterogeneity** - difficult to achieve standardization of a service, as quality differs with the person supplying it, e.g. different hairdressers.
- **Perishability** - services cannot be stored, e.g. unsold rooms in a hotel.
- **Ownership** - ownership does not move from the supplier of a service to the purchaser.

Types of service

- **Personal services** are sold to the general public, e.g. hairdressing.
- **Commercial services** are sold to other businesses, e.g. banking and insurance services

Is there really a distinction between goods and services?

There are few 'pure' products or 'pure' services. Most products contain service elements. When choosing a new car, customers take into account after-sales service, credit terms and image. The service element provides the 'value added' that differentiates one product from its competitors.

Most services have tangible elements e.g. when selecting a university, the choice is influenced by the reputation of lecturers, but also by the environment and facilities, e.g. gyms and computer rooms.

The marketing mix for services

Marketing plans include the setting of the marketing mix, or the '4 Ps' as the mix is often defined:

- **Product**
- **Price**
- **Promotion**
- **Place (or distribution)**

These ingredients are put together to make a successful product in terms of sales and profits. The ingredients in a marketing mix vary from product to product, just like different food recipes require different types of ingredient. The marketing mix was developed for manufactured products, not services, and some vital ingredients are missing from the mix for a service, especially in the not-for-profit sector. In recent years, the '4Ps' have been extended to include service elements:

- **People**
- **Physical evidence**
- **Process**

People:

People are the most important element of any service experience - think of a situation where the level of service offered enhanced or ruined a restaurant meal. Operational staff in service organizations may perform *and* sell a service.

Physical evidence:

The physical environment where the service is delivered will influence consumer satisfaction.

- Banks spend heavily on branch design.
- Restaurants focus on a clean, friendly environment.
- Petrol stations usually offer a homogeneous environment, e.g. colour, logos.

Examples of physical evidence include:

- Packaging
- Brochures
- Furnishings
- Signage
- Uniforms
- Building design

Some organizations use physical evidence as marketing communications, e.g. MacDonald's Arches.

Process:

The process of buying a service influences repeat purchase. If a customer enjoys the process of buying, such as excellent service, they are more likely to provide positive word of mouth promotion.

Examples include:

- Waiting time
- Payment methods
- Delivery
- Additional services e.g. After sales

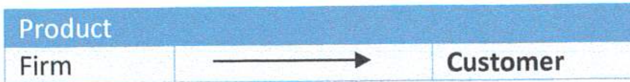
✓ Market orientation versus product orientation *(AO2)*

The concept of a specialist marketing function was developed to sell ***fast-moving consumer goods*** (**FMCGs**) e.g. food and clothing. The success of marketing in creating competitive advantage encouraged firms to adopt marketing techniques for other products and services.

We can classify marketing developments in terms of *orientations* or *concepts.*

A summary of the evolution of marketing orientations (concepts)

1. *Product orientation*



KEY TERMS

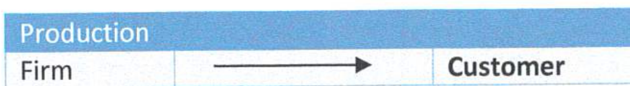
Product orientation is a management approach that emphasises the quality of the product, rather than the needs and wants of the target market.

Supply creates its own demand John Maynard Keynes

Product orientation is the belief that if the firm makes a good product it will sell. Firms concentrate on selling what they have already produced, rather than on the customer.

Product orientation, established at the end of the *19th century,* reflected the fact that production was by small firms and, as a consequence, *Demand > Supply.*

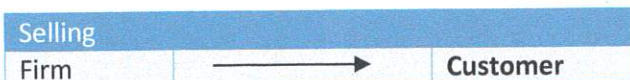
2. *Production orientation*



With the industrial revolution in the 1920s, the focus moved to production orientation. If a product could be made efficiently, its price would be lower and would sell. Henry Ford was credited with introducing mass production.

Nonetheless, large firms were still rare and *Demand > Supply*

3. Selling orientation



This approach, prevalent in the 1960s and 1970s, was built on the belief that a good sales person could sell any product. It resulted in the unethical *'hard sell',* forcing governments to pass consumer protection laws. For the first time in some markets, particularly FMCGs, *Supply > Demand*

4. Market/customer orientation

KEY TERMS

Market orientation is a management approach where firms seek to identify and quantify customer requirements and plan their production accordingly.

The market or consumer orientation is based on the principle that ***'the customer is king'*** and that success is achieved through customer and brand loyalty and ***'repeat purchase'.*** The process is *outward looking* as customer requirements are established through **market research,** before the firms produce. This approach, developed from the 1980s, reflected the fact that customers had considerable choice as *Supply > Demand* in almost all markets.

Market or product orientation?

The approach adopted is determined by the nature of the:

- Product
- Market
- Firm

Traditional firms may have corporate cultures encouraging product orientation, keeping costs low and emphasising efficiency. However, increased competition forces even these firms to be more market orientated.

✓ The difference between commercial marketing and social marketing *(AO2)*

> *Marketing is the social process by which individuals and groups obtain what they need and want through creating and exchanging products and value with others.*

Social marketing or societal orientation was "born" in the 1970s, when *Kotler* and *Zaltman* realised that marketing principles used to sell products could be used to "sell" ideas, attitudes and behaviours. The major impetus was increasing environmental awareness and grew out of an increasing concern about '**consumerism**', pandering to wasteful and undesirable needs of the consumer.

KEY TERMS

Social marketing seeks to influence social behaviours not to benefit the marketer, but to benefit the target audience and the general society

The societal marketing concept is to determine the needs, wants and interests of target markets and to deliver the desired satisfactions more effectively and efficiently than competitors, in a way that preserves or enhances the consumer's and the society's well-being.

Research **Long-term needs**

Like commercial marketing, the primary focus is on consumer wants and needs, but social marketing has been adopted by the non-profit sector, such as health trusts and education providers. It can be applied to promote society's well-being, e.g. prompting drivers to respect speed limits.

✓ Characteristics of the market in which an organization operates *(AO1)*

There are three main measures of a market's size:

1. Volume of sales - measures the amount of goods sold by quantity, e.g. Cola bottles
2. Value of sales - the amount spent by customers on the goods sold, expressed in a currency
3. Number of customers

Value versus volume

A company might sell a large ***volume*** of products, but its total sales ***value*** (revenue) is less than a competitor, which sells a smaller amount of a more valuable product, e.g. a fashion house might only sell a few hundred dresses a 'season', but at a high price per item. Their revenue will be larger than a local fashion shop, selling many more dresses, but at a fraction of the price.

Market growth

Market growth is the percentage change in sales of a product or service over a certain period of time. This reflects changes in volume and/or value and is a factor considered when evaluating the performance of a particular product in a market.

$$\frac{\text{Difference}}{\text{Original}} \times 100 = \text{market growth}$$

Year	Market value $m
2014	10
2015	12

Example:

Difference: $12m – $10m = $2m

$$\text{Market growth} = \frac{\$2m}{\$10m} \times 100 = 20\%$$

✓ Market share *(AO4)*

Market share is the percentage of all the sales in a particular market held by one brand or company, measured by ***volume*** (units sold) or by ***value*** (the revenue generated).

$$\text{Market share} = \frac{\text{Sales revenue of one product}}{\text{Total sales revenue in that product market}} \times 100 = X\%$$

If the sales revenue for a firm is $50m of a market worth a total of $250m, then the firm's market share is 20%.

✓ The importance of market share and market leadership *(AO3)*

Increasing market share produces:

- Greater economies of scale
- More market influence and power
- The ability to charge lower prices
- Lower costs and higher profit margins

> *The important factor in computing relative market share is not the exact number associated with the sales volume, your position relative to the competition is more important.*
>
> *The AMA Complete Guide to Strategic Planning for Small Business*

Market concentration

Market concentration is the extent to which a relatively small number of firms account for a relatively large percentage of the market. Concentration ratios are measures of the total output that is produced in an

industry by a given number of firms in the industry. The most common concentration ratios are the CR_4 and the CR_8, which measures the output of the 4 and 8 largest firms.

✓ The marketing objectives of for-profit organizations and non-profit organizations (NPOs) *(AO3)*

The **not-for-profit sector** in many developed countries is significant with large numbers employed by non-governmental organizations, government departments and religious organizations. Schools and colleges are often charitable institutions.

Non-profit organizations used to be amateurish, using voluntary labour with little business knowledge. However, seeking donations for 'good causes' has become more competitive and, marketing experts are now employed. Many charitable organizations provide services more commonly seen in the profit sector, such as running retail outlets using marketing approaches associated with commercial operations.

The differences between profit and non-profit organizations focuses on objectives and terminology. Profit or surplus may, in reality, be very similar. Firms in the private sector seek to maximise profits, while Charities, aim to maximise funds for their clients. Profit making firms may support good causes to promote a socially responsible image.

Not-for-profit organizations raise awareness of the causes they represent, more than raising awareness of the organization itself, often using political lobbying.

✓ How innovation, ethical considerations and cultural differences influence marketing practices and strategies *(AO3)*

Changes in consumer tastes, economic and market conditions and competitor reactions must be incorporated into revised marketing strategies.

Ethical considerations

Ethical principles extend across cultures and nationalities, although what is acceptable in one country may not be in another, so firms must be sensitive to the beliefs, values and lifestyles of local populations.

For example, although tourism can bring enormous wealth to a country or region, it can be regarded as unethical in its aims and operations. Tourism has negative impacts, such as encouraging less acceptable 'industries', such as prostitution and drugs. Profits earned by large hotel chains are often repatriated to the home countries of the tourist firms, rather than invested in local infrastructure.

Large corporations tend to ***export cultural norms and values***, e.g. tourists walking around town centres in beachwear, when local populations regard modesty as a religious requirement. Fashion trends are 'exported' through videos and on the web. Celebrities, such as Michael Jordan, endorse multinational brands and set fashion directions. The export of cultural values affects the aspirations of local populations with the 'new generations' demanding economic, cultural and social reform.
Cultural and ethical issues extend into employment practices. Ethical and policy considerations for multinationals, acting in international markets, include asking:

- Do we understand the societies and cultures in which we operate?
- Do we offer local staff similar terms and conditions to those offered in other regions?
- Are we aware of the norms and values of local communities?
- Do our operations have a negative effect on the local and/or national community?
- Are we regarded as a foreign or 'local' firm?

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S C Johnson

Case study

In 1976, the US multinational, **S C Johnson,** stated their guiding philosophy in their "**This We Believe**" corporate statement, identifying how they contribute to the well-being of communities where they conduct business.

4.2 Marketing planning (including introduction to the four Ps)

✓ The elements of a marketing plan *(AO1)*

The **marketing plan** may be developed for an individual product or an entire company, and describes activities involved in achieving specific marketing objectives within a set timeframe. Using market research, the plan identifies customer needs and then details marketing strategies to fulfil and generating a targeted level of profit. It includes analysis of the current market situation with action programmes, budgets, sales forecasts, strategies and projected financial statements.

A formal **marketing plan** helps organize marketing strategy for a company, its products or services and is influenced by the strategic **plan** and the objectives of the business.

Large businesses have **corporate plans** that fit the objectives of the smaller companies, operating within the group. Each division or subsidiary plans to deliver what the parent, or 'corporate' business requires.

The acronym **AOSTC** summarises **the elements of a marketing plan:**

Analysis:	A situational analysis (SWOT) of the firm's current position.
Objectives:	Setting SMART objectives for the future.
Strategies:	For achieving the objectives e.g. segmentation and positioning.
Tactics:	Application of the marketing mix.
Control:	Using benchmarks and budgets to monitor performance.

In preparing its marketing plan, the management moves through the following stages:

- **Where is the business now? An assessment of its present position**
  The management conducts a situational audit using **SWOT** analysis examining internal factors, controllable by the firm, by grouping its strengths and weaknesses. Then they examine external (**PEST**) factors, which create opportunities or threats.

- **Where is the business aiming to be in the future?**
  Using the SWOT and relevant market research, the management sets **SMART marketing objectives** for business, e.g. targeting new customers and markets. Objectives are:
  - Specific
  - Measurable
  - Agreed
  - Realistic
  - Time-bonded

- **How will the business achieve its objectives?** The firm develops **marketing strategies** outlining how it will 'deliver' day-to-day on the objectives. These are **operational or tactical plans.**

- **What are the revenues and costs generated in pursuit of its marketing objectives?**
  The firm sets detailed budgets showing a breakdown of expected revenues and costs by product, department or marketing activity.

- **How will the marketing process be controlled?**
  The management develops control mechanisms to measure marketing performance against forecast budgets and marketing objectives, such as market share. It conducts audits to ensure it is meeting customer needs.

✓ The role of marketing planning *(AO2)*

KEY TERMS

“ ***Marketing planning*** *is simply a logical sequence and series of activities leading to the setting of marketing objectives and the formulation of plans for achieving them.* ”

Malcolm McDonald

Benefits from planning

Businesses operate in dynamic market places.

Good planning helps the firm:

- Ensure that marketing activity is focused on corporate objectives
- Take advantage of market opportunities and address business threats
- Co-ordinate marketing activities and monitor how individual business functions are contributing to the marketing plan
- Provide employees with a ‘sense of direction’ to improve morale and performance
- React to changing environments
- Reflect on stakeholder interests
- Develop a rational approach to marketing decisions

Disadvantages of formalised marketing plans:

- A complex process, slowing decision making
- Time consuming and costly to construct
- Not well suited to dynamic markets

Management writers, such as *Henry Mintzberg,* suggest formal planning can be counter-productive in some markets. An ‘organic approach’ helps technology firms react more quickly to changing environments.

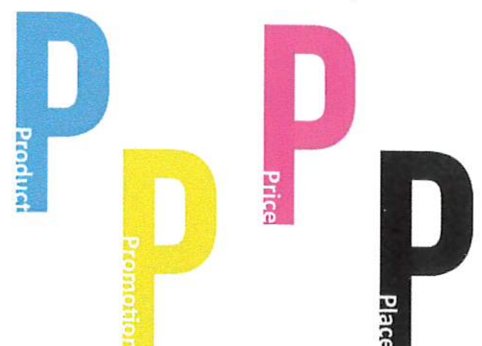
✓ The four Ps of the marketing mix *(AO2)*

KEY TERMS

The marketing mix is the mix of controllable marketing variables that the firm uses to pursue the desired level of sales in the target market. The *marketing mix* elements of price, product, promotion, and place (or distribution) are the basic, tactical components of a marketing plan.

The marketing mix is the combination of elements required to market a product or service successfully. To meet customer needs, an organization must:

- Develop **products** to satisfy them
- Charge the right **price**
- Get the products to the right **place** using an appropriate **distribution channel**
- Make consumers aware of the product through **promotion**



Product

A firm's product is whatever it sells. Traditionally this is a good *(tangible/visible*) or a service (*intangible/invisible*).

> *A product is anything that can be offered to a market for attention, acquisition or consumption that might satisfy a want or a need. It includes physical objects, services, persons, places, organizations and ideas.* Philip Kotler

Customers choose products based on perceived value. Satisfaction is the degree to which the actual use of a product matches the perceived value at the time of the purchase. The most important aspect of marketing is to create a Unique Selling Proposition (USP) for the product to distinguish it from competitors.

Price

The price is the amount of money a seller charges a customer for a good or service and reflects the concepts of ***value and opportunity cost*** – what something is 'worth' to the purchaser is often determined by what they would have to give up to buy it. For example, a consumer may want to buy a music download and a mobile phone credit both priced at $20, but only has $20 in total to spend. If the download is chosen, the financial cost is $20, but the opportunity cost is the item given up, e.g. the phone credit.

Prices of goods and services are subject to the forces of supply and demand. Price is influenced by a number of other factors:

- Production cost
- Competitor prices
- Business objectives
- Corporate image
- Quality

Place (Distribution)

The concept of place is often incorrectly used to mean *location* alone, rather than the process of distribution. Distribution examines the ways that a product gets from the producer to the consumer, e.g. direct selling on websites, or using intermediaries, such as wholesalers. **Channels of distribution** classify the various ways products reach customers.

Promotion

Sales promotion is an umbrella term for marketing activities, such as advertising, public relations and personal selling. Promotion is designed to attract attention to a particular product to increase sales and involves incentives to purchase, such as discounts and additional features.
Promotion is *classified* as:

- ***Above-the-line:*** the firm uses an *external medium* of promotion, e.g. television or newspaper. It relies on other organizations to control the nature and quality of the promotion.
- ***Below-the-line***; where the firm conducts the promotion itself, e.g. direct mail.

The *objectives* of promotion include:

- Creating an initial interest in a new product
- Encouraging previous, but lapsed customers, to buy the product again
- Fighting off competition

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Examiner Tip!

A word of warning: Examiners seldom ask questions that want just a simple list of the famous four; it's more important that you:

- Relate the marketing mix to the specific product or market in the question
- Analyse and evaluate the effectiveness of the selected mix in achieving the firm's marketing and corporate objectives

✓ An appropriate marketing mix for a particular product or business *(AO2/AO4)*

When preparing a dish, cooks use a recipe of ingredients, combined to produce the final product. Changing any of the ingredients or quantities may produce a different looking and/or tasting dish! This analogy applies well to the 'ingredients' of the marketing mix.

The marketing process has been defined as:

> "*Getting the right product to the right place at the right time and right price and making a profit out of the transaction*" Adcock et al

The appropriate combination of these elements is fundamental to a firm's marketing objectives. Getting one element wrong may lead to failure.

Case study

Mercedes

Mercedes conducted extensive market research before introducing their affordable 'A class' model, focused on the less-exclusive family orientated market segment, rather than an executive target group. The risk was that this lower priced model would undermine its established brand image for exclusive luxury models.

✓ The effectiveness of a marketing mix in achieving marketing objectives *(AO3)*

Marketing objectives are the **long-term** goals of the organization, such as:

- Increasing **market size** and **share**
- A desirable **corporate image**
- Developing **brand** and **customer loyalty** to achieve **repeat purchases**
- **Building** a **customer base** large enough to ensure business **survival**
- Focusing on a **particular market segment**
- Introducing **new products** and **services**
- **Moving into new markets**
- **Diversification** - developing new products in new markets

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✓ The difference between market segments and target markets *(AO2)*

KEY TERMS

Market segmentation is the division of the market place into distinct subgroups or **market segments**, each characterised by particular tastes and requiring a specific marketing mix.

The population of a country consists of millions of individuals with different wants and needs. By dividing a market into segments it is easier for the firm to research the needs of customers in a cost-effective manner. Each **market segment** shares certain characteristics while, at the same time, distinguishing it from other segments.

Some segments may be quite small, e.g. specialist sports such as archery, so firms will be marketing to a **niche market**, where the level of demand is limited.

Market segmentation is the first stage of a three stage process underpinning a firm's marketing strategy.

Segmentation ⇨ Targeting ⇨ Positioning (STP)

KEY TERMS

Targeting is the selection of potential customers to whom the firm wishes to sell products or services and then determining the products and services to be offered.

Targeting is used to develop a specific marketing mix for each distinct marketing segment, e.g. determining if various segments should receive one generic product (mass marketing), or if each segment should receive a customized product (multi-segment), based upon the market's diversity, the level of competition and volume of sales expected.

KEY TERMS

Positioning is the creation of a distinct image for a product or service in the minds of customers, both specifically to that item and in relation to competitive offerings.

Not all buyers will be the same, nor will competing products be identical. The firm decides on how it intends to ***position*** its products within each target market. Market positioning describes the way that the product is viewed by a firm's customers relative to competing products. The task of the marketing department is to match the positive attributes of the product with the needs and wants of customers in the selected market segment.

Firms apply positioning strategies by emphasizing the distinguishing features of their brand (what it is, what it does etc.) and then creating a suitable image (inexpensive or premium, utilitarian or luxurious) through relevant promotion. Customers use 'mental boxes' in which they place their perception of the product, brand or company.

Types of market segments

Market segmentation may be based on various ***characteristics***, such as:

- *Demographics* – the characteristics of human populations
- *Pyschographics* – attitudes, lifestyles, and opinions of consumers
- *Geographics* – where consumers live
- *Behaviour* – the predictable nature of a market segment

Demographic segmentation

- **Age** – some products do not interest all age groups, e.g. school materials.
- **Marital status** – married couples have different purchasing behaviours to single consumers.
- **Social class** – countries have socio-economic groupings, linked to education, tradition and income.
- **Education** – the level of education will influence lifestyles, buying patterns and behaviours.
- **Race and ethnicity** – different races and cultures influence their needs and wants. Increasing globalization has reduced differences, creating a fusion of demand patterns.
- **Religion** – religious beliefs influence buying behaviour, e.g. Halal foods.
- **Sexual orientation** – industries have developed to cater for groups, such as 'gay' and 'lesbian' consumers.
- **Gender** – males and females exhibit different buying behaviours, e.g. fashion. However, males and females are not homogenous groups and will also be segmented by other features, such as age.
- **Language** – this affects the nature of products or services purchased.
- **Family lifecycle** – households are classified in terms of family lifecycle, because purchasing behaviour is relatively homogeneous within each category, but different between categories, e.g. *single, newly married, families with children, families without children, retired.*

Psychographic segmentation

Psychographics is concerned with lifestyle, attitudes, emotions, personality and values.

