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BUSINESS

for Cambridge International AS & A Level

Peter Joyce
Sandra Harrison
David Milner

Oxford excellence for Cambridge AS & A Level

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Introduction

The subject

The great thing about Business as a subject is that, throughout all the topic areas, there is a direct and tangible link with what goes on in the "real world". This makes the subject ideal for studying from the perspective of observing what goes on around us. Newspapers, magazines, the TV and the Internet are all there as invaluable resources for us, and as stimuli for the way we think about things. Studying the subject is not just about what goes on in the classroom, it is also about being observant in our everyday lives.

The study of business naturally encourages us to develop A Level skills. So the skills you learn from this book will be very valuable at work and university. For example, most business situations are ideally suited to analysis and most of the work of management in businesses is about evaluation, both of which are transferable skills.

The subject is also holistic (all the parts interrelate). For example, when exploring a strategy for increasing sales of a product additional finance and management is needed, so not only is there a marketing dimension to the problem, there are also financial and human resources dimensions. This means that an important feature of the subject, and of the examinations, is to take a synoptic (all embracing) view wherever appropriate.

The purpose of this book

To observe the world and to learn from what goes on you need guidance, and that is the main purpose of this book.

In trying to help you make sense of the business world the book has been written with a number of specific objectives in mind:

- To stimulate your interest in the subject
- To provide you with all the background knowledge needed to help you achieve your best at AS and/or A Level
- To develop your understanding of that knowledge
- To give you opportunities to apply that knowledge in a variety of situations
- To develop your skills of analysis and evaluation
- To use knowledge, application, analysis and evaluation effectively in your examinations.

The features of the book

To help you get the best out of this book, and to help you succeed in the subject, the book has a number of important features:

- **Key terms** are used to highlight important concepts. These key terms will give you the "building blocks" for the subject and will help you answer the short questions to the best of your abilities. They are all collected together in the Glossary.
- **Progress questions** will enable you to check how well you are doing in terms of understanding the concepts as you work your way through the chapters.
- **Case studies** will help you with the skills of application, analysis and evaluation.
- **Activities** are things you can do in class, with your friends or on your own, which will help you relate the subject to the real world.
- **Getting it right** is designed to tell you some of the mistakes frequently made by students and to point you in the direction of good practice.
- **Exam-style questions** will help you familiarise yourself with the style of questions asked, and the sort of things students may be required to do.
- **Key concepts** help you to provide links between topics in your answers and to develop a deeper understanding of the subject.
- **Progress check** enables you to review what you have studied.

Website

Extra resources can be found online at www.oxfordsecondary.com/9780198399773. These include:

- **Exam preparation**, which will help you prepare for success.
- **Test yourself** multiple-choice questions, which reinforce learning.
- **On your marks**, which give guidance on how to answer short answer, data response and essay questions.
- **A glossary**, which contains all the key terms you need to know for A Level Business Studies.
- **Answers** to odd-numbered progress questions and odd-numbered exam-style questions to help you review your progress.

Development of skills

The development of skills is an essential part of the Cambridge International A Level Business qualification. Learning facts (**knowledge**) alone is insufficient for you to achieve your best so it is important that you use this book to learn how to:

- **Apply** what you have learned. Case studies, activities and exam-style questions will all help you to do this. Getting it right will also give you some useful clues.

- **Analyse** problems, situations, factors and issues. This will involve using reasoned arguments, discussing, exploring advantages and disadvantages as well as synthesising information from a variety of sources.
- **Evaluate**. This means making judgments, taking decisions, drawing conclusions and assessing different factors and priorities.

More information on these skills and how they can be demonstrated in examinations, can be found in Exam preparation on the support website.

Key concepts

Each chapter highlights how key concepts relate to the content of the chapter. These key concepts are:

- **Change:** Recognising that businesses need to be innovative, to change and evolve in a rapidly changing world.
- **Management:** Recognising that all successful business decisions and activities need to be effectively led and managed.
- **Customer focus:** Recognising that every successful business understands and responds to its customers' needs.
- **Innovation:** Recognising the dynamic environment in which businesses operate and the need to "reinvent" themselves to stay ahead.
- **Creating value:** Recognising that creating value is the core reason why businesses exist. The value may be financial (most private sector businesses) or non-financial (e.g. in social enterprises).
- **Strategy:** Recognising that a systematic way of improving the chances of success is to put into action plans that enable the business to achieve its key objectives.

The way the key concepts are explained in each chapter should enable you to use the appropriate key concepts in your answers.