Behavioural segmentation

Behavioural characteristics refer to how many times a customer buys a particular product and how brand loyal they are. In the age of e-commerce, behavioural segmentation is important, e.g. social media sites accessed.

The marketing industry enjoys producing acronyms for behavioural groupings, offering a shorthand for groups of individuals with particular purchasing behaviours:

- *Yuppies* – Young Urban Professional
- *Dinkies* – Dual income, no kids

Geographic segmentation

Geographic segmentation refers to where people live. Different countries have significantly different economies, cultures, languages, climates, traditions; all of which influences purchasing behaviours. For example, those in colder countries are more interested in heating, whereas those in warmer climates prefer air conditioning.

Countries can be divided into distinct geographic areas, with each regions having different lifestyles, cultures, ethnic backgrounds, climates and traditions. Whether an environment is urban or rural also influences buying behaviour.

Industrial markets

B2B providers segment their markets as well, by:

- Type of business
- Size of business
- Size of purchase

✓ The difference between niche market and mass market *(AO2)*

KEY TERMS

A **niche market** is a specialist area of the market. Niche markets are normally small segments of a market. Suppliers face less competition when entering such markets, but potential profits may be lower as opportunities for economies of scale are limited

A **mass market** is a market in which products with mass appeal, such as confectionary, are offered to every customer through mass retailers or independent stores, and promoted through mass media. There is no attempt to segment the market.

✓ Possible target markets and market segments in a given situation *(AO4)*

Once markets and segments are identified, firms must decide which to target:

- Should it target all market segments or focus on particular ones?
- Is the same marketing mix appropriate for different segments?
- How should the marketing mix be adapted for different segments?

Once the firm decides on its target market, it must decide on a marketing strategy:

1. **Undifferentiated marketing (mass marketing)**. This ignores different segments and blasts a single marketing mix at the whole market. This can be expensive as the firm is aiming to sell to the whole market, rather than just certain segments. However, it offers opportunities to gain economies of scale by using the same marketing message.
2. **Differentiated marketing**. Every segment is treated differently with a separate marketing mix. This can be costly and complex to manage and is used more often by large firms who can still gain economies of scale in larger market segments.
3. **Niche or concentrated marketing**. A particular segment is identified as the most appropriate and then targeted precisely with an appropriate marketing mix. The products satisfy minority interests, such as specialist sports, or provide expensive items, such as Rolex watches. Small firms can become big players by focusing on their target market and charging premium prices.

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✓ How organizations target and segment their market and create consumer profiles *(AO2)*

Firms must understand their target customer and describe their characteristics. Consumer profiles identify significant demographic and psychographic details about consumers, including:

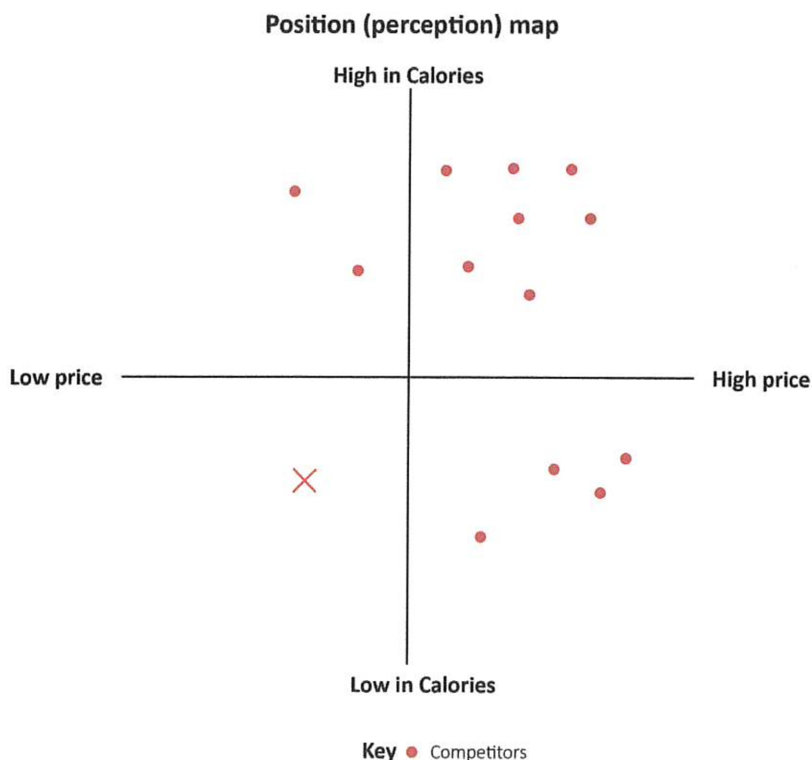
- Where they live
- Whether they are male or female
- What they do
- What their values are
- What they earn
- Where they shop and whether they are brand loyal
- How old they are
- Whether they are married, single or have children

Consumer profiles are different for each of a firm's target markets. Media publishers, for example, provide potential advertisers with reader profiles, to help the placement of particular advertisements.

✓ A product position map/perception map *(AO2/AO4)*

Respondents to market research are asked questions about their experience with the product in terms of performance, price etc. Answers are transferred to a chart called a *position* or *perception map* and used to improve the product or develop new ones. Position maps normally use price and quality as the two key variables, but other variables are used. Firms may use the map to find a 'gap' in the market, where new products may be positioned.

Position (perception) map



There is a gap in the market for a product low in calories and low in price. The firm must consider whether it has the strengths to take advantage of this gap.

✓ The importance of having a unique selling point/proposition (USP) *(AO2)*

KEY TERMS

The unique selling point, unique selling proposition or USP is the key aspect of a product or service that sets it apart from the competition.

To gain a USP, each product must:

- Make a proposition to the customer: "buy this product, and you will get this specific benefit".
- Be unique – offer something that competitors do not.

✓ How organizations differentiate themselves and their products from competitors *(AO3)*

A USP can be gained by:

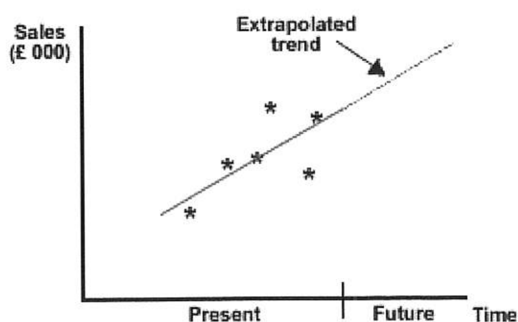
- Having an innovative *product* e.g. the iPad was unique when launched.
- Offering a *price* different to direct competitors, e.g. discount supermarkets offer lower prices than competitors by offering fewer product lines and gaining economies of scale by bulk buying.
- Using unique *distribution chains,* e.g. Amazon is proposing delivery by drones.
- Creating distinctive *promotional* approaches, e.g. teaser campaigns.

4.3 Sales forecasting

✓ Trends and extrapolation *(AO4)*

When you look at sales figures for a business, there may be underlying patterns of growth or decline – referred to as a **trend**. Examination questions ask for an analysis of the figures, suggesting ***reasons for the changes*** and ***consequences for the business*** and then, using past data, to predict the future by **extrapolation**.

Figure 1 shows a trend and an extrapolated trend.



Extrapolated trend

The graph shows inconsistent sales figures over a period. However, it is possible to produce a 'line of best fit' called a *trend line*, which forecasts improving sales in the future. This trend is established using **MOVING AVERAGES** to smooth out variations in data.

Benefits of sales forecasting

The firm can use sales forecasts to:

- Plan **future production levels** allowing more efficient use of resources.
- Improve **cash flow and working capital** by calculating cash flow needs.
- Improve **stock control** using the sales forecasts.
- Drive **marketing campaigns,** including distribution and promotion.
- Underpin the **budgeting** process: sales drive budgets.
- Identify **significant trends** and use to adapt its product portfolio.
- Identify the influence of **economic cycles** on **demand patterns**.

Time series analysis

A time series helps predict future sales levels, using past sales data.

What are the variations that make the underlying trend hard to see?

Secular trend – the very long term growth or decline of a series, which may explain the trend itself, e.g. product life cycle.

- **Seasonal variation** – short-term variation reflecting seasonal changes, e.g. weather influences on agriculture.
- **Cyclical variation** – long term cycling of a trend, e.g. the business cycle repeats over a number of years.
- **Irregular or random variation** – irregular, unpredictable shocks that hit all economies, e.g. floods.

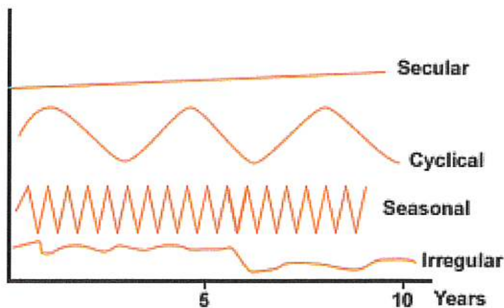


Illustration of cyclical, secular and seasonal variation

Moving averages

A moving average is used to 'smooth' data and remove seasonal, trade cycles and random variations. The IB required that you can calculate a:

- Three-point average
- Four-point moving average

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Three-point moving average

The easiest and quickest moving average, but it does not completely smooth the trend line and makes accurate extrapolation difficult. Calculated by taking a number in the series with the previous and next numbers and averaging all three.

Calculating a three-point moving average:

Example

Series: Actual sales
2080
1200
1520
2560
2160
2000

The underlying trend in the series above is not clear, because of variations within the data. By calculating a moving average, we remove some of these.

Moving Average (1): take the first three figures in the series and average them:

$$\frac{2080 + 1200 + 1520}{3} = \frac{4800}{3} = 1600$$

Moving Average (2): drop the first figure from the front and add in the next in the series

$$\frac{1200 + 1520 + 2560}{3} = \frac{5280}{3} = 1760$$

Moving Average (3): continue to use the next set of three figures in the series

$$\frac{1520 + 2560 + 2160}{3} = \frac{6240}{3} = 2080$$

Moving Average (4): continue to use the next set of three figures in the series

$$\frac{2560 + 2160 + 2000}{3} = \frac{6720}{3} = 2240$$

From a set of 6 sales figures, we produce 4 three point moving average calculations:

- **1600**
- **1760**
- **2080**
- **2240**

Clearly, the trend is positive and there is sales growth.

Three point moving averages help work out average variations across a longer period, because the average of three numbers falls on the middle of the series and can be compared directly with the actual sales for that period.

Series: Actual sales	Trend (3-point) Sales	Variation Sales - Trend
2080		
1200	**1600**	**-400**
1520	**1760**	**-240**
2560	**2080**	**+380**
2160	**2240**	**-80**
2000		

Four-point moving average

A four-point moving average smooths the trend line more effectively than a three-point moving average and corresponds with quarterly sales reporting. However, it has the following problems:

- Fewer moving average results.
- The average falls on a mid-point that does not correspond to an actual sales figure, requiring further adjustment.

Calculating a four-point moving average:

Example

Series: Actual sales
2080
1200
1520
2560
2160
2000

The underlying trend in the series is not clear, because of the data variations. Calculating a moving average removes some of these variations.

Moving Average (1): take the first four figures in the series:

$$\frac{2080 + 1200 + 1520 + 2560}{4} = \frac{7360}{4} = 1840$$

Moving Average (2): drop the first figure from the front and add in the next in the series

$$\frac{1200 + 1520 + 2560 + 2160}{4} = \frac{7440}{4} = 1860$$

Moving Average (3): continue to use the next set of three figures in the series

$$\frac{1520 + 2560 + 2160 + 2000}{4} = \frac{8240}{4} = 2060$$

Examiner Tip!

For a moving average based on an odd number, the midpoint coincides with one of the original sales values. For a moving average based on an even number it does not.

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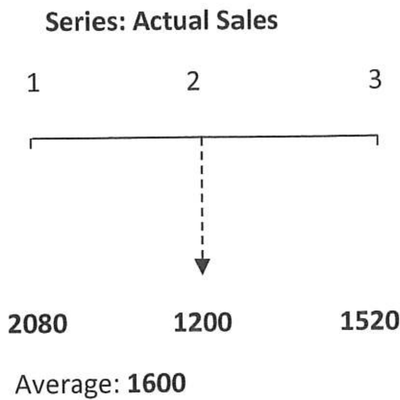
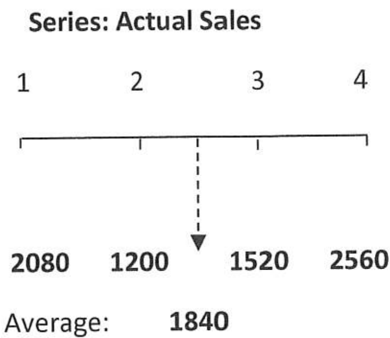
Mean of three-point average



The average falls on the mid-point of the series which is the second sales figures, so it can be compared directly with the actual sales, showing the trend sales are 400 higher than actual sales.

Mean of four-quarter average



The trend average falls ***between*** *2 and 3 in the series and cannot be directly compared with either the actual sales for period 2 or period 3.*

So with a four-point moving average we only produce three results from our series, and these do not correspond with actual sales and so no variation can be established:

Series: Actual sales	Trend (4-point) Sales
2080	
1200	
	1840
1520	
	1860
2560	
	2060
2160	
2000	

So how can a variation be established?

Centring

Example

Centring means averaging two averages to produce a result that does correspond with an actual sales figure.

Worked example using a four-point moving average: Sales of XYZ Ltd.

Sales Revenue	($000s)			
Year		Quarters		
	1	2	3	4
1	240	224	204	240
2	244	236	220	262
3	260	254	230	286

A qualitative examination of this data shows that the general trend is one of rising sales. But with a seasonal variation.

Extracting the 'trend'.

After calculating an average of year 1, consisting of quarters 1 to 4, we drop the first quarter's sales value and replace it with that of quarter 1, year 2. The average has, therefore 'moved' forward one quarter.

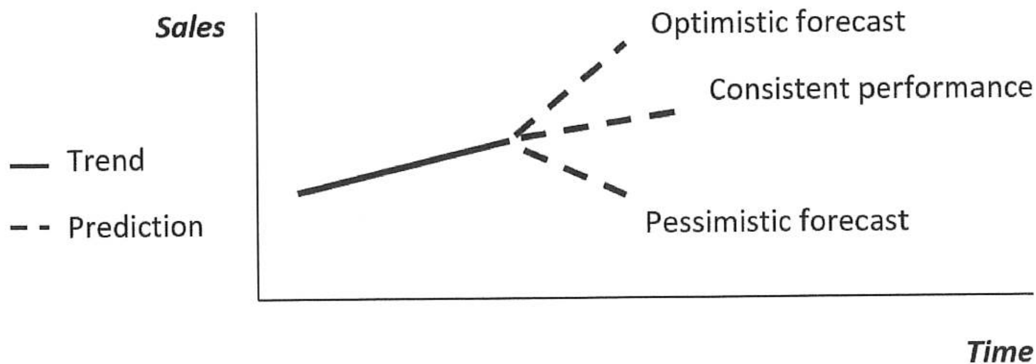
Periods used (Yr/Qtr)	Moving Average	Trend
1/1, 1/2, 1/3, 1/4	(240+224+204+240) / 4	= 227
1/2, 1/3, 1/4, 2/1	(224+204+240+244) / 4	= 228
1/3, 1/4, 2/1, 2/2	(204+240+244+236) / 4	= 231
1/4, 2/1, 2/2, 2/3	(240+244+236+220) / 4	= 235
2/1, 2/2, 2/3, 2/4	(244+236+220+262) / 4	= 240.5
2/2, 2/3, 2/4, 3/1	(236+220+262+260) / 4	= 244.5
2/3, 2/4, 3/1, 3/2	(220+262+260+254) / 4	= 249
2/4, 3/1, 3/2, 3/3	(262+260+254+230) / 4	= 251.5
3/1, 3/2, 3/3, 3/4	(260+254+230+286) / 4	= 257.5

The problem with this method is that the resulting trend figures do not fall on a particular quarter, but between quarters. Since it is necessary to compare the sales trend with actual sales, it is advisable to obtain a trend that falls on a particular quarter. This is achieved by a **CENTRING**, where we add and average pairs of trends. The resulting average is thus based on eight quarter's data.

In practice, it is easier to add the two successive 4-period moving totals together and divide the result by 8, as shown below.

Year	Quarter	Sales ($000s)	4 quarter total	8 quarter total	Quarterly moving average
1	1	240			
	2	224			
	3	204			227.5
	4	240	908		229.5
2	1	244	912	1820 / 8	233
	2	236	924	1836 / 8	237.75
	3	220	940	1864 / 8	242.5
	4	262	962	1902 / 8	246.75
3	1	260	978	1940 / 8	250.25
	2	254	996	1974 / 8	254.4
	3	230	1006	2002 / 8	
	4	286	1030	2036 / 8	

The trend line can be extended to forecast the future trend line on the assumption that the trend of the past continues in the future. The angle of the extension can be changed according to other data, e.g. economic forecasts that suggest the future will be better, worse or similar to now.



Identifying the seasonal variation

Looking at the original sales figures we see an upward sales trend in and a consistent seasonal pattern. Sales in quarter 1 and quarter 4 are higher than the trend sales, and sales in quarter 2 and quarter 3 are lower. We can calculate an ***average*** variation from the trend for each of these quarters to take account of the recognised seasonal pattern of the past. In other words, the trend line and the extrapolated trend smooth out seasonal variations – what we need to do to forecast future actual sales per quarter is to recreate these variations around the extended trend.

Quarter	Sales ($000s)	Moving average trend ($000s)	Sales – trend = seasonal variation ($000s)
1	240		
2	224		
3	204	227.5	- 23.5
4	240	229.5	+ 10.5
1	244	233.0	+ 11
2	236	237.75	- 1.75
3	220	242.5	- 22.5
4	262	246.75	+ 15.25
1	260	250.25	+ 9.75
2	254	254.4	- 0.4
3	230		
4	286		

We use seasonal variations to calculate the average seasonal variations. However, these are based on a small number of observations.

Quarter	Calculation	Average seasonal variation
1	(11 + 9.75) / 2	10.375
2	(- 1.75 + - 0.4)	- 1.075
3	(- 23.5 + - 22.5) / 2	- 23
4	(10.5 + 15.25) / 2	12.875

The average seasonal variations can be used with the extrapolated trend to produce a more accurate forecast. For quarters 2 and 3, the predicted actual sales is below trend sales. The average seasonal variations for quarters 1 and 4 are added to the trend sales figure to produce more accurate results - if the projected sales for the first quarter of year 4 are $140,000, this figure is increased by $10.375 to provide a more accurate prediction.

Trend Analysis Summary Method

- Plot the actual sales
- Work out the trend by using 8 quarter moving averages
- Add the trend to the original graph
- Extend (extrapolate) the trend
- Calculate average seasonal variations
- Predict actual future by recreating the seasonal variation around the extrapolated trend
- Read the predicted actual sales for the future period required

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✓ The benefits and limitations of sales forecasting *(AO3)*

Benefits of sales forecasting

- Improves financial plans to improve liquidity
- Supports operational planning, ensuring supply matches demand
- More efficient workforce planning and stock holding
- Supports the planning of marketing campaigns

Limitations of sales forecasting

- Results are only as good as the data used to produce the forecasts
- It ignores qualitative factors and other the external environment changes

4.4 Market research

KEY TERMS

Market research is defined as 'the systematic and objective collection of forms of information that allows trends in market behaviour to be identified and predicted'. It is the process by which firms find out market information, note its relevance and decide how to act upon it.

✓ How market research reduces risk by providing data to support market planning *(AO2)*

Market research provides a firm with data on:

- Current market performance and predictions of market trends
- Customer purchasing behaviour
- Levels of current satisfaction with existing products
- Customer response to planned products and services
- Existing and future needs of markets
- Required changes to its marketing mix
- The local, national and global economy

✓ Market research methods and techniques *(AO2)*

Primary market research

KEY TERMS

Primary research is the gathering of new or 'first-hand' data specifically tailored to provide information on the firm's own products, customers and markets. Data is collected by *fieldwork* such as questionnaires, observation and surveys. It is expensive, but also relevant, accurate and up-to-date.

Primary data can be collected from *internal* or *external* sources.

Secondary market research

KEY TERMS

Secondary research *(desk research)* is the assembly, collation and analysis of existing or 'second-hand' marketing data. This process is cheaper than primary research, but the data may be less relevant as it was not collected for the specific needs of the firm and may be out of date.

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The following summarises the advantages and disadvantages of primary and secondary data:

Advantages of secondary data	Disadvantages of secondary data
Quicker and cheaper to collect and analyse	Quickly out-of-date
Wide range of potential sources	Available to competitors
Provides data on the whole industry and/or economy rather than focused on the firm	Not specific to the firm's needs and may not be in the format required for analysis

Primary research methods and techniques

When gathering primary research the firm may use the following:

- Surveys
- Interviews
- Focus groups
- Observations

Surveys and interviews

Surveys and interviews come in various different types. The most common is stopping members of the public and asking them product related questions. However, how questions are asked may influence those interviewed, and introduce bias. The main forms are:

- Postal
- Online
- Telephone
- Personal

Questionnaires

- **Face-to-face** – a researcher asks the questions, explaining the purpose.
- **Self-completion** – often used after a service, e.g. hospital patients are asked about their treatment.
- **Postal** – may follow product purchase. Firms often provide incentives for completion, e.g. vouchers.
- **Telephone** – similar to a face-to-face questionnaire, except respondents can hang up!
- **Internet** – *pop-ups* appear after ordering online, asking for views on products and/or services.

Questionnaires can be:

- ***Structured***: relying mainly on '*closed*' questions that provide respondents with a list of possible responses, such as 'satisfied/unsatisfied'.
- ***Unstructured***: using more '*open*' questions allowing respondents to develop answers and express opinions. Provides more information, but answers are difficult to quantify.

Focus Groups

Focus groups are presented with marketing messages to see which have favourable impacts, providing information on changes in public attitudes and tastes. Participants are introduced to a general area, such as 'organic foods', and then *focus* on what the researcher really wants to know - e.g. 'what are your impressions of our new organic vegetable range?'

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Observations

Researchers watch potential and actual consumers' behaviour, possibly using in-store cameras. Often used to design store layouts to maximise sales. Online behaviour is more difficult to observe than physical behaviour, but market research organizations are developing increasingly sophisticated ways of tracking behaviour. Many consumer groups believe that observation is an unacceptable intrusion into consumers' private lives and advocate stricter controls on techniques, such as downloading spyware onto private computers.

✓ Secondary research methods and techniques *(AO2)*

Secondary data is collected from existing sources:

- **Internal**: annual reports, sales data, customer records, client databases, payment records.
- **External**: government data, national and local media, competitor reports, market research reports, company websites.

Market analyses

The goal of a *market analysis* is to determine the attractiveness of a market, both now and in the future. Specialist research organizations, such as Mintel, evaluate the future attractiveness of a market and evolving opportunities and threats. Firms use these reports to consider the fit between market opportunities and their strengths.

Academic journals

Academic journals include original research articles, written by researchers in a particular academic discipline. Many academic journals are subsidised by professional organizations, and do not exist to make a profit

Government publications

Government publications are articles issued by local, regional, or national governments or by their agencies. These provide valuable market information, including social trends, government statistics and economic data.

Media articles

The media describes forms of mass communication including television and newspapers. Some magazines and newspaper, such as the Wall Street Journal, specialise in economic and business topics, which provide useful market information.

✓ Ethics of market research *(AO3)*

The issue of governments tapping into phone conversation and tracking internet traffic has led to global discussion about the ethics of governments and commercial firms, when collecting, storing and using personal data; gathered without the consumer permission or knowledge. The development of the Internet and World Wide Web resulted in unprecedented abuse of data and the invasion of privacy.

Market and personal data is of huge value to commercial organizations and is regularly bought and sold.

✓ The difference between qualitative and quantitative research *(AO2)*

KEY TERMS

Qualitative research is in-depth research into the motivations behind customer purchasing behaviour and attitudes, providing information on preferences, tastes, and buying habits, using personal diaries and techniques like 'focus' groups.

Quantitative research concentrates on numerical data, such as market share, gathered through opinion polls and customer surveys.

Qualitative research asks 'why' customers buy and gathers information of the strength of demand. This type of information is difficult to present in a succinct form. Quantitative research asks questions about who buys the product and how much they buy, which is easier to graph and present visually.

Sampling

It is normally too costly and almost certainly impossible to ask everyone in the target population. So, firms sample a proportion of opinions.

KEY TERMS

A **sample** is a group that is selected for study, which is representative of the total population for a given experiment. The study is normally conducted to understand how the population will react to an item, by testing it on a sample that represents the population the item will target.

Answers given by the sample should reflect the whole populations' opinions as closely as possible. In research, the term 'population' represents all the *target* market. Obviously, by asking fewer people the firm saves time and resources, but the results may not be *statistically significant*, and the firm cannot rely on the results representing the views of the entire target population.

✓ Methods of sampling *(AO2)*

Random sampling

A ***simple random*** sample is where all participants have an equal chance of being chosen. Computers are used to generate a random selection for researchers. To be effective, researchers must possess a full and accurate record of all those who could participate (the *sample frame*).

Examiner Tip!

Often respondents are chosen merely because they are convenient to ask. Selecting the first ten people entering a shop **is not** a random sample as every member of the population does not have an equal chance of being selected - only those entering the shop.

Quota sampling

Quota sampling is based on market segmentation using characteristics, such as age and gender. A set number of people (the quota) from each group are interviewed. In a school, the researcher might interview 10 females and 9 boys from Year 8, reflecting the gender breakdown of the total population. This is a cheap and effective way of compiling a representative sample. However, it is possible that the girls selected may not be representative of all female students, as they are selected on a non-random basis.

Stratified sampling

A stratified sample is where the population is divided into subgroups. The sample reflects each subgroup in proportion to their representation in the population as a whole. For example, in a school the researcher picks a sample where the proportions of boys to girls, year group to year group, reflect the school population as a whole, e.g. 5 girls and 4 boys from Year 8.

Cluster sampling

Cluster (or area) sampling is used when the population is dispersed, e.g. a multinational corporation would find it too expensive to interview individuals from all their markets, so it select a particular geographic area to sample, which it believes represents its markets in general. This may lead to bias (in the selection of the area) and sampling error if the cluster is not representative.

Snowballing

Snowballing (or chain sampling) interviews an initial contact who is asked to suggest other potential interviewees to provide additional experience. This is used when the researching organization has little knowledge of the issues, but relies on recommendation for a broad selection of informed advice.

✓ Results from data collection *(AO2)*

Strategic decisions are based on the research data, e.g. launching new products or moving into new markets. Getting these decisions wrong may be extremely costly and may lead to the closure of the business.

Two forms of error can creep in when samples are prepared:

- **Bias** - where external effects influence the result, e.g. the sample selection may be biased in favour of friends.
- **Statistical sampling error** - even without bias, there are random variations from sample to sample.

Although, results will not be fully accurate using a sample, an estimate of the error or accuracy is possible knowing the sample size and the experimental method.

4.5 The four Ps (product, price, promotion, place)

Product

✓ The product life cycle *(AO4)*

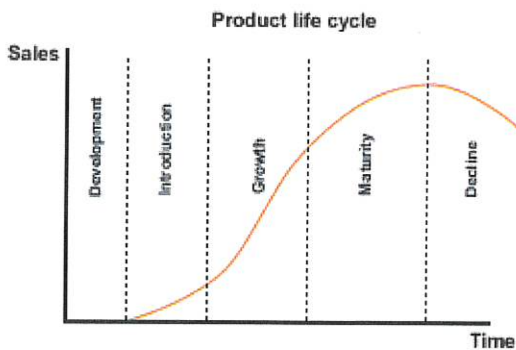
Marketers compare the life cycle of a product to the human life cycle.

- Products, like human beings, are conceived and born.
- As time passes, products move through infancy, grow and reach maturity and like humans they will eventually decline and die. Like humans, death may happen at any stage.

However, unlike a human:

- A product's life is measured in terms of sales and products may be reborn.
- The speed at which a product moves through its life cycle varies.

The stages of the product life cycle



Product life cycle

The standard phases of the product life cycle:

✓ Stage 1: Development

The research and development (R&D) department develops the product and the marketing department conducts extensive market research.

New product development (NPD) follows a pattern:

1. **Idea generation** – ideas come from brainstorming, market research, various departments and from customers and employees.
2. The **screening stage** – products are assessed according to marketing, production and strategic factors, with many ideas dropped at this stage.
3. **Testing of the concept** – market research or focus groups used to assess reaction.
4. **Market/business analysis** – marketing department forecasts market potential, costs, sales, profit and return on investment.
5. **Product development** – products not excluded by screening go forward. Costs at this stage are high. A prototype is produced and focus groups provide feedback.
6. **Test marketing** – products are tested in a small geographical area, selected because they have the characteristics of the target market. Feedback is analysed and adjustments made before full launch.
7. **Product launch/commercialisation** – launching into the intended market is costly, requiring careful planning. Sales are analysed to see if the product will earn profit.

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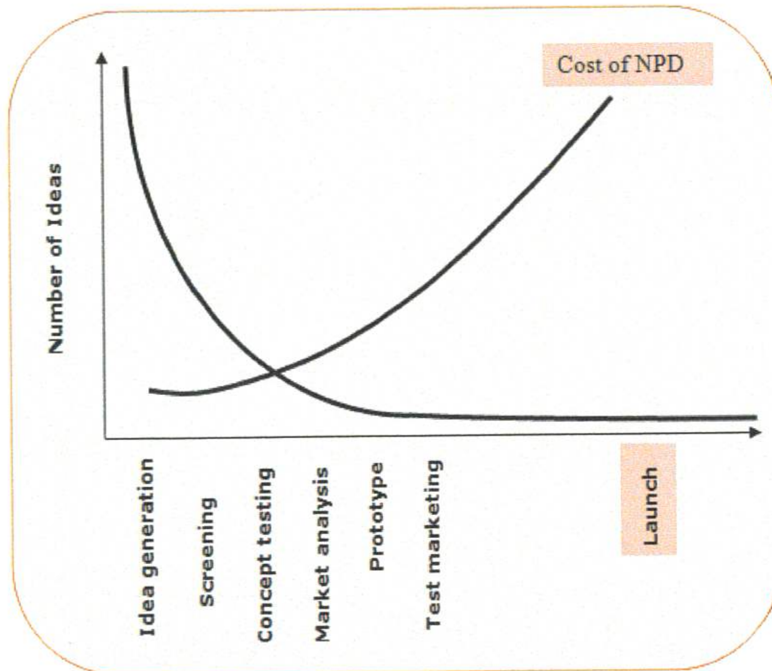


Costs of NPD through the stages of the product life cycle

✓ Stage 2: Introduction or launch

The product is launched into test market(s).

- Significant promotion required, so marketing costs are high.
- *Informative advertising* tells potential consumers of product's benefits.
- There are few economies of scale.
- Price can be high if the product has 'first mover advantage', e.g. new technologies. This *price skimming* strategy is used to cover development costs.
- Prices are set lower if there are existing competitors to allow the firm to gain market share – *penetration pricing*.

✓ Stage 3: Growth

- *Persuasive advertising* tells customers why the product is better than its competitors - to establish brand loyalty.
- Sales growth.
- *Penetration pricing* used to gain market share.
- Costs fall as the firm achieves *economies of scale*.
- Sales revenues increases and profits rise.

✓ Stage 4: Maturity and Saturation

Maturity

- Growth slows, but firm has significant market share.
- High sales and low unit costs leads to high profit margins.
- Positive cash flows are used to fund new product development.
- New competitors enter the market in response to high profitability and customers becomes price sensitive.
- *Competitive pricing* used to maintain market share.
- Advertising used to remind customers of product benefits.

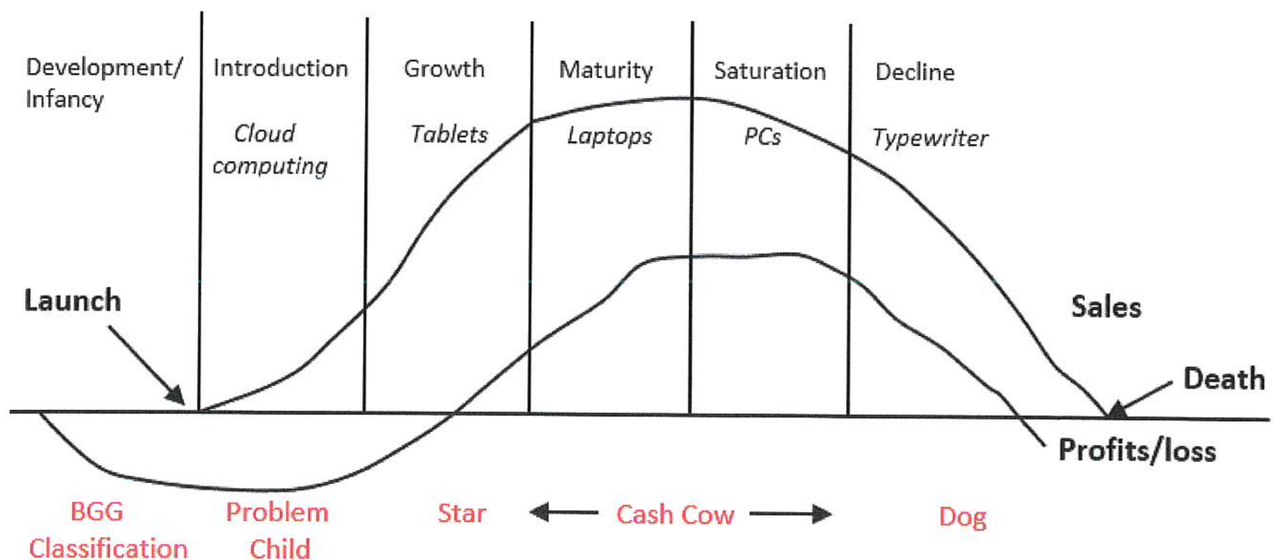
Saturation

- Sales fall as more competitors enter the market and compete on price.
- Prices fall with *competitive pricing* to maintain market share.
- *Extension strategies* employed e.g. redesigning packaging.

✓ Stage 5: Decline

- Sales and profits decline.
- Low cost rivals gain market share.
- *Cost cutting* inevitable, e.g. firm reduces human resources, sales outlets and investment.
- Promotion cut.
- Further *extension strategies*, e.g. prices reduced.
- Product eliminated.

The Product Life Cycle: shows the stages of *an individual* product:

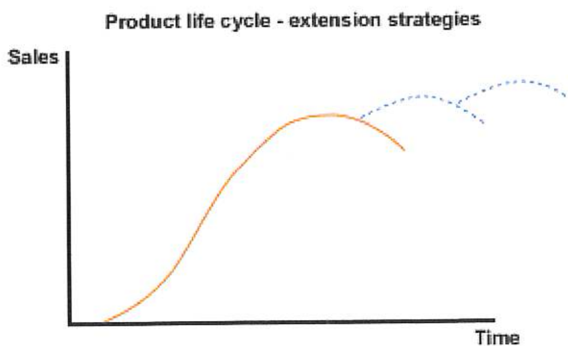


✓ The relationship between the product life cycle and the marketing mix *(AO2)*

	Introduction	Growth	Maturity	Decline
Product	Offer a basic product	New options and extensions	Brand and product extensions	Drop weaker models
Price	Introductory offers or price skimming	Penetration pricing	Competitive pricing	Discounts
Place/ distribution	Selective markets	Increase distribution channels and markets	Intensive distribution	Phase out weak markets - reduced distribution channels
Advertising	Focus on early adopters using informative advertising	Build awareness and persuade potential customers of product benefits	Remind customers of product benefits and value	Selective advertising focused on loyal customers
Promotion	Heavy promotion to raise awareness	Reduce as awareness and demand increases	Encourage brand switching	Minimal promotion

✓ Extension strategies *(AO3)*

Firms use extension strategies to prolong product life cycles and delay decline.



Product life cycle – extension strategies

Extension strategies prolong the life of a product:

- Modifying the product e.g. New ingredients
- Promoting more heavily
- Developing complementary products
- Finding new uses
- Lowering price
- More effective distribution

✓ The relationship between the product life cycle, investment, profit and cash flow *(AO2)*

The cash flow from a product changes through its life cycle.

Introduction and growth stages

High development and promotional costs result in a *negative* cash flow.

Maturity stage

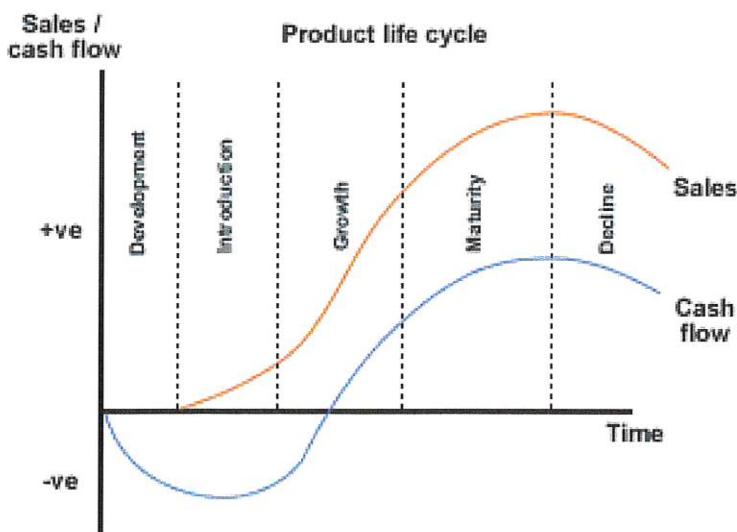
As products move into maturity, cash flow becomes *positive*. Economies of scale causes falls in unit costs and profits **increase rapidly.**

Saturation stage

As a product becomes matures, competition increases and demand becomes more price elastic. Falling price reduces profit margins.

Decline stage

Sales fall and cash flow declines, possibly leading to losses.



Product life cycle and cash flow

✓ Boston Consulting Group (BCG) matrix *(AO3/AO4)*

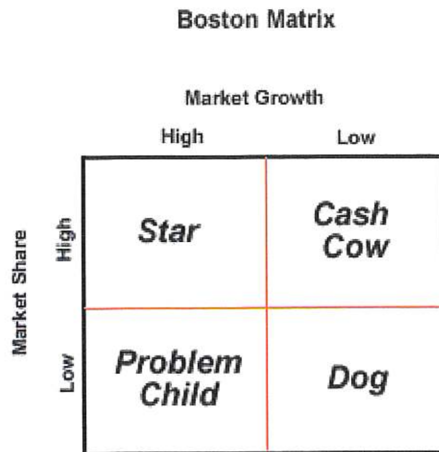
A company may have products at various stages of their life cycle, illustrated by a ***Boston Matrix.*** The *market share* of a product is plotted on the horizontal axis with *market growth* on the vertical. Products within a firm's product mix are classified into four categories, used to support a firm's marketing strategy.

Question marks/ problem children: *small market share, high market growth*. New products are potentially successful, but require considerable financial support. They may become stars, or fail and become dogs.

Stars: *high share of a fast growing market*. Still require considerable investment, but profit rises substantially.

Cash cows: *high market share, but little market growth*. Sales revenues high and costs low. Cash flow 'milked' to provide funds for new product development.

Dogs: *both low market share and little prospect of growth*. Extension strategies employed or the firm drops the product.



BCG supports *four strategic options:*

- **Sow**: investment in research and development and marketing to launch the product, raise awareness and develop distribution channels.
- **Nurture:** investment to turn problem children into stars, increasing promotion and developing new distribution channels and markets.
- **Harvest:** funds from sales of cash cows used to finance other products and improve cash flows.
- **Plough (Divest):** liquidate product or sell it to another business.

✓ Branding *(AO2)*

KEY TERMS

A **brand** is a name, sign or symbol used to identify items or services of the seller(s) and to differentiate them from competitors' products.

A brand usually carries a logo or trade mark. Brands differentiate products from their rivals. Brands allow customers, to:

- **Identify them quickly**, e.g. the Apple logo.
- **Relate to the firm** and feel good about their product
- **Trust the firm** by providing reliable, good quality products

Global brands are recognised throughout the world. Firms employ a unified approach to support the brand and its development, using consistent packaging, colour, fonts and logos.

Brand awareness

Familiarity with a brand allows businesses to reach a wider audience. Brand extension occurs when the firm produces new products under the same brand umbrella; e.g. Cadbury uses its Dairy Milk brand across a range of confectionary and ice creams.

Brand development

Brand development is an on-going evolution. The process begins with market research to:

- Understand what the firm's brand stands for and what differentiates it from the competition.

If the brand perception is not what a firm wants, it creates a marketing plan to reposition it in the minds of consumers, which requires it to:

- Consistently express the brand values (verbally and visually).
- Actively engage with customers wherever they get information about the firm's products.
- Expand into complementary markets or products that align with the brand strategy.

Brand loyalty

A brand name is often a firm's most valuable asset, shown in the balance sheet as an **intangible** asset. Brand loyalty should lead to:

- Repeat purchases
- Word of mouth endorsement
- Economies of scale
- Lower price sensitivity
- Market leadership

Brand value

Consumers rarely have a relationship with a product, but are loyal to brands. When Tata Motors bought Jaguar from Ford they paid $2.56 billion; the majority of which was to acquire the brand name.