AS Level and A Level

This book is designed to cover the whole of the Cambridge International AS and A Level syllabus. You may be at a school that sits the AS Level papers at the end of the first year of the course, and the A Level papers at the end of the second year. Alternatively you may sit all of your papers at the end of the second year.

Whichever way you do the qualification you will find the book conveniently divided into AS topics and A Level topics.

DO REMEMBER, THOUGH, THAT THE A LEVEL PAPER COVERS THE WHOLE OF THE SYLLABUS.
AS + A = A Level.

1 Business and its environment

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **AS** the nature and purpose of business activity
- **AS** the concept of "creating value"
- **AS** economic activity, the problem of choice and opportunity cost
- **AS** the dynamic business environment
- **AS** what a business needs to succeed
- **AS** why many businesses fail early on
- **AS** the qualities an entrepreneur is likely to need for success
- **AS** the role of business enterprise in the development of a business and a country
- **AS** the range and aims of social enterprises
- **AS** triple bottom line – economic (financial), social and environmental targets

1.1 Enterprise

Introduction

Business activity is around us, everywhere. We pass shops on our way to school, we see lorries delivering products, we see advertisements on TV and in newspapers, and we see people going off to work.

Figure 1.1.1 A bustling town in Zanzibar ▲

All of these activities involve decision-making by owners, managers of businesses, customers and governments.

This book is concerned with the decisions that need to be made, the factors that influence these decisions and how the decisions are made.

The best way to understand the contents of the book – and the subject – is to take a keen interest in the business world around you. The shops you pass, the people you know who work, and the products and services you buy can all tell you something about business behaviour. Newspapers and television programmes can be a source of ideas and understanding.

Unlike most other subjects, Business Studies has two key features:

- Understanding can be found in the world around you
- The subject is highly interdependent. This means, for example, that what you learn about finance can have an impact on marketing decisions and other areas of a business.

Case Study

Sadie's new business

Sadie has worked in a printing business for a number of years. Although she enjoys her job and has developed many specialist printing skills she really wants to work for herself. She is attracted by the idea of having the freedom to do what she wants and being her own boss.

Sadie has some savings. She has seen a small printing business advertised for sale at a price she can afford. She believes she has the right contacts to get customers and the determination to make sure that their demands are met. She thinks she will be able to do this at a cheaper price than the business where she currently works, but she has not done her sums yet.

1. Why does Sadie want to set up her own business?
2. What potential problems might Sadie face in starting her business?
3. Why will careful planning be important for Sadie?
4. What is the major risk Sadie is undertaking?

Activities

1 Set up a folder for keeping cuttings from newspapers, advertisements and notes on what is going on in the business world around you. To begin with collect anything that seems interesting, later on you can be more selective.
2 Choose a well-known business in your country. Create a second folder in which to keep any information that you can find on that business. Keep the folder up to date.

The nature and purpose of business activity

When we eat a bar of chocolate we take many things for granted. We expect the shop to stock the chocolate and to accept our cash when we pay for it. We expect the chocolate to taste nice and be in a proper wrapper. We expect it to be sold at a price we can afford. We probably do not think much beyond that apart from enjoying it when we eat it!

If we analyse the situation we can see the huge range of businesses that are involved in getting that bar of chocolate to you. These include:

- The farmer who grew the cocoa beans
- The farmer who grew the sugar
- The farmer who supplied the milk
- The businesses that supplied the other ingredients
- The transport companies and shipping agents involved in transporting the cocoa, sugar, milk and other ingredients to the factory. This may have involved lorries, ships and aeroplanes
- The insurance companies that insured the shipments
- The business that owns the chocolate factory
- The businesses that supplied the machinery to the chocolate factory
- The businesses that supply other products and services to the chocolate factory, including telephones, gas, electricity, water etc.
- The businesses that marketed the chocolate
- The television stations, magazines and newspapers that carried advertisements for the chocolate
- The wholesale businesses that supplied the shops
- The businesses that transported the chocolate to the shops
- The shop where you bought the chocolate
- The banks that provided finance and other services to all of the businesses mentioned above.

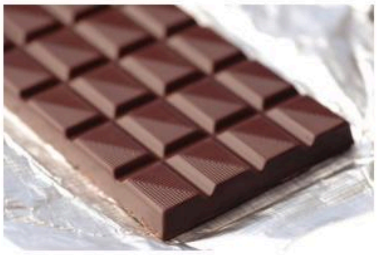


Figure 1.1.2 A huge range of businesses are involved in making this bar of chocolate available for you to buy ▲

And all of this for one bar of chocolate!

So, what does a business do?