In 2013, Interbrand valued the Apple brand at $m98.316 overtaking Google, which was the second most valuable brand at $m93.291.

✓ The importance of branding *(AO3)*

The term 'brand' is associated with a product that has a unique, consistent and well-recognised character, such as Apple. Brands convey quality, credibility, image and experience that outlives products and creates emotional attachments with customers. In recessions, branded products perform better than unbranded products.

✓ The importance of packaging *(AO3)*

Packaging is part of products and/or promotion. The specific requirements of packaging mean that it is often considered as a distinct 'P' within the marketing mix. Packaging has been described as the 'silent salesman' as it grabs customers' attention and makes products stand out from competitors.

Packaging has a number of functions:

- Physical protection in distribution and storage
- Content information, e.g. Weight, ingredients and storage details
- Convenient use and disposal, e.g. *Tetrapacks* for liquids
- Protection against theft by incorporating security tags
- Promotion by displaying logos and brand names

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✓ Price and pricing strategies *(AO3)*

Selecting the right price is a crucial element of the marketing process. There are a number of different pricing techniques:

- **Cost-plus pricing** - price is set by adding an agreed level of profit to average cost. This ensures a certain amount of profit per unit sold, but ignores competitors' prices.
- **Contribution pricing** - price covers variable costs and makes a contribution to fixed costs.
- **Price discrimination** - different prices are charged to different customers for the same product in different market segments. To work the markets must be kept separate.

Pricing strategies can be selected from a range of options:

- **Skimming pricing** - a high price is set to earn a high level of profit. This works if a product contains new technology and there are few direct rivals. Customers associate the price with a high quality, but it may reduce sales.
- **Penetration pricing** - a deliberately low price is set to gain market share when established brands already exist. Customers may regard a low price to be associated with a poor quality.
- **Price leader** - a dominant firm, with a significant share of the market, sets the price and other, smaller firms follow.
- **Predator or destroyer pricing** - a firm deliberately sets a low price, possibly beneath average cost of production, to force rivals out of the market. This strategy may breach competition rules.

In addition there are tactical pricing decisions. The most popular of these are:

(a) **Loss leading** - certain items are sold very cheaply to entice consumers into a shop in order that they pay full price for other items bought.
(b) **Psychological pricing** - prices are set to make consumers believe they are getting 'value' e.g. 99 cents and not $1. The firm establishes ***price points*** for each of their products.

The elements of the market mix must be consistent with each other. There is a close correlation between price and product. If a product is priced towards the top end of consumer's price perception, then a higher promotional effort is required to persuade the customer that it is a premium product justifying a premium price. Philip Kotler proposes a price quality strategy matrix:

	High price	Medium price	Low price
High quality	Premium price	Penetration pricing	Superb value
Medium quality	Overpricing	Average price, average quality	Bargain
Low quality	Hit and run pricing	Shoddy goods	Cheap goods

Firms may use a ***combination of pricing strategies*** in response to changes in the market and marketing activities of competitors.

✓ Promotion *(AO2)*

Promotion of products and services aims to:

- **Build** brand image, awareness and recognition.
- **Inform** customers about new and improved products, their functions and price
- **Persuade** customers to make a purchase and/or switch brand loyalty.
- **Remind** customers of the firm products to retain loyalty or to renew purchasing of its established products.
- Attract **attention** to the 'family' of products offered by the business and build corporate image.

Promotion is NOT simply advertising. It's all the various ways in which consumers are made aware of the goods and services offered by a firm.

Above-the-line promotion (ATL) – Advertising

Above-the-line promotion is paid-for promotion that is carried out through independent mass media that allow a firm to access a wide audience. These includes radio, television, newspapers and the Web. The firm passes control of promotion to specialist external organizations.

Advertising is directed at a mass audience to generate customer loyalty and repeat purchasing, allowing the firm to produce or buy in bulk and enjoy ***economies of scale***. Advertising is a media message paid for ***by a sponsor***.

For advertising to be effective, it should:

- Reach the desired target audience
- Be appealing to the target market
- Generate more sales revenue than it costs the firm

Advertising tends to be of two types:

- **Informative**: providing information to consumers on the product's key features and characteristics, specifications, availability and price.
- **Persuasive**: convincing consumers to purchase the firm's products, often in preference to the competitor's products. Adverts may promote brand image.

Below-the-line promotion (BTL)

Below-the-line promotion is promotion over which the firm has direct control. It includes direct promotion like direct mailing, exhibitions and trade fairs and sales promotions.

BTL promotions target individuals based on their needs or preferences and can lead directly to sales, e.g.

- Sales promotion
- Direct marketing
- Public relations (pr)
- Sponsorship
- Personal selling
- Merchandising
- Telemarketing
- Trade fairs

Sales promotion

Sales promotions are temporary methods to improve sales by attracting new customers and encouraging existing customers to purchase more. Sales promotion are not without cost. Discounts and free samples, for example, reduce a firm's profit margin.

Sales promotion can be divided into *two types*:

- **Into the pipeline** activities designed to encourage retailers and wholesalers to stock the product. These include incentives such as discounts, credit terms, prizes, merchandising and display materials.

- **Out of the pipeline**: activities carried out by manufacturers to encourage customers to buy in greater quantities. These include incentives such as discounts, free gifts and samples, BOGOF offers (buy one, get one free), vouchers, competitions.

Point-of-sales promotions are directed at customers in retail outlets, such as special displays, tastings and sales presentations, combined with vouchers and other incentives to encourage ***impulse buying***.

Direct marketing

Direct marketers target customers with advertising techniques such as fliers, catalogues and promotional literature. If an advertisement asks the customer to respond in some way, such as calling a free phone number, this is called direct response advertising.
Direct marketing is predominantly used by small to medium-size enterprises with limited advertising budgets.

Direct mail involves the delivery of promotional material to named individuals at their homes or businesses, selected from a list of known customers. This is often called 'junk mail' because most people throw the materials away as they are not seen as desired.

Public relations (PR) – Publicity

Publicity is more cost-effective than advertising, because PR messages are not paid for directly, although they are not cost free. Promotional materials give information about an event, business or person included in press releases and show the firm in a positive light to enhance its reputation. A positive article about a firm will be remembered longer than an advertisement, which is clearly sponsored. For the media, good PR is often treated as a news story, even though it promotes an organization.

Other PR tools, used to provide positive information, include brochures, newsletters and annual reports. Increasingly PR departments use social networking sites, such as Twitter and Facebook, to engage in two-way communication and receive immediate feedback from stakeholders.

Sponsorship/celebrity endorsement

Sponsorship is where an organization pays to be associated with a particular event, cause or image. It is evident in the sports' arena, where no major event is without significant sponsors. Celebrity endorsement encourages fans to link the image of the athlete with products and services. Firms look for positive qualities such as an athlete's global popularity and recognition, credibility, fitness, physical attractiveness, trustworthiness and expertise.

The promotional mix

The promotional mix is the way in which the components of an individual promotional campaign are blended as part of an overall promotional strategy. The elements include advertising, public relations, direct marketing, packaging, personal selling and sales promotion.

The nature of the promotional mix depends on:

- **How the product is perceived by consumers**. The inexpensive end of most markets tends to receives less promotional expenditure.
- **The target market** and customer needs.
- **Cost**: Firms divide their overall promotional budget between brands and products.
- **Where the product is in its life cycle**.
- The most **cost-effective method** of promotion.

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✓ The impact of changing technology on promotional strategies: e-marketing *(AO3)*

Word-of-mouth promotion is one of the most powerful transmitters of customer satisfaction, but new technologies have made this contagious transmission of information less controllable and predictable. If the messages are positive the firm acquires the kind of exposure that it could not have generated through major marketing campaigns costing millions of dollars. If the message is negative, the impact can be devastating.

Significant promotional opportunities exist through a firm's own website, which carries a range of articles, images, pages and general information that promote the firm, provides its story and informs customers of their products and services and the benefits they bring.

Social media

Most firms are increasingly sensitive to the power of the social media in promoting their products and brands. However, like traditional PR activities, it can be difficult to measure the impact of social media investment on revenues and profits. Social media marketing (SMM) is the process of gaining website traffic or attention through social media sites and social networks, such as Facebook, LinkedIn, Twitter, YouTube and WhatsApp.

Social network users draw the attention of their peers to products, such as new music; they follow, or 'like', specific products or companies, identifying themselves as customers or fans of brands. A survey by Mashable, a popular social media blog, found that 78% of people trust peer recommendations, compared with 14% for advertisements.

Viral marketing

Viral marketing is a marketing technique that uses customers to promote the product and increase brand awareness. Web users pass on marketing messages to other sites or users, creating an exponential growth in the message's visibility. Viral marketing may take the form of video clips, games, images, text messages, email messages, web pages, search engines and other social media to spread the message.

However, viral messages are not always consciously engineered; as they multiply, evolve and mutate, they may not reflect the strategic intentions of the firm's marketing plan.

Advantages and disadvantages of technology on promotional activities

Advantages of new technology for businesses

- Speed - the message reaches the target audience quicker than traditional media.
- Availability - the web is available 24/7.
- Wide reach - firms can access a global audience with little cost.
- Cost-effective - e-commerce is cheaper than traditional promotion.

Disadvantages of new technology for businesses

- **Lack of control** – firms have little control over the transmission of marketing messages between users and consumers.
- **Access** – not all consumers have access to the Web.
- **Attention spans** – the Web is crammed with messages, many of them conflicting. Users of the web tend to spend little time on Web pages.
- E-commerce sites and payment gateways offer opportunities for hackers.

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✓ Guerrilla marketing and its effectiveness as a promotional method *(AO3)*

Guerrilla Marketing focuses on low-cost unconventional marketing tactics that yield maximum results and was inspired by guerrilla warfare including ambushes, sabotage and elements of surprise. *Guerrilla marketing* uses similar tactics, including promotions through a network of individuals, or organizations.

It relies on energy and imagination, rather than a big advertising budget and is popular with small and medium sized firms. It requires creativity, flexibility and a willingness to take risks. It is about creating a 'social buzz', especially online. Research shows it creates a more lasting impression on consumers than traditional forms of advertising and marketing.

Methods of guerrilla marketing

Guerrilla marketing uses:

- Social media sites, such as Facebook, to begin campaigns, share features and event host events.
- Competitions or discounts to encourage users to share or create content related to products or events.
- Videos showing entertaining or surprising events that internet users share.
- Interactive activities, such as games, to stimulate product interest and engagement and promote events.

✓ The importance of place in the marketing mix *(AO2)*

Place is one element of the marketing mix, more accurately described as 'distribution'. Where a product is sold is place or location; getting it from the producer to the consumer is distribution, which is an active process known as **physical distribution management** (PDM); often carried out by specialist *logistics* companies, using computer controlled distribution to maximise cost-effectiveness.

The path from producer to consumer normally involves more than one organization, though new technologies have shortened the distribution chain and encouraged firms to sell directly to the consumer, so reducing costs and lowering prices.

Channels of distribution

KEY TERMS

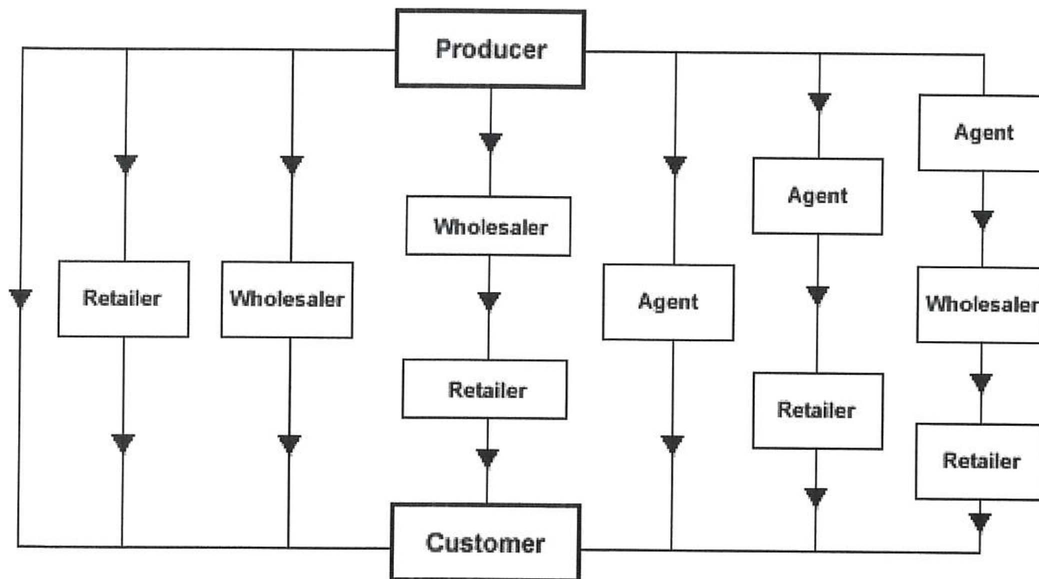
A **distribution channel** is the set of firms and individuals that take title, or assist in transferring title, to a good or service as it moves from the producer to the final consumer or industrial user.

Producers use middlemen to distribute their products even though they take a profit margin, because this is more cost-effective and efficient.

Traditionally distribution has involved the following intermediaries:

- ***Agents/brokers*** bring buyers and sellers together and receive a commission.
- ***Wholesalers*** buy in bulk and break this down to offer smaller amounts for sale.
- ***Retailers*** buy in bulk from the wholesaler and then sell on to the consumer. They also break bulk as most sales are of single items.

The various methods of distribution are summarised in figure 1 below.

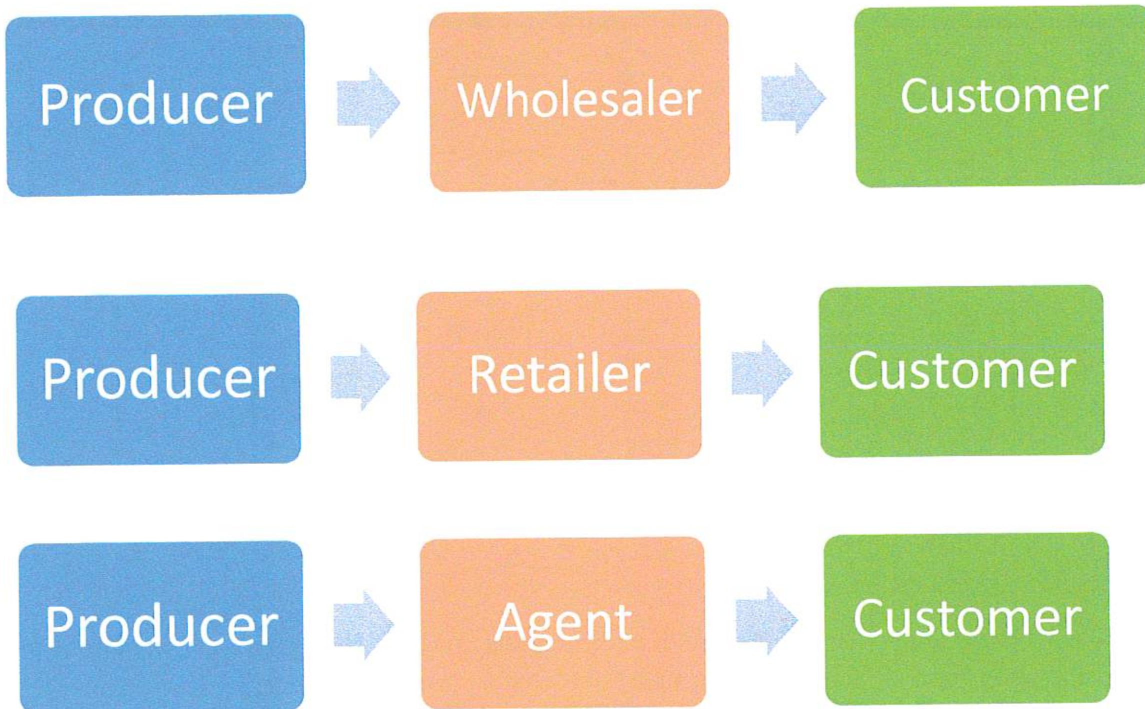


Methods of distribution – producer to consumer

The distribution process ***breaks bulk*** through the use of intermediaries such as wholesalers, allowing firms to mass produce and customers to buy single units. Each part of the chain takes a profit margin.

1. A **zero-level** or **direct marketing channel** consists of a manufacturer selling directly to consumers, e.g. door-to-door sales, mail-order, manufacturer-owned stores, e-commerce and telesales.

2. A **one-level channel** contains one intermediary. In a consumer market this is typically a retailer, while in an industrial market this will be an agent.



3. A **two-level channel** contains two intermediaries and, where these are a wholesaler and a retailer, represents the most common form of consumer distribution.

✓ The effectiveness of different types of distribution channels *(AO3)*

This length, and nature, of the distribution channel depends on:

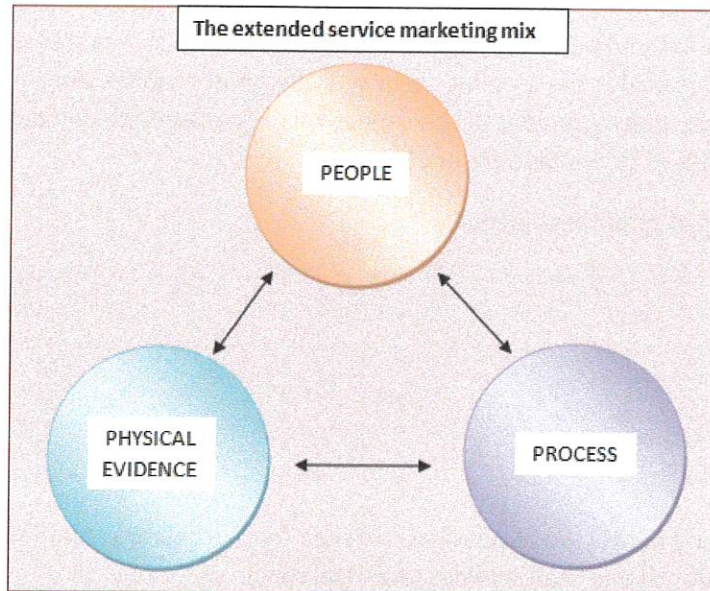
- **The nature of the product** – perishable products require different channels to consumer durables.
- **The nature of the customer and market segment** – certain customers require delivery of products in particular ways and in particular locations.
- **The objectives of the firm** – firms looking for cost- efficiencies may change distribution methods.
- **The market** - a regionally concentrated market requires different channels than global markets.
- **Legal restrictions** – not all products are openly sold and distributed, e.g. drugs distribution is controlled.
- **Quantity to be delivered** – direct delivery of small quantities may not be economic.
- **Security** – valuable products require greater security measures.
- **Frequency of delivery** – regular customers may justify customised distribution.

4.6 The extended marketing mix of seven Ps

✓ The marketing mix for services *(AO2)*

The marketing mix was developed for products, not for services. Some vital elements are missing from the mix for a service, especially in the not-for-profit sector. In recent years the '4Ps' have been extended to include elements more suited to the features of a service:

- **People**
- **Physical evidence**
- **Process**



✓ People

The importance of employee-customer relationships in marketing a service (AO3)

People are the most important element of any service experience and can have a profound positive or negative effect on customer satisfaction. The reputation of a firm's brand rests in the hands of its employees.

Services are normally produced and consumed at the same moment and aspects of the customer experience are altered to meet individual needs.

Customers buy services from people they like, so the attitude, skills, behaviour and appearance of staff is crucial to satisfaction and service quality. The training of staff is central to successful service delivery.

Examiner Tip!

Remember, **people** in the context of a service refer to the employees who deliver the service, not to the public or to customers.

✓ Processes

The importance of delivery processes in marketing a service and changes in these processes (AO3)

The process of buying a service influences whether the customer repeats that purchase. Cheerful, attentive and concerned staff may enhance the process or overcome problems, such as delays or queuing. If a customer enjoys excellent restaurant service, they may tell others and provide word of mouth promotion.

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Processes in service marketing include:

- Waiting time
- Payment methods
- Speed and quality of delivery
- Additional services e.g. After sales

Physical evidence

✓ The importance of physical evidence in marketing a service (AO3)

The physical environment influences the satisfaction of consumers receiving a service. Banks, for instance, spend considerable amounts on the design of branches and the automated machinery. Restaurants focus on a clean, friendly environment and a homogeneous environment, such as that created in every Esso petrol station around the world, provides the tangible security a customer requires before buying a service. Physical evidence is an essential ingredient of the service mix as consumers' perceptions of the service is influenced by their perception of the delivery environment.

There are many examples of physical evidence:

- Packaging
- Web pages
- Brochures
- Signage
- Uniforms
- Building design

Some organizations depend heavily upon physical evidence for marketing communications, such as tourist attractions (e.g. Disney World) and mail services (e.g. DHL vans).