If you examine all of the examples above, the businesses carry out a very wide and diverse range of tasks. However, one thing is common to all of them:

They all use resources of one sort or another to meet the needs and wants of customers.

These customers could be other businesses (the chocolate manufacturer buys cocoa from the farmer or wholesaler) or end customers like you or me who actually eat (consume) the chocolate.

Activity

See if you can think of any other businesses involved in getting the bar of chocolate to you!

Key terms

Capital goods: the machinery and equipment used to produce products and services.
Intermediate goods and services: the products and services bought by a business to be used in producing its own products and services or to be sold to another business.
Customer: the person/organisation that buys products or services. When this is the final person/organisation in a chain it is also known as the consumer.
Final goods and services, also known as consumer goods and services: the products and services sold to the general public, the end customer.

Businesses identify what their customers need and then set about meeting their customers' needs with whatever resources they have available.

Most of what happens involves businesses buying from other businesses. What the businesses buy includes, in this instance, raw materials (cocoa), finished products (bars of chocolate) and services (such as insurance and banking). Customers who buy from one business and are suppliers to another business are called intermediate customers, they buy both capital goods (machinery, equipment etc.) and intermediate goods and services (raw materials, components etc.). You, the end customer, only come in at the last stage when you buy the product. You are the "end customer", often known as the "final consumer", and you buy both final goods and services.

To make the products or supply the services businesses need resources. The resources available to a business need to be identified. Each of the businesses mentioned above need the following to function:

- **Intermediate goods and services**: The farmer needs diesel for the tractor, the chocolate factory needs cocoa to make the chocolate, and the shop needs chocolate bars to sell.
- **Capital goods: machinery, equipment, land or premises**: The farmer needs a tractor and land, the chocolate manufacturer needs a factory and chocolate-making equipment, the shop needs premises, counters and displays. Note that in many Economics textbooks, land is treated as a separate input and includes natural resources.
- **People**: The farmer needs someone to drive the tractor, the chocolate factory needs to employ people to work in the factory, the shop needs someone to serve you and, finally, the shop needs an end customer.
- **Enterprise**: The farm, the chocolate factory and the shop each need owners who take all the risks and make all the decisions.

The other essential item that each of these businesses needs is money:

- To pay for the raw materials and other inputs such as wages
- To buy the necessary machinery, property and so on
- To make all of the risk-taking and decision-making worthwhile for the owner
- As a reward for all the work done.

Case Study

Some facts about chocolate

One of the main ingredients of a bar of chocolate is cocoa. The other ingredients include sugar and, often, milk. Typically a 100g bar of chocolate has 30 per cent cocoa. In many countries this bar of chocolate will cost the equivalent of $3. Some chocolate manufacturers have signed up to the Fair Trade concept and guarantee to pay their suppliers a "fair" price. The cocoa farmer is estimated to receive between $0.02 and $0.06 per chocolate bar for Fair Trade chocolate bars, and about $0.01 for non-Fair Trade chocolate bars.

1 Why do you think a bar of chocolate costs $3 when the cocoa farmer only gets up to $0.06?
2 How can it be described as "Fair Trade" if the farmer seems to get so little?
3 Review your answer to Question 2 when you have studied the concept of creating value below.

Getting it right

When answering questions it is important to be clear about what market the business is aiming at and the nature of its products/services. These will affect the decisions the business will make.

Progress questions

1 Distinguish between capital goods and final goods.
2 Give three examples of final goods.
3 Give three examples of intermediate goods.

The concept of "creating value"

Continuing with the chocolate case study, the transformation from cocoa bean to chocolate bar involves many stages and many businesses, all helping to convert the cocoa bean into chocolate.

You might buy a bar of chocolate for $3 but you would not buy a cocoa bean for $3. Why not?

The bar of chocolate is something you would like to buy and you think is worth $3, but the cocoa bean has little value to you because you want chocolate.

However, if the farmer did not grow the cocoa bean you would not have the chocolate bar.

The simplified process is shown in Figure 1.1.3.

farmer grows cocoa **has a value to the local factory**	→	local factory makes cocoa concentrate **has a value to the chocolate maker**	→	chocolate maker makes bar of chocolate **has a value to the wholesaler**	→	chocolate delivered to shop **has a value to the shop**	→	shop sells chocolate **has a value to the end customer**

At each stage some work has been done:

The farmer plants the trees, harvests the beans and sells them to the factory.	→	The local factory converts the beans into cocoa concentrate. This is more valuable to the factory than the chocolate beans.	→	The chocolate factory takes the concentrate and other ingredients and makes the chocolate bar. The chocolate bar is more valuable because it is now something the business can sell to the final customer.	→	The transport company delivers the chocolate to the shop, making it even more valuable as it is now in the right place.	→	The shop sells you the chocolate bar, which is now at its most valuable as this is what you, the final customer, want.