4.7 International marketing

International marketing is carried out to satisfy different buying patterns, demographics and market segments in overseas markets.

International and global marketing are often used interchangeably, although there is a difference. Global marketing employs a uniform approach to the marketing of goods in overseas markets, rather than adapting marketing to local conditions, e.g. McDonalds maintains a consistent product and message around the world.

✓ Methods of entry into international markets *(AO2)*

Firms enter markets by a variety of routes:

- **Direct exporting** - the firm makes the products at home and sends them to the country of consumption, potentially losing control of the marketing process.
- **Franchising** - a firm sells the right to a franchisee to trade under its name and logo requiring the franchisee to maintain the quality and reputation of its brand.
- **Licensing** - a local firm buys the right to produce the goods of a multinational company.
- **Joint venture** - two or more companies join together to fulfil a particular contract, sharing the risks.
- **Direct investment** - a firm produces and distributes products in an overseas market.
- **Mergers and takeovers** - a firm buys a business operating in the country in which it wants to sell.
- **E-commerce** - a method to access global markets.

✓ Opportunities and threats of entering international markets *(AO3)*

Opportunities

- **Increased profitability** – larger markets result in increases in sales and profitability, because of greater *economies of scale,* lower sourcing costs and possible higher prices.
- **Diversification / spreading of risk** – a fall in economic activity in one market may be mitigated by shifting production to other growing markets.
- **Increased brand exposure and recognition** – global brand recognition increases its value, making it easier for the firm to introduce new products and services.
- **Legal differences** – cheaper and easier production; not all countries apply the same legal and safety standards.
- **Market saturation** – firms can boost sales and prolong product life cycles by selling overseas.

Threats

External environment risks are more significant in an international context:

- **Social factors**: differences in social conditions, religion and culture affect consumers' perceptions and buying behaviour and demographic changes impact on products demanded.
- **Technological factors:** the growth of the Web increased international competition.
- **Economic factors**: the purchasing power of global populations vary, affecting the products demanded and supporting marketing.
- **Ethical factors**: firms adopt ethical approaches to promoting and selling products that may harm local populations and their way of life.
- **Political factors**: governments may impose restrictions on marketing to local populations.
- **Legal factors**: marketers must be aware of laws governing acceptable marketing and selling techniques.
- **Environmental factors**: marketing must avoid detrimental effects on the environment.

✓ The strategic and operational implications of international marketing *(AO3)*

Globalization and growing Internet access increased the interdependency and interconnections of countries and the firms that operate within them.

Managing stakeholder expectations

The complexities of international marketing means MNCs have more stakeholders with differing expectations and, therefore, potential for conflict. The firm's ability to manage conflicts influences its international marketing success.

✓ Cultural differences in international marketing *(AO3)*

What is acceptable in one country may not be in another. Firms must be sensitive to local beliefs and consider the ethics of exporting cultural norms and values, e.g. the representation of men and women.

- ***Culturally bound products:*** Religious taboos or differences may make certain products unsellable in certain countries e.g. pig products.
- ***Status relationships:*** In many Asian cultures, status is very important and language reflects this, with different words used to express similar ideas.
- ***Advertising:*** Some cultures dislike aggression and others prefer symbols to language. Humour is very culturally specific.

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- ***Packaging:*** Colours have associations with death, sickness or national pride. Western countries associate black with death, but Asian cultures use white.
- ***Language:*** Translation may be difficult if suitable words are unavailable in other languages, e.g. in Saudi Arabia, Pillsbury's *'Jolly Green Giant'* was translated as *'Intimidating Green Ogre'*.

Whether local populations perceive MNCs as 'foreign' or 'local' influences purchasing decisions.

✓ The influence of globalization on international marketing *(AO3)*

Growing international trade and globalization leads to:

- Increasing competition as markets are deregulated.
- Changing consumer tastes and preferences as local populations absorb ideas and values imported from abroad through global media.
- Opportunities for marketing economies of scale.

4.8 E-commerce

✓ Features of e-commerce *(AO1)*

Electronic commerce, or **e-commerce**, is the buying and selling of products or services over electronic systems, such as the Internet and other computer networks. It also includes electronic funds transfer.

E-commerce allows firms to operate 24 hours a day.

✓ Changing technology, e-commerce and the marketing mix *(AO2)*

Product: e-commerce allows firms to offer a wider range of products and provide more information on specifications with greater customisation opportunities.

Price: lower overheads reduce the prices of goods. Customers compare prices using search engines and price comparison sites.

Promotion: e-commerce supports innovative promotion, e.g. purchase suggestions based on search behaviour.

Place: e-commerce reduces the number of intermediaries in the supply chain, and increases opportunities to find suitable products and services.

✓ Types of e-commerce *(AO2)*

Business to business (B2B) – businesses selling to other businesses, e.g. retailers order stock from suppliers.

B2B e-commerce is used to:

- Attract, develop, retain and cultivate customer relationships.
- Streamline supply, manufacturing and purchasing to deliver the right products and services to customers quickly and cost effectively.
- Capture, analyse and share customer information.

Business-to-consumer e-commerce (B2C): business selling goods directly to consumers, e.g. ordering goods and services directly from Amazon.

Consumer-to-consumer e-commerce (C2C): transactions between one consumer and another, characterised by the growth of electronic marketplaces, peer-to-peer sites and online auctions, e.g. eBay.

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✓ The costs and benefits of e-commerce to firms and consumers *(AO3)*

Potential customer benefits

Many firms operate physical and online stores, offering different purchase options. Customers can use the web to investigate options and then purchase from a physical outlet.

Online stores usually have:

- Lower overheads than physical competitors and consequently lower prices
- A larger range of products available
- Search facilities to find the correct product and information more easily
- Reduced transaction times
- Purchase tracking
- Higher service levels, e.g. Links to frequently asked questions
- Encrypted payment systems

Potential firm benefits:

- Potential access to global markets
- Increasing opportunities for small producers in niche markets
- Cost savings and improved efficiency
- Improved relationships with trading partners along the supply chain

Potential risks to customers:

- Fewer quality controls on online businesses and product quality may be less than in physical retail outlets
- Laws protecting shoppers in one country may not apply to purchases from foreign sites
- Customer security may be compromised online, e.g. Fraudulent operations
- Cybercrime is growing with hackers and spammers disrupting commercial activities and stealing information

Potential risks to firms:

- Harder to develop online brand loyalty as customers can search for cheaper alternatives
- Expensive to develop reliable secure sites, with payment facilities and links to distribution systems
- Vulnerability to cyber-attacks from competitors, spammers and hackers and loss of commercially sensitive information
- Some products difficult to market online as customers want to try out before buying, e.g. furniture

✓ Potential IB question on Unit Four topics for each assessment objective

AO1

- Define marketing and describe the relationship with other business activities
- Describe the difference between market and product orientation
- Describe the elements of a marketing plan
- Outline possible target markets for XYZ plc's new distribution service
- Describe the importance of innovation in an era of rapid technological change

AO2

- Explain the difference between the marketing of goods and services
- Analyse the marketing techniques of non-profit organizations
- Apply the elements of the marketing mix to
- Explain the values of a marketing audit as a business tool
- Comment on the role of market research in XYZ plc's marketing plan
- Comment on the importance and role of branding
- Analyse the usefulness of market segmentation and consumer profiles
- Apply the BCG matrix to XYZ plc
- Analyse the effect of e-commerce on the marketing mix

AO3

- Discuss the ethical issues of what is marketed and how it is marketed: nationally, internationally and across cultures
- Evaluate different methods of market research
- Discuss how XYZ plc can differentiate itself and its products from competitors
- Discuss the problems and financing research and development
- Examine the relationship between the product life cycle and the marketing mix
- Compare the various promotional tools and discuss their effectiveness
- To what extent is entry into international markets an opportunity and threat for XYZ plc?
- Discuss the costs and benefits of e-commerce to firms and consumers

AO4

- Calculate market share from given information
- Construct an appropriate marketing mix for
- Construct a position map from given information

Unit 5: Operations management

5.1 The role of operations management (production)

Operations Management is concerned with the design of products and services and management of processes and supply chains. It describes the acquisition, development, and utilisation of the resources that firms require to produce and deliver the goods and services that their customers want, and covers strategic and tactical activities and decisions:

- Strategic decisions about size and location of factories and appropriate supply chains
- Tactical decisions about factory design, project management and equipment selection
- Operational decisions about production scheduling and quality control

Operations activities apply in all three economic sectors:

- Primary sector, e.g. Extracting raw materials
- Secondary sector, e.g. Manufacturing, construction and processing
- Tertiary sector, e.g. service provision

✓ Operations management and its relationship with other business functions *(AO1)*

Production is concerned with ***converting inputs,*** e.g. raw materials into ***finished products,*** to meet the customer needs and wants. Production will ***add-value*** allowing firms to charge a higher price for the finished product, than it paid in terms of costs.

The Operations department is closely linked with other business functions:

Marketing: The marketing department generates demand and liaises with operations to ensure this quantity can be produced.

Finance: production generates revenue, but create costs that must be paid. Many firms fail because they run out of cash during production.

Human Resources Management: The HRM department must guarantee the numbers of skilled staff required to produce the goods demanded, through appropriate recruiting and training.

✓ Producing goods and services *(AO2)*

Production transforms tangible inputs, such as raw materials, and intangible inputs, such as knowledge and ideas into goods and services. It can be difficult to separate out ideas, say in the form of innovation, from the physical process of production.

✓ Operations management and economic sustainability *(AO3)*

Although the key objective for operations is satisfying the needs and wants of customers profitably, there is an increasing emphasis on a firm's Corporate Social Responsibility, and that production is sustainable.

> "*Sustainable development meets the needs of the present without compromising the ability of future generations to meet their own needs*"
>
> *World Commission on Environment and Development, 1987*

Consisting of three pillars, sustainable development seeks to achieve economic development, social development and environmental protection.

Economic sustainability

The aim of the sustainable economic model is the fair distribution and efficient allocation of resources.

Social sustainability

This pillar supports initiatives like peace, social justice, reducing poverty, and other movements that promote social equity.

Environmental sustainability

This pillar supports initiatives like: renewable energy, sustainable agriculture and fishing, organic farming, tree planting, recycling and better waste management.

5.2 Production methods

✓ Main production techniques *(AO2)*

1. Job/customised production
2. Batch production
3. Mass/flow/process production
4. Cellular manufacturing

Job production

KEY TERMS

Job production is the manufacture of individual 'one-off', or unique items, made to customer specifications. The product is seen through the whole process, from start to finish, by an individual or group of workers.

Job production is associated with *bespoke* production, with products made individually and to order; customised to the buyer's specification, such as buildings. Production is highly skilled and *labour intensive*. Production costs are usually high with premium pricing.

Job production is suited to smaller firms with few economies of scale and less price-sensitive customers, although large-scale projects also satisfy the objectives of larger firms in terms of profit levels, e.g. major construction projects.

Managing job production may be difficult, as processes differ from job to job with *cost control* and *cash flow* issues, because payments for products made to order, such as yachts, may not be until delivery.

Advantages of job production:

- Profit margins normally high
- Variety motivates staff
- Little, or no, stockholding
- Large market share in niche markets
- High quality output matched closely to customer needs
- Design and specifications can be changed throughout the process
- Good customer relations
- Capital costs are likely to be low

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Disadvantages of job production:

- Short production runs increase average costs
- Fewer opportunities for economies of scale
- Labour costs of skilled, flexible employees are high
- Capacity utilisation is often low
- Minimal stock levels reduce opportunities for impulse buying
- Firms cannot cater for unexpected demand

Batch production

KEY TERMS

Batch production involves the production of identical products made in groups (batches). The group remains together as it passes through each stage of production until all processes are complete. Changes may be made between batches. Batch production is normally used when the demand for the product is relatively constant, e.g. clothing, bakery products and pharmaceuticals.

Advantages of batch production:

- Lower capital costs, because a single production line is used for different products
- Lower unit costs than job production
- Firms gain some economies of scale
- Offers customers a wider choice
- Output higher than job production
- Used for trialling new products
- Some goods can be kept in stock to meet unexpected demand
- Useful for the production of seasonal items, e.g. cards

Disadvantages of batch production:

- Higher start-up costs than job production
- Downtime between batches
- Higher unit costs than flow production
- More stocks of raw materials tie up cash
- Requires careful planning and coordination
- Less flexible than job production
- Production not individualised to customer requirements
- Workers specialise with lower skills
- Higher capital cost than job production

Flow/mass/process production

KEY TERMS

Flow production is where all operations required for production are carried out in a sequence, one after the other. Used where mass production is required to meet high levels of demand and when the product being manufactured is reasonably standardised.

Flow (mass or line) production is the continuous movement of items through each stage of production, often along an assembly line. The process involves the manufacture of a large volume of identical, standardised products in sequence. Employees are semi-skilled. It is highly capital-intensive with high set-up costs, requiring firms to operate near capacity (high capacity utilisation) and is suited to automation.

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Advantages of flow production:

- High volumes produced, e.g. FMCGs
- Products produced more rapidly, flexibly and cheaply, often with better quality
- Lower unit costs because of significant economies of scale
- Fast and efficient production, with little downtime
- Output higher than job production
- Labour costs low as employees are semi-skilled
- Suited to mechanisation and automation
- Unexpected demand met easily
- Quality control more reliable, because of standardised production
- Replacing low-skilled staff is relatively easy
- New technologies allow increased customisation

Disadvantages of flow production:

- Less flexible production as goods standardised
- Requires consistent high demand
- Heavy set-up costs requiring large production runs
- Work can be boring and staff turnover rates can be high
- Assembly lines are integrated, so a breakdown in one area may stop the whole line
- Less flexible than job and batch production
- Defective stock is normally rejected
- Raw material availability requires expensive control systems

Summary of production methods

Job Production - made to order with specific features e.g. Olympic Stadia.

Batch Production - a group of items passing through a number of stages as a batch, e.g. bread: dough made, loaves produced, put in oven, sliced and wrapped.

Mass/Flow Production – an item flows from one stage of a process directly to the next, often by conveyor belt e.g. cars.

	Job production	Batch production	Flow production
Output potential	Low	Intermediate	High
Capital requirement	Low	Intermediate	High
Product quality	High	Intermediate	Lower
Flexibility of product	High	Intermediate	Low
Unit cost	High	Intermediate	Low
Labour skill requirement	High	Intermediate	Low
Labour productivity	Low	Intermediate	High

Cell production

KEY TERMS

Cell production is an important ingredient of lean manufacturing. A manufacturing system where the workforce is divided into self-contained teams who complete a particular manufacturing process or product.

The team is responsible for quality control and 'sells' the part-finished product to the next cell which is regarded as an 'internal customer'; a key element in the **Kaizen** quality control. Each cell operates as an individual assembly factory, normally arranged in a 'U' shape. Cell members are multi-skilled, allowing flexibility through job rotation. Cell production enable greater flexibility in the production of a variety of low demand products, while maintaining the productivity of larger scale production.

The team allocates specific roles, appoints supervisors and organizes training. Each cell is responsible for a **complete unit of work**, which Herzberg identified as **job enrichment**.

Advantages of cell production:

- Good communication between the members
- Processes managed efficiently and cost-effectively
- Workers multi-skilled and flexible
- Completing an entire product offers job satisfaction
- Staff involved in decision-making and better motivation
- Quality improves because each cell has 'ownership' over production
- Low stock requirements allows the operation of a just-in-time (jit) system
- Improved customer response time

Disadvantages of cell production:

- Machinery is not used as intensively as in flow production
- Greater investment required in management and control
- Possible rivalries between cells

✓ The most appropriate method of production for a given situation *(AO3)*

The choice of production method rests on:

- **The level of demand** – mass demand for a product may justify investment in flow production.
- **The nature of the target market** – price sensitive markets may require high volume, standardised products, but demand for high quality customised products requires job production.
- **The nature of the product** – certain products may only be produced by one method, e.g. sports stadiums require job production.
- **The comparative costs of labour and capital** – large firms minimise labour cost by investing in automation. However, cheap labour allows for labour-intensive production methods.
- **The nature of the firm itself** – small firms will not have the funds to invest in mass production.
- **New technologies** - as technologies become cheaper, smaller firms can acquire the capital for batch or flow systems.
- **The goals of the business** – firms seeking to maximise market growth and profitability, may invest in flow production, whereas small firms may use job production methods to create unique selling points, e.g. 'hand-made'.
- **Government policies** – government may stimulate economic growth by offering subsidies and tax breaks for capital investment.

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5.3 Lean production and quality management

Lean Production originated in Japan in the 1950's. After a visit to the Ford River Rouge plant, Toyota managers concluded that:

- Mass production was riddled with waste ('*muda*')
- Standardisation was unacceptable to customers
- Quality was poor with high reject rates

✓ The ten rules of lean production *(AO1)*

1. Eliminate waste
2. Minimise inventory
3. Maximise flow
4. Pull production from customer demand
5. Meet customer requirements
6. Do it right the first time
7. Empower workers
8. Design for rapid changeover
9. Partner with suppliers
10. Create a culture of continuous improvement

✓ Methods of lean production *(AO2)*

Continuous improvement (Kaizen)

Continuous improvement **(Kaizen)** was developed in Japan, although first proposed by **Dr W. Edwards Deming** in the USA. Small groups are formed with the target of identifying changes and improvements to products, procedures and methods. Kaizen teams make small improvements in quality on a continuous basis with the objective of increasing customer satisfaction. Over time, these small steps generate significant improvements in quality and competitiveness at relatively low cost.

The Kaizen Institute says that employees have two jobs: 'doing their job and then looking for ways of improving it'.

Just-in-time (JIT)

KEY TERMS
Just-in-time is a management and manufacturing philosophy aimed at the total elimination of waste. JIT minimises the costs of holding raw materials, components, work-in-progress and finished goods by supplying to each part of the production process exactly what is needed, when it is needed and in the quantity it is needed.

Critical components of JIT include total quality management, lean production and employee involvement, requiring changes to corporate culture, organizational structures and a more democratic management style.

JIT is an element in lean production:

- Minimal buffer stocks, relying on regular deliveries from trusted suppliers
- Production meets specific customer orders, not produced ***just-in-case***; products are '***pulled through***' the factory, rather than '***pushed through***'
- Finished goods delivered immediately to the customer, reducing working capital levels

Production teams are ***multi-skilled***, working as teams within automated production cells, often with heavy use of robotics.

Advantages of JIT:

- Reduces cost of holding stock
- Space used for storing stock released for other activities
- Minimal inventory releases cash flow
- Less risk of obsolete or damaged stock
- Lower break-even point
- Improved motivation and teamwork with multi-skilled employees
- Promotes customer focus and responsiveness to individual needs
- Greater customisation
- Focus on quality and zero defects
- Collaboration along the supply chain

Disadvantages of JIT:

- Failures in delivery by suppliers can lead to expensive production delays and stock-outs
- Does not cope well with sudden surges in demand
- Lower purchasing economies of scale - frequent small deliveries are likely to be expensive
- Administration costs higher
- Requires a change in management style
- Higher training costs
- Expensive computer technologies required
- Holding stock may be more cost-effective in times of inflation

Kanban

A Kanban is a 'pull system', where production of the next batch is not started until the user signals a need, enabling the firm to hold only a minimal buffer stock. The signal can be cards, empty containers, flags or computer screens authorising production.

Andon

Andon refers to any visual display that shows the status of manufacturing on the plant floor or at a particular work station, e.g. simple lights signalling the line status and providing real time feedback:

- Green for normal operation
- Yellow when assistance needed
- Red when the line is down

More sophisticated visual displays are now used in manufacturing, but the purpose remains the same.

✓ Cradle-to-cradle design and manufacturing *(AO2)*

The cradle-cradle philosophy encourages firms to design products that, after their useful life, provide nourishment for something new - either as "biological nutrients" that safely re-enter the environment or as "technical nutrients" that circulate within closed-loop industrial cycles, without being "downcycled" into low-grade uses (as most "recyclables" now are).

Cradle-to-cradle describes efficient and waste free production techniques, different to the concept of *cradle-to-grave* which refers to firms taking responsibility for the disposal of goods they have produced.

✓ Quality control and quality assurance *(AO1)*

Quality Assurance is **process oriented** and focuses on defect *prevention*; while quality control is **product oriented** and focuses on defect *identification*

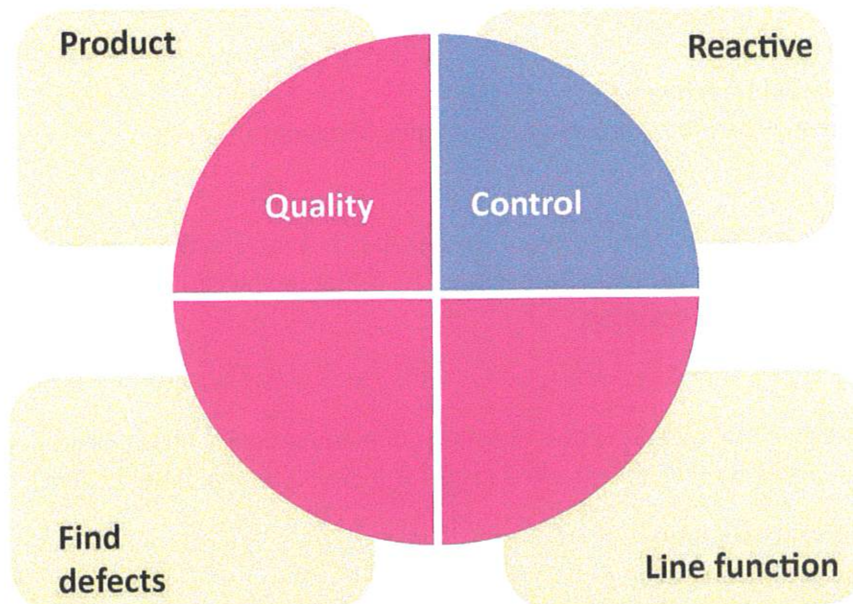
KEY TERMS

Quality Control (QC) is associated with the process of creating products and services and used to verify that pre-determined quality standards are being met through quality inspections and reviews which detect poor quality, and identify, non-conformance with those standards.

Quality Assurance is the process used to assure the consumer that a firm's products or services are fit for purpose, by preventing quality issues rather than detecting them. The objective is to meet quality standards at each stage of production to ensure customer satisfaction with the final product or service.

Key differences between Quality Control and Quality Assurance *(AO1)*

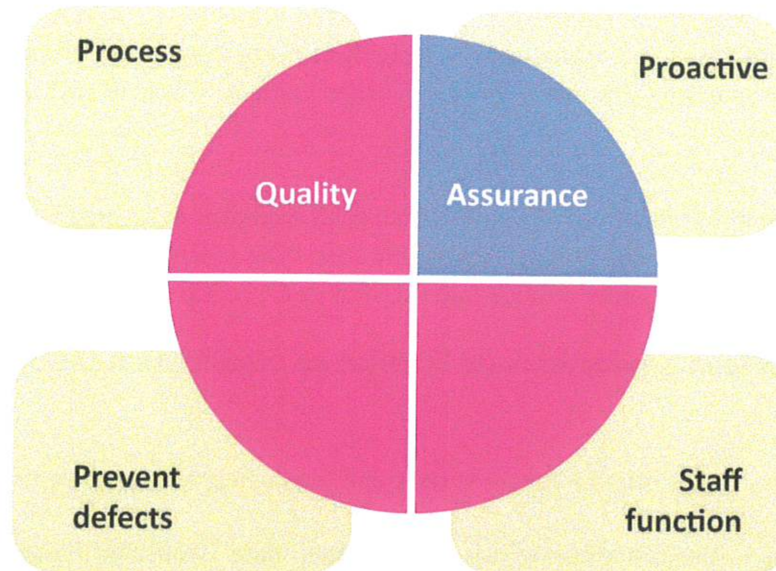
- Quality control is about adherence to requirements for a particular product. Quality assurance is generic and not concerned with the specific requirements of a product.
- Quality assurance activities are determined before production and performed while the product is being developed. In contrast, quality control activities involve inspection and sampling *after a good is manufactured.*



Quality control works by selecting *samples,* which are subjected to a set of predetermined quality standards using **Statistical Process Control** (SPC) to ensure that finished products fall within acceptable tolerance levels, e.g. size.

> *In effect, a company is paying workers to make defects and then to correct them. Quality comes not from inspection, but from improvement in the process.*
>
> Mary Walton, *Deming Management Method*

Quality assurance *prevent defects* by setting up the controls and mechanisms to check the quality at every stage of the process to achieve *'zero defects'*.



✓ Managing quality *(AO2)*

Quality circles

A quality circle is a multidisciplinary team meeting voluntarily and regularly, to examine products and procedures and to make recommendations for improvement. The group is made up from shop floor employees and trained in leadership, problem-solving and decision-making skills. Quality circles require delegation of responsibility by management and effective two-way communication.

Benchmarking

Benchmarking is a systematic process of comparing the activities and work processes of an organization with those of outstanding organizations, normally in the same industry, with the objectives of improving performance. Firms benchmark different aspects of their production process against competitors who excel in each of these aspects, e.g. a car manufacturer benchmarks its engine performance against that of the market leader.

Types of benchmarking:

- Internal benchmarking – compares function within the same industry.
- Functional benchmarking – compares function regardless of the industry.
- Competitive benchmarking – gathers information about direct competitors.

Advantages of benchmarking:

- Resources used more effectively
- Improves customer satisfaction and reduces complaints
- Reduces waste
- Increases awareness of innovation and alternative solutions
- Improves employee motivation and productivity
- Increases sales revenue and profits
- Provides 'market intelligence'
- Awareness of new developments
- Firms adopt best practice

Total quality management (TQM)

A total quality culture requires a commitment to quality at every stage of the production process from research and development to after-sales service, in order to meet or exceed customer expectations.

KEY TERMS

TQM is a philosophy and style of management which gives everyone in an organization the responsibility to deliver quality to the customer at the lowest possible cost. TQM views every task in the organization as a process that is a customer/supplier relationship with the next process in the supply chain.

✓ The impact of lean production and TQM on an organization *(AO3)*

Features of TQM

- **Teamwork** – teams offers a range of skills and ideas, help solve problems and improve quality and morale.
- **Monitoring** – close monitoring using quantitative data (*Statistical Process Control*) on production quality.
- **Company policy** – focus on TQM at all levels of the firm starting with senior management.
- **Quality chains** – focus on quality at all stages of production and distribution by creating quality chains from supplier through to customer.

Advantages:

- Improves the quality of the final product or service
- Reduces waste
- Employee productivity, motivation and retention improves
- Increased market share by creating competitive advantage and greater customer satisfaction

Problems:

- Demanding quality standards
- Requires significant investment in new equipment and staff training
- Requires close monitoring and the collection of considerable data

✓ National and international quality standards *(AO2)*

Quality standards are designed to help organizations achieve a recognised level of quality certified by international bodies, such as the *International Organization for Standardization* (ISO).

ISO International Standards ensure that products and services are safe, reliable and of good quality, reducing costs by minimising waste and errors, and increasing productivity. They help facilitate free and fair global trade.

5.4 Location

✓ The reasons for a specific location of production *(AO2)*

The choice of location is probably the single largest expense when setting up a new business. It is likely to have a significant impact on the number of customers a firm attracts, and consequently its sales revenues and profit levels.

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Factors affecting location

Cost factors

- **Labour** - firms seek to maximise labour productivity, e.g. the highest output per dollar wage rate. Wage rates fluctuate between different regions.
- **Land** - manufacturing firms need more space and prefer suburban locations, where land is relatively less expensive and less difficult to develop. Warehousing firms need to locate close to suitable communication hubs and distribution networks.
- **Transport**
    - if the business is ***bulk-gaining,*** because the finished item is larger than its components e.g. furniture, firms locate close to the market place to minimise transport costs
    - if the business is ***bulk-reducing,*** it makes economic sense to locate the manufacturing process close to the source of the raw materials or components to minimise transport costs

Linked industries and agglomeration - firms tend to locate in areas where there is already a concentration of similar firms to gain *external economies of scale*, such as access to skilled labour.

Revenue factors

- **Customer convenience** – customers visit locations offering convenience in the shopping experience, e.g. shopping malls. Retailers locating in malls are likely to enjoy high sales revenues and profits.
- **Location image** – certain locations have a particular connection with a product or service that will attract customers looking for a concentration of outlets and, therefore, a broader choice.
- **Geography and climate** – some industries, such as leisure and tourism, are influenced by the nature of the local landscape and the climate.

Qualitative factors

- **Infrastructure** – infrastructure includes communications, utilities, support services and transport links. Government attract business investment into a region, by improving the quality of the local infrastructure.
- **Quality of life and local culture** – employees will be attracted to join firms in areas that offer attractive schooling, shopping facilities, transport, housing and facilities such as golf courses.
- **Future growth opportunities** – a location decision may be made on an assessment of the ability to acquire additional land and buildings if the firm grows.
- **Ethical** and **CSR issues** – firms which believe passionately in corporate social responsibility and ethical operations, will avoid locations where they believe the firm could potentially create environmental damage.
- **Planning restrictions** and **local population objections** – firms will avoid contentious location decisions.

Public policy factor

- **Regulation** – firms may locate in areas with more 'relaxed' regulation on construction and operations.
- **Taxation** – profit-making firms seek locations where they can maximise profits, such as 'tax havens'.
- **Financial incentives: grants and subsidies** – governments offer firms incentives to encourage economic growth, business set-ups and innovation, such as grants to build new production facilities and offer jobs to the unemployed, and training for the young in areas of high unemployment.

✓ Reorganizing production nationally and internationally *(AO3)*

Firms may choose to re-organize their production nationally and internationally by changing both the location of their operations or contracting with external specialists to undertake some of their non-core activities. This can be achieved by:

- **Outsourcing/subcontracting**
- **Offshoring**

Operational problems and customer dissatisfaction with the quality of products and services have led some firms to bring previously outsourced production and operations back inside the business. A process referred to as **insourcing** or **reshoring** (see section 2.1 for more details).

5.5 Production planning

✓ The supply chain process *(AO2)*

The supply chain is the system of organizations, people, activities, information, and resources involved in moving a product or service from supplier to customer. Supply chain activities transform raw materials and components into a finished product delivered to the end customer.

Managing the supply chain involves two flows:

1. The flow of the product from raw material to finished and packaged item. Faulty or returned products may be transferred back down the supply chain.
2. The flow of information about the product, the supplier, the customer, the payment and the delivery process. These flows are commonly performed electronically.

One key issues is the control of inventory levels. With competition so intense, finding cost savings by managing the supply chain efficiently is increasingly important. Many firms use specialised logistics companies to manage their processes.

✓ The difference between JIT and just-in-case (JIC) *(AO2)*

'Just-in-case' is the traditional approach to stock control. The firm holds **buffer stocks** of raw materials for production, in case there are demand or supply fluctuations. Holding minimum stock levels means:

- Flexibility to meet customers' needs and unexpected demand changes
- The firm can buy in bulk and gain from purchasing economies of scale
- The firm can avoid stock-outs and production downtime

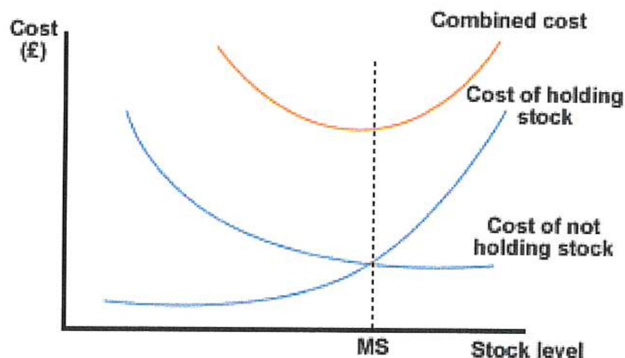
The just-in-case system runs counter to the principles of Total Quality Management (TQM) and Lean Production as there is no incentive to achieve zero defects, since spare stock is held at all stages of the production process.

✓ Stock control *(AO2/AO4)*

Holding stock increase the possibility of cash flow problems. Stock-control charts are used to reduce liquidity problems. These include details on stock levels, usage rates, order quantities and delivery times, such as:

- **Minimum stock holding**. The minimum level of stocks held by a firm is called the **buffer stock** level. This absorb 'shocks' and act as a contingency if there is unexpected demand. Firms aim to minimise buffer stocks as these tie up capital.

- **Economic order quantity (EOQ)**. Purchasing managers who order large quantities gain large discounts, but these are offset by high costs of stock-holding. The optimum level will depend on distribution costs and the nature of the stocks, e.g. bulky goods tend to be delivered in larger quantities to reduce delivery costs. The optimum stock level is the lowest point of the total stock cost graph, which is the combination of the cost of holding stock and the cost of not holding stock.



Minimum stock level

KEY TERMS

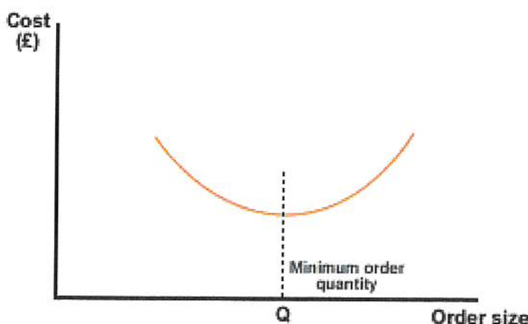
The **stock re-order method** calculates the optimum order quantity of a specific product by balancing the conflicting costs of holding stock and delivery of replenishment stocks.

- **Planned usage rate.** Firms calculate stock usage rates over a given period. Although inconsistent, there are often predictable demand variations caused by seasonal patterns and spikes during holidays and festival, which are built into the forecasting process.
- **Lead time/delivery time.** The time it takes to place and receive an order, including the time it takes to send orders to the supplier and the supplier's delivery time.
- **Re-order level.** The level of stock at which the firm will have to reorder to guarantee sufficient stock to stay above their minimum stockholding. This builds in the lead time.

Preparing the Stock Control Diagram

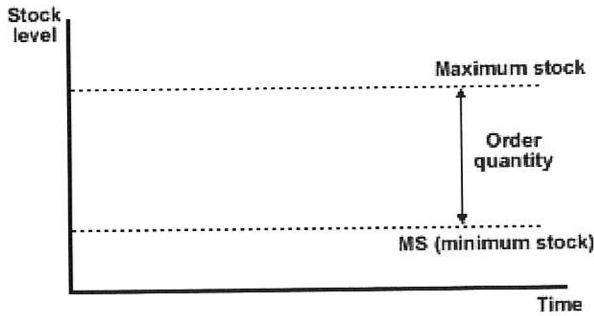
Minimum stock (MS) – The minimum, or buffer stock level, combines the cost of holding stock and the cost of not having any stock and is placed on the chart.

Minimum order quantity – The bigger the order, the higher the storage cost, but the lower the administration costs. Smaller orders increase administration costs, but lower storage costs. This optimum order quantity of Q is added to the stock control chart.



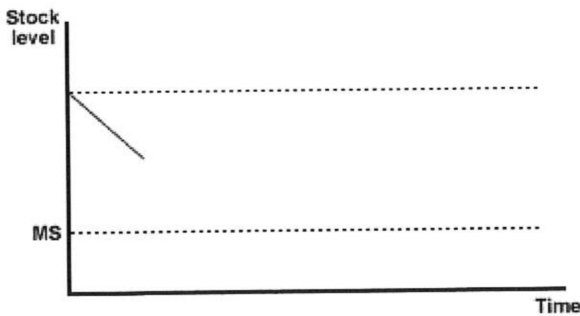
Minimum order quantity

The first order for stock is **Q + MS**: the minimum stock level plus the minimum order quantity.



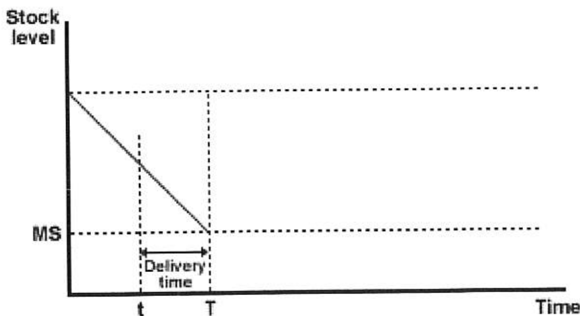
Stock order quantity

The firm forecasts its stock usage pattern, estimating the fall in stock week by week.



Using stocks

At time **'T'** the stocks fall to MS, at which point a second order must be received to ensure stock does not fall below the buffer stock level. The new order should be placed a set time before stocks hit minimum levels. The order should be placed at point **'t'**, to take account of the time between placing an order and delivery.

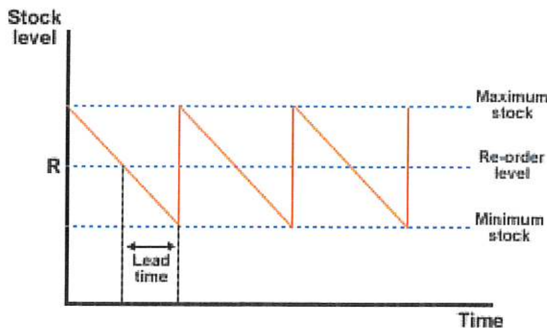


Delivery time on a stock control chart

The purchasing department issues a new order for the re-order quantity **'Q'** when stock drops to point **'R'** on the chart. Stock level **'R'** is the re-order quantity of stock. The replenishing stock should arrive before the

stock falls to the minimum quantity and should be sufficient to take stock back to maximum stock levels. This continuous process produces a classic 'saw-tooth' stock chart.

By ordering at point '**R**' the firm maximises the order quantity it can place (the difference between maximum and minimum stock levels), attracting the highest possible bulk discount.



Full stock control chart

Assumptions of EOQ:

- **Usage rate is constant** and as planned
- **Delivery time is correct** and constant
- **Order is completely delivered**

✓ Capacity utilisation rate *(AO2 / AO4)*

Capacity (the amount a firm can make) depends upon the resources, such as machinery and labour. Capacity utilisation is the extent to which that capacity is being used. When making full use of its resources, the firm is working at full capacity or 100% capacity utilisation.

$$\textbf{Capacity utilisation (\%)} = \frac{\textbf{actual output per period}}{\textbf{maximum possible output per period}} \times 100$$

If a firm could produce 2000 units per month, but is producing only 1200 units, its capacity utilisation is:

$$\frac{\text{1200 units per month}}{\text{2000 units per month}} \times 100 = \mathbf{60\%}$$

Example

As capacity utilisation *increases*, fixed overheads decrease per unit as overheads are spread over more units of production.

A firm has fixed overheads of $24,000 per month and a capacity of 2000 units. The fixed overhead per unit would be $20 per unit at 60% capacity utilisation, but only $12 per unit at 100% capacity utilisation. Any price would have to cover the unit overhead cost.

Firms aim to operate close to full capacity, but probably not at 100% as this creates a number of potential problems:

- Machinery and equipment requires downtime for routine maintenance.
- Working at full capacity creates stressed workers and managers, resulting in increased mistakes and lower productivity.
- Some spare capacity provide flexibility to satisfy sudden surges of demand.
- Overtime payments may be necessary to reach full capacity, increasing labour costs.
- High capacity utilisation may increase queuing times and results in poorer customer service, e.g. overcrowding at holiday resorts reduce customer satisfaction.

Firms operating near capacity may have to invest in new premises or ***subcontract or outsource*** orders to other companies with spare capacity.

✓ Productivity rate *(AO2 / AO4)*

Productivity is an average measure of the efficiency of production expressed as the ratio of output to inputs used in the production process, i.e. output per unit of input. It is a good measure of a firm's efficiency. Labour productivity is how much each employee produces per hour compared to what each worker costs the business.

$$\text{Productivity rate} = \frac{\text{total output}}{\text{total input}} \times 100$$

Increasing productivity is a major goal for firms, as the more productive a workforce, the lower the costs and the higher the profit margin. Increasing productivity means that employees are producing more quickly or completing services at a more rapid rate than before. Comparing a firm's labour productivity rate with an established standard or expected rate of output helps determine how the business compares to its competition and the market as a whole.

✓ Cost to buy (CTB) and Cost to make (CTM) *(AO2 / AO4)*

Make or buy decisions are decisions about whether the firm should produce goods themselves or buy them in and impacts on the decision to outsource production. No organization should make something, when it can buy the same product for a lower price.

When deciding whether to make a product or whether to buy it in, the firm is comparing costs and benefits and needs to calculate the following:

Cost to buy: CTB = P x Q
Cost to make: CTM = FC = (AVC x Q)

Key:	
P	price per unit charged by the supplier
Q	expected sales volume or quantity
FC	fixed costs associated with making the product, e.g. rent
AVC	average variable costs - the direct cost per unit of making the product, e.g. wages

Example A joinery firm needs to supply a customised order of 20 doors for a property firm. It approaches an overseas supplier, which is prepared to offer the doors at a unit cost of $500. The operations manager says it has the capacity to produce the doors if required at an estimated direct cost of $300 and an allocated fixed cost of $3,500.

Should the firm make the doors or buy them in?
Cost to buy = $500 x 20 = $10,000

Cost to make = $3,500 + ($300 x 20) = $9.500

On a pure financial basis the company should manufacture the doors, although the costs are similar. However, the firm may consider additional factors:

- Relative quality of the finished product
- The impact on capacity utilisation and the flexibility to meet unexpected demand
- The reliability of the supplier
- Exchange rate fluctuations

5.6 Research and Development

Research and development involves two separate, but integrated processes. Research is the focus on finding new ideas and processes, whereas development is the application or commercialisation of these ideas by developing new products and services with unique selling propositions.

KEY TERMS

The aim of **research and development (R&D)** is the discovery of new products, processes or procedures to meet customer needs. It involves investment in new technologies, with the objective of increasing the capacity and potential profitability of a firm. The process may result in ownership of intellectual property , such as patents and copyrights.

There is no guarantee that R&D will be successful. It is possible to spend millions of dollars researching new energy sources or medical cures without success. However, without successful R&D, firms in some industries will not survive. New drug treatments are the lifeblood of pharmaceutical industries and determine their commercial success or failure. Other firms develop existing ideas or sell 'me-too' products, which copy a competitor's product or innovation and sold at a cheaper price.

✓ The importance of research and development for a business *(AO3)*

The R&D department works closely with both marketing and production. R&D can be linked to the product life cycle. The shorter the life cycle of a product, the faster new products must be developed.

Typical R&D cycle:

- **Marketing** identify a need for a new product. They 'design' it in terms of concept, performance and consumer needs.
- **R&D** produces one or more products to meet the marketing brief.
- Products may go to **market research** and test marketing.
- Suitable products, after **investment appraisal**, go into **production** and onto the **market.**

Frequently work will start on a new project before the last project is finished. So R&D ends up working on a portfolio of projects.

Benefits of the R&D process:

- Higher sales and profits as a result of brand switching and increased customer satisfaction levels
- First mover advantage
- Entry into new markets or market segments
- Increasing market share as the firm gains a competitive edge
- Quality improvements
- Greater employment opportunities
- Higher morale as employees feel greater pride in the firm's products
- Social benefit and a better improved quality of life, e.g. Medical improvements

Limitations associated with R&D:

- Expensive process with high failure rates; few ideas make it to commercialisation
- Larger firms can afford greater investment in R&D, helping them grow at the expense of smaller firms
- Significant short-run opportunity costs
- Budgets are susceptible to cuts in poor economic periods
- New products may push the boundaries of what is social acceptability and challenge existing ethical values, e.g. Stem cell therapy

✓ Meeting customer needs through R&D *(AO2)*

Firms are always looking at opportunities to create competitive advantage, such as:

- Developing new products that address customer's unmet needs, whether they are aware of these or not! New products can, in fact, create demand that did not exist before. An example of this was Sony's Walkman.
- New technologies which improve functions, aesthetics and performance.
- New technologies that lower cost and price.

One of the key aims of the R&D department, in partnership with the marketing department, is to research the market to find gaps that can be filled profitably.

Once R&D produces new products and services, these need to be protected from copying. Just as there are laws to protect physical property against theft, so there are a series of laws designed to protect intellectual property. Intellectual property comprises copyright, commercial designs, patents, confidential information, symbols, images, artistic works and trademarks, so called 'creations of the mind'.

There are four main types of ***Intellectual Property*** (IP) rights that are used to protect inventions or creations to ensure that the firm or inventor retains first mover advantage:

Patents

Patents protect the features and processes that make things work, allowing inventors to profit from their inventions. Patents are registered at a national or territory level with an appointed government body and typically take 2 to 3 years to be granted.

To obtain patent protection a technical innovation must be both *novel* and *inventive*; terms which have clear legal definitions. The decision to award protection is based upon proving the product is different from that which has gone before.

A patent provides the owner with the right to stop others from copying, manufacturing and selling the invention without permission and the right to take legal action to stop other individuals or organization exploiting the invention leading to a claim for damages.

Trademarks

Trademarks are signs (e.g. slogans and logos) that differentiate goods and services from those of competitors. A registered trademark is obtained by filing an application with the appropriate authority. Registered trademarks use the abbreviation 'TM', or the '®' symbol.

Copyright

Copyright is an automatic right of the 'first owner', which applies when an original work is written or recorded - it does not have to be applied for. A work is original if adequate skill, labour and judgment is expended on creating it.

Copyright applies to works such as:

- **Literary works** – novels, computer programs, song lyrics, newspaper articles
- **Dramatic works** – plays, films or dance productions
- **Musical works** – concerts, recordings and broadcasts

It is a breach of copyright to reproduce protected work without permission in any medium, such as publishing photographs downloaded from the internet.

Designs

A design is legally defined as being "the appearance of the whole or part of a product resulting from the features of, in particular, the lines, contours, colours, shape, texture etc." A registered design protects the overall visual appearance and 'look' of a product or a part of a product in the country where it is registered. This covers elements such as colour, shapes and materials.

✓ Types of innovation *(AO2)*

Innovation is particularly important in markets where competition is strong and product life cycles are short. Radical innovation is rare, but steady, incremental innovation is vital to maintain competitive advantage and/or acquire market share.

KEY TERMS

Innovation is the creation, development, implementation and commercialisation of new products, managerial and manufacturing processes and services with the objectives of improving efficiency, effectiveness, profitability and competitive advantage.

The '4Ps' model, developed by *Bessant and Tidd*, puts forward four broad categories of innovation:

- **Product innovation** relates to the development of new products, changes in design of established products, or use of new materials or components in the manufacture of established products. Product Innovation is likely to be incremental rather than radical, with a focus on product improvement, rather than the creation of totally new products.
- **Process innovation** relates to improvements in efficiency and effectiveness at all levels. It involves a change in the way a product or service is manufactured, created, or distributed. It may result from significant changes in techniques, equipment and/or software and/or leadership styles, approaches and corporate culture.
- **Position innovation** refers to the creation of value by changing the customer perception of a product such as the repositioning of the drink, Lucozade, away from its original context of recovery from illness to association with athletics/fitness, targeted to teenagers and young adults.
- **Paradigm innovation** usually occurs where there are radical changes in social behaviour or an innovation changes the way the population lives its lives. The development of the Internet is obvious example.

✓ Forms of creativity *(AO2)*

Creativity present in R&D is *categorised into two main types*:

1. Adaptive creativity refers to thinking that applies existing solutions, techniques, or products to new scenarios or conditions.
2. Innovative creativity refers to thinking that results in new solutions.

Adaptive creative thinkers try to do things better, while innovative creative thinkers try to do things differently.

✓ Influences on R&D *(AO3)*

There are a number of factors that influence research and development practices and strategies in an organization:

- *Pace of change* – some external environments are highly dynamic and require firms to invest heavily in new technology to remain competitive.
- *Organizational culture* – some firms have cultures that are risk aversive and others embrace risk. The firm's culture and leadership styles underpin attitudes to research and development.
- *Ethical considerations* – cutting-edge R&D inevitably pushes boundaries, e.g. stem cell research is opposed by religious groups.
- *Available finance* – the budget set aside by management may constrain the extent of R&D.
- *Competition* – the more competitive the market place, the more pressure on firms to be innovative.
- *Legal* - firms must ensure that new products satisfy legislation requirements.
- *Technology* – the Web provided firms with new routes to conduct R&D, e.g. crowdsourcing provides a whole community willing to support research programmes.

5.7 Crisis management and contingency planning

✓ The difference between crisis management and contingency planning *(AO2)*

KEY TERMS

Crisis management refers to actions taken by an organization to maintain its credibility and good reputation after a situation has occurred that may affect it in a negative manner and therefore reduce sales of its products or services.

Contingency planning is an approach seeking to anticipate future events that are not expected to occur, but are possible. Should those future events occur, a plan of action to respond effectively is already in place.

Crisis management

Crisis management is reactive rather than proactive. Managers respond to events, which threaten the business and minimise the potential damage. It may result in an autocratic approach.

Three elements are common to most crises:

1. Threat to the organization
2. The element of surprise
3. Short decision time

Crises, such as fire or IT system failure, may make it impossible to conduct an organization's activities and may result in the loss of customers or even closure. Unplanned events can have a devastating effect on small businesses.

Crisis management includes a strong focus on public relations to recover damage to the organization's public image.

✓ Effective crisis management *(AO2)*

- *Transparency* - pretending a crisis is not happening is the worst option. The firm needs to be honest about the situation, but outline how it will deal with the impacts.
- *Communication* - stakeholders must be informed about the impact of the crisis and progress to deal with its effects.
- *Speed* - crises often create panic, but also inertia. Good management reacts quickly before the impacts multiply.
- *Control* - the firm must control the crisis and may call on specialist help to deal with novel situations where the firm lacks expertise.

Contingency planning

Contingency planning include procedures to handle, contain and resolve an emergency in coordinated steps. The organization questions what might happen, identifies alternatives and examines how these may resolve the problem or minimise its effects, so it can continue its activities. It prepares for:

- Predictable and quantifiable situations
- Situations for which there is advanced notice
- Unexpected events

Contingency planning uses simulations to ask questions, such as:

What happens if?

- Sales are more or less than planned?
- Costs are higher or lower than planned?
- Computer or energy system fail?
- There is a flood or a fire?

✓ Advantages and disadvantages of contingency planning for a given situation *(AO2)*

- *Cost:* Contingency planning is likely to be expensive as it involves senior managers and the services of specialist consultants. However, these costs may be dwarfed by the costs of a crisis.
- *Time:* Contingency planning is time consuming, especially where the external environment is constantly changing.
- *Risks:* The firm will need to assess the range of risks and decide which of these requires plans to be updated.
- *Safety*: Breaches of health and safety legislation could have huge financial consequences.

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✓ Potential IB question on Unit Five topics for each assessment objective

AO1

- Describe the features of job production
- Define and give examples of fixed and variable costs

AO2

- Distinguish the features and applications of job production from those of batch production
- Explain the meaning of revenue and comment on possible sources of revenue for XYZ plc
- Explain the causes and consequences of location, both domestically and internationally

AO3

- Discuss the move from traditional quality control methods to total quality management (TQM)
- Compare and contrast just-in-case, and just-in-time, production

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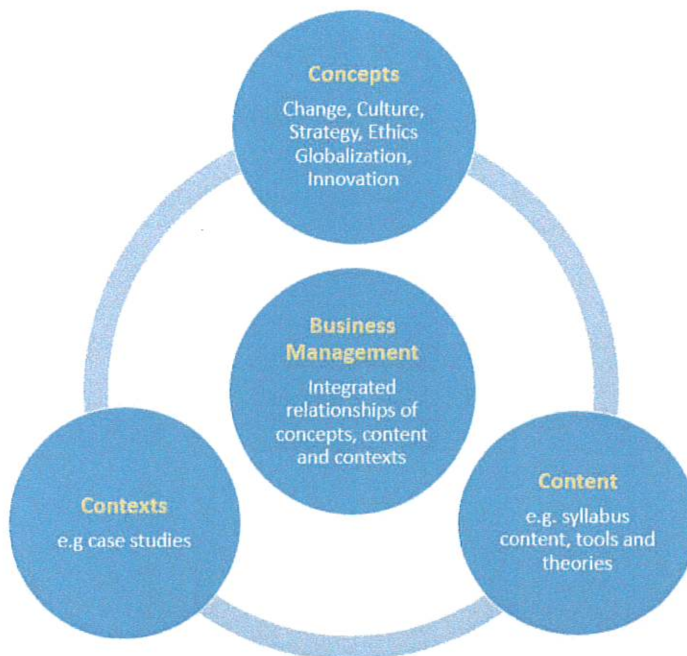
APPENDICES

Appendix One: Concepts, Content and Contexts

The Business Management course is based on the integration of business Concepts and business Content, illustrated through a range of Contexts, such as case studies and business investigations and illustrations.

Pages 11 - 14 of the Business Management guide offers suggestion on how the subject content in the syllabus can be explored through the subject specific content. Your task, as you revise the subject content, is to link this content to business concepts and to business case studies that you have investigated over the duration of the course.



Concepts in Business Management

To develop a deeper, more holistic and more integrated understanding of business management in a global context, you have been introduced to **six concepts** that underpin the course.

- ***Change***, reflecting the greater speed with which business decisions need to be made and the increasingly dynamic nature of the external environment within which businesses operate
- ***Culture***, appreciating that businesses need to align a broad spectrum of individual, collective and societal goals
- ***Ethics,*** emphasizing the fact that the ethical considerations businesses face are substantial and near all-pervasive, instead of being peripheral and isolated
- ***Globalization***, reflecting the interconnected patterns of production and consumption shaped by businesses and affecting them
- ***Innovation,*** emphasizing the need for businesses to renew themselves in the competitive, technologically advanced market place with increasingly sophisticated customers
- ***Strategy,*** reflecting the importance of holistic long-term planning in an operating environment with the above attributes

The 6 Business Management concepts (abbreviated by the possible acronym, 'CUEGIS' for memory purposes) are combined with the tools, techniques and theories of the subject and then applied to case studies and other business examples. The two examination papers you will face, require that you illustrate

your knowledge of business content and business concepts by applying these to business examples you are given, or to business organizations you have studied throughout your course.

You are required to link the 3 Cs, of *concepts, content* and *contexts*, specifically on **Section C question on Paper 2**. There are a large number of possible combinations of concepts and business functions that a question on paper 2 may examine.

Possible paper 2, section C questions:

- *With reference to one or two organizations that you have studied, evaluate different strategies that organizations can implement to respond to the impact of a sudden change in the external environment.*
- *With reference to one organization that you have studied, discuss the importance of innovation and change on its production processes.*
- *With reference to one organization that you have studied, discuss the importance of innovation and change on its research and development practices.*
- *With reference to one or two organizations that you have studied, discuss how marketing strategies may vary in two cultures or two countries with which you are familiar.*

Examiner Tip!

It is essential, therefore, that the case studies you select, and revise, provide a range of issues that can exemplify the six concepts and can be applied to a business function, such as marketing and HRM. Case studies relating to multinational corporations offer greater depth and breadth to support an answer across several concepts and business functions than smaller, local businesses. Whichever case studies you revise, you must be able to:

- Identify the context and issues raised by the case study or question stimulus
- Explain how these issues relate to different areas of the syllabus content and the six concepts
- Apply the business tools, techniques and theories that might be appropriate for understanding the issues raised in the case study or question stimulus

Appendix Two: Assessment objectives and command terms in examination questions

Command terms associated with the assessment objectives:

✓ AO1 - Demonstrate knowledge and understanding: *the lowest skill level*

AO1 Command terms in examination questions:

Define, Describe, Outline, State

AO1 requirements:

If you see these command terms, the examiner wants you to show that you have learned information and understand its meaning. You are not required to explain it – simply list, define, outline or state. ***Do not write too much*** for these type of questions - in most cases, a bullet point list is enough. Few marks are allocated to these questions. Relate the marks to the time you spend on your answer.

Examiner Tip!

You must take note of the **command terms** used in examination questions, because these indicate the *breadth and depth of answers* required by the examiner. The *marks* allocated for the question, or parts of the question, are also another key indicator of the depth and breadth expected. Before entering the examination room be sure you know how much time to allocate to each mark awarded, by totalling the minutes available and dividing by the maximum marks possible.

✓ AO2 – Demonstrate application and analysis: relate your knowledge to business data and case studies

AO2 Command terms in examination questions:

Analyse, Apply, Comment, Demonstrate, Distinguish, Explain, Suggest

AO2 requirements:

If questions use these command terms, you are required to show that can break down ideas into simpler parts, such as advantages and disadvantages, and to apply your knowledge to stimulus materials you are given e.g. case study materials. So, for instance, you might explain a theory, such as Ansoff's growth matrix and then apply it to the case study materials.

✓ AO3 – Demonstrate synthesis and evaluation: *the highest skill level*

AO3 Command terms in examination questions:

Compare, Compare and contrast, Contrast, Discuss, Evaluate, Examine, Justify, Recommend, To what extent?

AO3 requirements:

If questions use these command terms, you are required to rearrange ideas and to make ***supported judgments*** (reach conclusions) based on evidence or a set of criteria. Your answers must be balanced showing ***both sides*** to an answer, even if one side is weaker. Then you should conclude which is the better option and why, or make recommendations for future action. In a case study question, for example, you might be select the best strategic option for the firm, as it moves forward.

Answers should be in full prose and structured, showing you understand the main issues and how they relate. Your conclusion will contain a judgment, although you can also make judgments throughout. Spend more time on your answers to these questions than AO1 and AO2 questions, checking the mark allocation for guidance. **DO NOT** leave these questions unanswered, even if it means answering them first.

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✓ AO4 – Demonstrate a variety of appropriate skills: *mostly practical skills*

AO4 Command terms in examination questions:

Annotate, Calculate, Complete, Construct, Determine, Draw, Identify, Label, Plot, Prepare

AO4 requirements:

If questions use these command terms, you are required to show that you understand business tools and can apply them in given situations. You may be asked to construct diagrams, or graphs. If you are, pay attention to presentation skills, such as including a key, labelling axes and appropriate titles. Please use a ruler to construct graphs and models! In most cases, you will also need a calculator, so enter the examination room totally equipped.

Appendix Three: Practice data response questions

When answering the following stepped, data-response questions, take note of the following:

- ***Read the question carefully*** and do not 'roll out' a revised answer to a similar question that does not fully address the question you have actually been asked.
- ***Apply your answers to the stimulus information*** provided in the question and to the particular organization(s) referenced. Do not write generic textbook answers that could be applied to all organizations.
- ***Pay attention to the command terms*** in each part of the question, and do not spend too much time on low skill level questions.
- If you are running out of time, ***answer the high tariff questions first*** if they do not rely on previous answers.

Question One: Heinz and Kraft

US food giant *Heinz* is to merge with *Kraft Foods Group*, creating the third-largest food and beverage company in the US. *Heinz* shareholders will own 51% of the combined company with *Kraft* shareholders owning a 49% stake. The "mega deal" will create the world's fifth-largest food and beverage company. Its brands will include *Kraft, Heinz*, and hotdog maker *Oscar Mayer*, with combined sales worth some $29bn and a portfolio that includes eight $1 billion-plus brands.

The combined firm, *Kraft Heinz Company*, expects to make annual cost savings of $1.5bn. Many product lines seem to be complementary, such as Heinz mustard or ketchup on *Oscar Mayer* hot dogs. There are various ways in which the management hopes to take advantage of the synergies that the combination of these two large food companies should provide, such as higher economies of scale in the North American market.

The firm is likely to cut, or divest, overlapping lines to reduce costs and there will also be savings through redundancies in finance, marketing and IT following the merger. *Heinz* has a global footprint. It derives 60% of its sales from regions other than North America. Emerging economies contribute 25% of its sales. *Kraft*, on the other hand, derives 98% of its sales from North America. This provides scope for the combined entity to sell *Kraft's* brands in international markets and gain cost savings through international economies of scale.

(a) Outline **two** differences between a merger and a takeover.

(b) Using *Kraft* and *Heinz* to illustrate your answer, distinguish between internal and external growth.

(c) Examine the role and impact of globalization on the growth of large businesses, such as *Kraft Heinz*

(d) To what extent will national, and organizational, cultural forces affect the success of newly merged companies like the *Kraft Heinz Company*.

Question Two: Buntu

How can smaller firms challenge the established giants in any market, such as Apple and Samsung, when resources required for research and development are so significant and where large firms gain from substantial economies of scale and brand loyalty? Mass production methods create cheap goods and, with automation and robotics, standardization is no longer the automatic downside. So when *Buntu*, an innovative, for-profit social enterprise based in Nigeria, wanted to enter the local telephone handset market, they explored a range of options that would allow them to compete with established handset manufacturers.

Buntu's solution was to create a niche brand, producing cheap, but robust telephone handsets for low income manual workers. *Buntu* believed that this was a market segment ignored by Nigerian companies and overseas telecoms firms, which concentrated on the smartphone sector. However, even with excellent ideas, start-ups hoping to innovate find it difficult to finance their projects, and Buntu has been turned down for loans by three banks. *Buntu* has considered a number of sources of finance, including venture capital and crowd financing.

(a) Define the following terms:
- Niche brands
- Mass production

(b) Explain the processes *Buntu* will have to go through to start up the new business.

(c) Examine how *Buntu* can differentiate itself and its products from direct competitors in Nigeria.

(d) With reference to *Buntu,* and firms like Apple and Samsung, evaluate the relative merits of small and large scale organizations

Question Three: Transference

Transference is a medium-sized travel agency based in a major city. The Board of Directors are concerned about staff turnover levels, particularly its difficulty in retaining its experienced staff. The Human Resources director has been conducting 'exit' interviews with employees leaving the business and has identified issues related to working hours, increasing face-face, online and phone enquiries from customers and the cost of travel to work. She has produced a report for an emergency board meeting that proposes the following:

- Reducing core staff by outsourcing phone enquiries to an overseas call centre and some peripheral activities, such as accounting functions, to specialist firms in the Philippines.
- Allowing staff more flexible working conditions, including flexible working hours and homeworking.
- Motivating staff though job enrichment and greater empowerment.
- Additional appraisal and training opportunities, including the opportunity to attend internal and external professional development courses.

(a) Define the following terms
- Staff turnover
- Appraisal

(b) Distinguish between internal and external professional development.

(c) With reference to Handy's Shamrock Theory, examine the advantages and disadvantages for *Transference* if it decides to outsource some of its business activities.

(d) Using Maslow's motivation theories, discuss how non-financial rewards, such as job enrichment and empowerment, can affect job satisfaction and productivity at *Transference.*

Question Four: Dalil discount stores

Dalil runs a number of retail outlets, which are divided into three separate operating divisions, focusing on different market segments. The business has grown rapidly over the last ten years. Each group operates under a different business name so that the customers are not confused about brand image and product offer, and management of each division is decentralized. Marketing activities for each group aim to support the customers' perceptions of where each brand is positioned. Two of the subsidiary groups have been performing well, but Dali's discount stores have come under attack from new entrants into the market, and

Dalil Bousaid, the group's chairman, has asked to see financial data for the last three year's accounts for the discount group. The chief accountant sends the summary figures below:

Dalil Discount Stores: Year ending 31st December $000			
Year	2xx3	2xx4	2xx5
Sales Revenue	180	200	260
Gross profit	58	59	64
Profit before interest and tax	15	17	17
Profit after tax	14	16	16
Capital employed	100	110	140
Current assets	60	64	80
Current liabilities	40	45	59
Stock	20	24	30
Debtors	19	19	30
Cash at bank	21	21	20

(a) Describe the features of a decentralized organization structure.

(b) For each year calculate:

- The return on capital employed
- Gross profit margin
- Net profit margin
- Current ratio
- Acid test ratio

(c) Analyse the advantages and disadvantages of *Dalil* operating as separate divisions focused on different market segments.

(d) Evaluate the financial position of *Dalil's* discount stores and recommend possible financial and other strategies to address any weaknesses you have identified.

Question Five: Habanar Cigars HL ONLY

Higher Level extension question

José López and María Famosa own *Habanar*, one of the largest Cigar manufacturers in Cuba. The recent improvements in the political and social environment have encouraged José and María to consider expanding their business into international markets. José proposes that Habanar should enter the South American market by setting up their own production facilities. María, however, has wider ambitions and believes they should take their business global through the use of mergers, acquisitions and e-commerce. José is concerned about the cost of this option. The two owners asked their marketing and finance departments to research both strategic options and report back. The finance manager has produced the following decision tree to support their analysis of the options.

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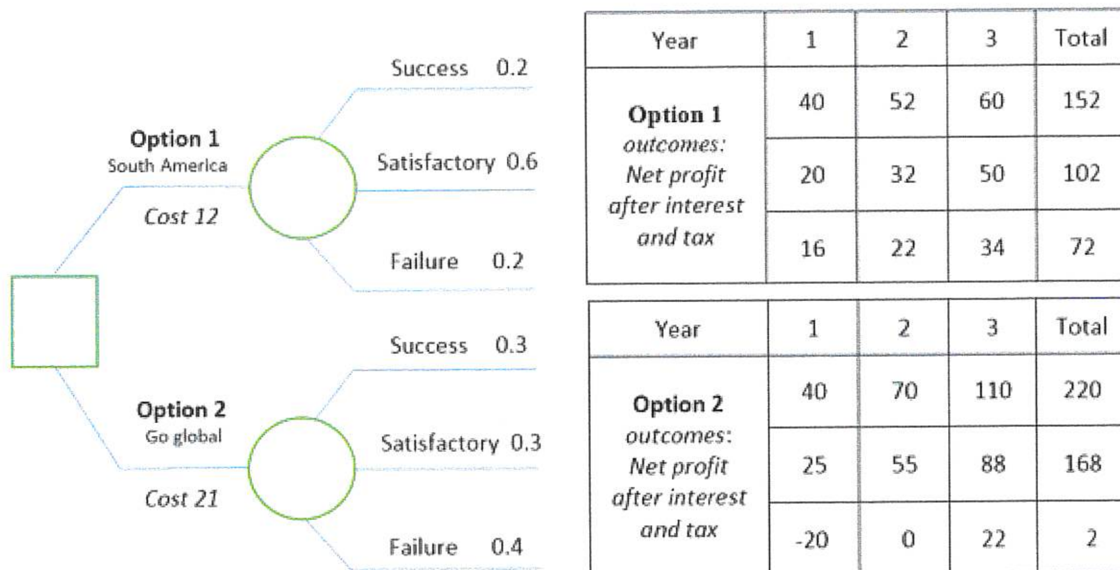
Decision tree information for Options 1 and 2 (figures in $ millions)

The information in the tables on the right of the decision tree represent the three financial outcomes (*success, satisfactory, failure*) for each option for the first three years of operation.



Year	1	2	3	Total
Option 1 *outcomes: Net profit after interest and tax*	40	52	60	152
	20	32	50	102
	16	22	34	72

Year	1	2	3	Total
Option 2 *outcomes: Net profit after interest and tax*	40	70	110	220
	25	55	88	168
	-20	0	22	2

(a) State **two** changes in external economic factors and **two** changes in external political factors that might have encouraged José and María to consider expanding their business.

(b) Using the decision tree information, calculate the expected values for each option, using **only** the three-year net profit after interest and tax totals.

(c) Examine the costs and benefits of e-commerce of to *Habanar,* if José and María decide to take the business into global markets.

(d) Evaluate the opportunities and threats posed by entry into international markets. Discuss these in the context of the two options for *Habanar* cigars.

Appendix Four: Suggested answers to practice data response questions

Question One: Heinz and Kraft

(a) Outline **two** differences between a merger and a takeover.

- In a merger the integration is agreed by both parties, but a takeover may be hostile and unwanted by the firm being acquired.
- With an acquisition the acquiring firm is dominant and becomes the owner. The acquiring firm is usually larger, whereas in merger, it is more likely to be a merger of equals in terms of size.
- After a merger, the separately owned companies become jointly owned and obtain a new single identity.
- The taken-over firm faces redundancies, cost cutting or closures of branches.

(b) Using Kraft and Heinz to illustrate your answer, distinguish between internal and external growth.

Internal organic growth is achieved by:

- Improving products and services
- Better marketing
- Investment in research and development
- Improving workforce training
- Expanding the number of offices, factories and outlets

Internal growth is relatively inexpensive, because the firm can use retained profits, rather than external loans.

Major types of external growth:

- Mergers and acquisitions (M&As) and takeovers
- Joint ventures
- Strategic alliances
- Franchising

External growth may be more expensive as funds are required for takeovers.

In the case of Kraft and Heinz, growth is being achieved through a merger looking for synergies and cost saving.

(c) Examine the role and impact of globalization on the growth of large businesses, such as *Kraft Heinz*.

Globalization is offering MNCs, like Kraft and Heinz, Increasing opportunities for international trade and easier capital transfers. By developing global strategies, large firms can create global brand and corporate awareness. An increase in mergers and joint venture agreements support increasing access to global markets, allowing the merged organizations to acquire even greater economies of scale and competitive advantage. Modern production techniques allow location flexibility and access to lower resource costs and communications technologies allow control of dispersed operations. However, globalisation has also increased competition, and supported access into previously secure markets.
Heinz has a global footprint with 60% of its sales from regions other than North America, with emerging economies contributing 25%. Kraft, derives 98% of its sales from North America. This

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provides scope for the combined entity to sell Kraft's brands in international markets and gain cost savings through international economies of scale.

(d) To what extent will national, and organizational, cultural forces affect the success of newly merged companies like the *Kraft Heinz Company*.

MNCs like Kraft and Heinz have to be aware of cultural differences across their global operations as it will impact on their sales revenues, profits and growth. Cultural diversity creates contrasting norms and values. These values will impact on diverse workforces in terms of expectations, motivation and productivity. They will also influence the success of the commercial operations of the business as these differences will have significant effects on the success of marketing and promotional activities. The newly merged firm will have to be sensitive to these issues, and ensure that training is given to staff who have not come into contact with diverse cultural mixes of staff and customers.

Mergers and acquisitions often fail at the implementation stage and negotiation stage, because of cultural difference between the two firms and the proposed management composition of the combined business. Existing corporate cultures may clash when Heinz and Kraft merge and this could be disastrous in term of the merged firm's performance. Often the merging firms have different administrative and cultural practices and personnel traits, so these differences will have to be effectively managed for the merger to be successful internally.

Question Two: Buntu

(a) *Niche brands* target small market segment. A niche brand is one that specialises in meeting the needs of customers in a particular market position, such as satisfying a minority interests, e.g. specialist sports, or providing expensive items, e.g. Rolex watches.

Mass production is the continuous movement of items through each stage of production, often along an assembly line. The process involves the manufacture of a large volume of identical, standardised products in sequence. Employees are semi-skilled. It is highly capital-intensive with high set-up costs, requiring firms to operate near capacity (high capacity utilisation) and is suited to automation.

(b) Explain the processes *Buntu* will have to go through to start up the new business.

The processes include:

- Considering basic questions, such as its name, its legal form and why the entrepreneur wants to run a business.
- Next researching the market to see if the proposed good or service is viable and to establish the target market and any USP it can create.
- The founder will need to prepare a business plan, especially if finance is required from investors.
- Examining any legal requirements or restrictions on the business, such as the need for licences.
- Finding sources of income. Some may be from personal savings, but more may be required.
- Testing the market to ensure that the business plans actually work on a smaller scale and providing feedback on the likelihood of success if the business goes to a full launch.

(c) Examine how *Buntu* can differentiate itself and its products from direct competitors in Nigeria.

Buntu simply does not have the scale in a mass market to compete with much larger, established firms in Nigeria. By concentrating on a niche market, it can differentiate itself, because this basic product is probably not offered by other firms, especially at a very low price point. The fact that it is a social enterprise can also provide additional market leverage and branding possibilities focused on its USP. The question is whether the market is large enough to justify even a minimal capital investment and whether the firm has the expertise or financial resources to market the product effectively and then to distribute it.

(d) With reference to *Buntu,* and firms like Apple and Samsung, evaluate the relative merits of small and large scale organizations

Small organizations have a number of distinct advantages that can allow them to be profitable and survive. They can be flexible and close to customers and offer a bespoke or customised product or service. *Buntu*, for example, may adjust its design for its target segment. Decision making can be quicker and overhead costs of small firms tend to be lower than large firms, because smaller firms have fewer formal structures. The advantages of small firms relate to the nature of the products and services they offer, and the needs of the markets in which they operate.

Large scale firms, however, like Apple and Samsung have distinct advantages in terms of reaching the customer and creating a respected brand. Unit costs tend to be lower, because the firm can take advantage of economies of scale from mass production, and they can mitigate risks by spreading their operations over a number of products and markets. However, they can also suffer from inflexibility, bureaucracy and diseconomies of scale. Cheap funding is available through share issue and low interest loans.

In terms of *Buntu*, it is likely that the product will need to be standardised, so this will reduce some of the advantages offered by customisation, and access to technology and specialist services will be significantly lower than available to larger firms. *Buntu* has already experienced difficulties in accessing funds, although the range of sources for smaller firms is growing, such as crowdsourcing and peer to peer sites.

Question Three: Transference

(a) Define the following terms

Staff turnover is a measure of the success of the firm' retention policies, i.e. what percentage of the workforce leave in any given year. Shown by the formula:

$$\frac{\text{Numbers of staff leaving the firm in one year}}{\text{Average workforce during a period (usually one year)}} \times 100$$

Appraisal is the formal process of assessing an employee's performance by comparing actual performance against goals. Sometimes conducted through a questionnaire, but more often by a one-to-one discussion between employees and their line managers. Following the appraisal, the manager and employee may identify training and development needs.

(b) Distinguish between internal and external professional development.

Internal professional development will involve training within the firm's workplace and offered by its own staff. The focus will be on the needs of the firm and may involve actual experience with customers. It tends to be cheap as it uses existing resources.

External professional development will involve the employee leaving the site and attending a course offered by an external provider, such as a college. It may be officially certified. It tends to be more expensive than internal training, and may not be focused on specific needs of the firm.

(c) With reference to Handy's Shamrock Theory, examine the advantages and disadvantages for *Transference* if it decides to outsource some of its business activities.

Charles Handy suggested that organizations do not consist of just the *Core* and the *Periphery*, since the periphery can be subdivided. He calls this a shamrock organization. Handy called the second leaf, the ***contractual fringe.*** These are non-central activities that can be contracted out to specialist firms, such as marketing, computing and communications. Outsourcing these activities, will allow *Transference* to reduce its expensive core staff and to allow a firm that specialises in a certain activity, such as payroll, to carry it out. This should be cheaper and more effective, and allow it to concentrate on its core activities. In the longer term, this may support the firm's capacity to grow.

However, *Transference* may find that losing staff lowers morale and motivation of the remaining staff and increases turnover even more. There is also less control over the specialist firm taking over the activity, and the firm may be inefficient. It is difficult to pass on local expertise and cultural knowledge to an external provider. *Transference* may find it is facing higher costs and may have to accept an off-the-shelf system.

(d) Using Maslow's motivation theories, discuss how non-financial rewards, such as job enrichment and empowerment, can affect job satisfaction and productivity at *Transference.*
Maslow's Hierarchy of Needs includes a mixture of extrinsic and intrinsic needs. Maslow identified five different levels of needs, represented as a triangle with the most basic needs at the base and the highest at the top. Most people can achieve the lowest level of needs, but few are able to satisfy higher order needs. The higher order needs satisfy intrinsic motivational needs and include:

- Social needs of friendship and belonging
- Self-esteem or ego needs
- Self-actualisation or self-realisation needs

Job enrichment builds a higher sense of challenge and achievement and attempts to satisfy higher order needs. An enriched job will contain a range of tasks and challenges of varying difficulties and a complete unit of work, which can prove more meaningful for the employee. Empowerment provides employees with increased decision-making powers to encourage initiative and entrepreneurial spirit. The individual is not only given a task, but the authority to carry it out independently. It also provides opportunities for promotion. *Transference* will need to ensure that the employees do not feel that they are just being asked to do more for the same money, and that they are adequately supported through training. If not, these 'rewards' may be perceived as punishments.

Question Four: *Dalil* discount stores

(a) Describe the features of a decentralized organization structure.

A decentralized structure delegates responsibility to those lower down the chain of command e.g. to individual departments. Decentralization:

- Encourage greater empowerment and motivates those lower down
- Offers greater personal development for all employees
- Increases the speed of decisions and can include local market features

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(b) For each year calculate:

Dalil Discount Stores	2xx3	2xx4	2xx5
The return on capital employed NPBIT/capital employed x 100	15%	15.45%	12.14%
Gross profit margin Gross profit/sales revenue x 100	32.2%	29.5%	24.6%
Net profit margin NPBIT/sales revenue x 100	8.33%	8.5%	6.53%
Current ratio CA/CL	1.5	1.42	1.36
Acid test ratio	1	0.89	0.85

(c) Analyse the advantages and disadvantages of *Dalil* operating as separate divisions focused on different market segments.

By operating as separate divisions focused on different markets, *Dalil*, can develop separate marketing mixes suitable for each of its targeted segments. Customers of the different divisions will not be confused about what is on offer in the shops and *Dalil* will be able to identify its key consumers for each of its divisions through the use of age, gender, income and social group, which should underpin more effective market research.

However, operating as separate divisions probably reduces the economies of scale available to Dalil as some functions will be duplicated and purchasing economies will be lower. It is possible that the three divisions will be competing with each other for some customers, which is a waste of resources.

(d) Evaluate the financial position of *Dalil*'s discount stores and recommend possible financial and other strategies to address any weaknesses you have identified.

The performance of *Dalil*'s discount division should be causing concern. Although the ROCE increased between 2xx3 and 2xx4, it fell significantly the following year. ROCE is considered the primary efficiency ratio, which means that *Dalil* is becoming less effective in turning its sales into net profit. In addition, its gross profit margin has fallen for the last three years, meaning the cost of sales has been rising. Although the net profit margin rose slightly from 2xx3 to 2xx4, it fell back significantly in 2xx5, showing its overheads are not under control. The two liquidity ratios are also worrying as they indicate that there is a cash flow problem at *Dalil* discount stores, with the acid test ratio falling below 1, which means that they may be unable to pay of their debts and meet their expenses.

Sales revenue is not the problem at *Dalil* as this has been rising at an increasing rate. There are three areas that *Dalil* needs to address:

- Increasing cost of sales
- Increasing overheads
- Decreasing liquidity

Strategies for improving the situation may include:

- Changing to a cheaper supplier or renegotiating purchase terms.
- Exploring whether it is possible to purchase some items for all three divisions together to maximise discounts and economies of scale.
- Exploring the reasons why overheads have been rising and becoming more effective at controlling these. This might involve cutting staff, for example, to reduce wages.

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- Managing cash flow more effectively. One area of concern is increasing stock levels, so *Dalil* might consider introducing just-in-time stock control and reducing waste through total quality management approaches.

Question Five: Habanar Cigars HL ONLY

(a) State **two** changes in external economic factors and **two** changes in external political factors that might have encouraged José and María to consider expanding their business.

Possible *economic* factors:

- Countries recovering from the 2008 recession
- Increasing growth rates in South American countries
- Changes in tax rates on tobacco
- Cuts in interest rates on loans to expand the business
- Favourable movements in exchange rates

Possible *political* factors:

- Improving relations between Cuba and the USA
- Increasingly stable government
- Changes in the law allowing export of tobacco products
- Changes in the law that are more favourable to businesses e.g. more liberal trade policies

(b) Using the decision tree information, calculate the expected values for each option, using **only** the three-year net profit after interest and tax totals.

(c) Examine the costs and benefits of e-commerce of to *Habanar,* if José and María decide to take the business into global markets. E-commerce is the buying and selling of products or services over electronic systems, such as the Internet and other computer networks. It also includes electronic funds transfer and will allow *Habanar* to operate 24 hours a day.

Option 1: Figures in *($ millions)*								
	Probability		Outcome			EV	*less* cost	Net EV
Success	0.2	x	152	=	30.4			
Satisfactory	0.6	x	102	=	61.2	106	12	94
Failure	0.2	x	72	=	14.4			
Option 2: Figures in *($ millions)*								
	Probability		Outcome			EV	*less* cost	Net EV
Success	0.3	x	220	=	66.0			
Satisfactory	0.3	x	168	=	50.4	117.2	21	96.2
Failure	0.4	x	2	=	0.8			

Habanar will be using business-to-consumer e-commerce (B2C) by selling cigars directly to consumers, or business-to-business e-commerce (B2B) if it sells cigars directly to business distributors. E-commerce offers the following benefits for *Habanar*.

- Potential access to global markets
- Cost savings and improved efficiency
- Improved relationships with trading partners along the supply chain

If *Habanar* sell directly to customers, online stores usually have:

- Lower overheads than physical competitors and consequently lower prices
- Search facilities so customers can find the cigars they want and information on the product
- Reduced transaction times
- Purchase tracking
- Higher service levels, e.g. Links to frequently asked questions
- Encrypted payment systems

However, having an online presence is not cheap. It is expensive to develop reliable secure sites, with payment facilities and links to distribution systems. The site may be vulnerable to cyber-attacks from competitors, spammers and hackers with the potential loss of commercially sensitive information

(d) Evaluate the opportunities and threats posed by entry into international markets. Discuss these in the context of the two options for *Habanar* cigars.

Opportunities

- Increased profitability – larger markets result in increases in sales of cigars and profitability, because of greater *economies of scale,* lower sourcing costs and possible higher prices.
- Increased brand exposure and recognition – global brand recognition of *Habanar* cigars.
- Access to global markets that may not apply the same safety standards on the sales of tobacco products.
- Market saturation – *Habanar* cigars can prolong its product life cycles by selling overseas if the Cuban market is saturated.

In terms of the two options for *Habanar*, global markets may offer opportunities less restricted by legal and social barriers and higher economies of scale given the larger potential sales. However, Cuban Cigars have their roots in Spanish culture and South America has many Spanish speaking countries. It is cheaper to expand into South America.

Threats

- Ethical and social factors: In the longer term, the tide of opinion in many countries may turn against tobacco sales and consumption, in the same way that it has in many developed countries.
- Demographic changes may impact negatively on demand for cigars.
- A further downturn in key markets may result in poor returns and falling profits.
- More governments may impose restrictions on marketing tobacco products to local populations.

Cuban cigars have a very strong brand reputation across the world and do not have the same social stigma as cigarettes, probably because they are consumed less frequently and on 'special occasions'; rather than frequently – especially given their price. Competition in international markets will be difficult for non-Cuban cigars, because of the competitive advantage provided by the Cuban brand.

The decision tree shows that in terms of the two options, the expected returns are quite similar with expansion into South America offering lower returns than global expansion. However, the initial cost of the global expansion is far higher. There may be other factors that would make expansion into South America a better option, such as language, even though the expected returns are likely to be lower. José and María must also be aware that decision trees produce 'weighted' average outcomes, rather than actual results. In addition, probabilities are usually estimates.

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