Figure 1.1.3 Stages in producing a chocolate bar ▲

Key term

Creating value/Adding value: the process of increasing the value or worth of a good or service.

Link

Value added is covered in more detail in AS Level Chapter 4.1 The nature of operations.

Activities

1 Investigate three products you use every day. Describe the stages involved in getting these products to you, the customer.
2 Identify the various stages in making a car. What value added is created at the retail stage?

Key terms

Needs: products and services that are essential to our well-being.
Wants: those products and services we desire but are not essential to us.

Each stage of the process takes the product closer to what is required for the "end product", the product that the end consumer wants: in this case, a bar of chocolate. This is known as creating value or, sometimes, adding value, because the work done at each stage adds value to the inputs of that stage, so at each stage the product is worth more. The created value is measured by comparing the value of the inputs to a good or service with the value of the good or service itself.

So, for example, the chocolate factory takes cocoa concentrate as an input which, together with other inputs, produces chocolate bars. The work done by the chocolate factory creates value. Created value/value added is measured by taking the value of the inputs to a process away from the value of the output.

Progress questions

4 How does a transport business create value for a packet of tea?
5 How is "value added" measured?

Economic activity, the problem of choice and opportunity cost

Businesses can only survive and flourish if they meet customers' needs and wants. These needs will be investigated in later chapters, particularly in Topic 3 Marketing. A business should focus on how to meet customer needs and wants, and businesses know that they cannot meet every customer's needs or wants. A car manufacturer cannot possibly make cars for everyone in the world.

From the customers' perspective, the customers' own wants can never be fully met either at an individual level or on a global level. There simply are not enough resources in the world for everyone to have a new car, a new yacht and a new iPhone. Not only are there insufficient resources to make everything everyone wants, many people do not have the financial resources to buy what they need. Many poor people cannot afford the basic requirements of life: clean water, adequate food and shelter.

Because all our wants and needs cannot be met we all have to make choices. We as customers have to prioritise what we buy, and businesses have to choose what products or services they will provide.

The process of businesses producing and customers buying is known as economic activity. The economic activity of a country is the process of suppliers (businesses) and customers (other businesses and end customers) interrelating to match needs and wants with available resources. In wealthy economies many of the needs and wants can be met; in poorer economies the focus is likely to be on more basic needs and wants.

The key point is that all participants in an economy have to make economic choices.

- Businesses have to make decisions about what they will make or what services they will provide. They also have to make choices about the inputs they will buy and use.
- Customers have to decide what products and services they will buy with their limited resources.
- Governments have to decide which services they will provide and what the role of government is in managing the economy.

In economic terms choice is often an "either/or" decision: if I decide to buy the latest iPhone I will not have the money to buy a new pair of trainers; if I buy a new car I will have to go on a cheaper holiday; if a business decides on an expensive marketing campaign it may have to reduce spending elsewhere.

Key term

Opportunity cost: the value of the next best opportunity that is lost by taking a particular decision.

This aspect of choice introduces the concept of opportunity cost, an idea that you will meet throughout Business Studies. In making a decision, other opportunities have been foregone (given up). For example, if a government decides to build a new hospital rather than a new school because it cannot afford to do both, it gains the benefit of improved healthcare but loses (foregoes) the benefit of better education facilities for some children. The benefit foregone from the next "best" alternative opportunity is known as the opportunity cost. The opportunity cost is the value of the opportunity foregone.

So, for example, if I spend money on an expensive meal rather than a new textbook, the opportunity cost is the lost benefit that I would have got from the book. Of course, balanced against this I do have the benefit of enjoying an expensive meal! The opportunity cost of the government spending money on pensions is that there is less to spend on defence. The opportunity cost of a business deciding to build a new factory is the income that would have been generated had the money spent on the factory been put to some other productive use.

Getting it right

It is often useful to think what the opportunity cost of a particular decision is. But remember, opportunity cost is a concept rather than an actual cost incurred.

Progress questions

6 Define opportunity cost.
7 Identify a decision you have made recently. What was its opportunity cost?

The dynamic business environment

It may be hard to imagine, but DVDs did not become available until 1995. Prior to that film was recorded onto video cassettes. CDs have only been available since 1982. Before that music was recorded on tape and vinyl disc. Although digital photography was developed in the 1950s, the first professional digital cameras were introduced in 1991 and the first widely available digital cameras were sold in 1995. In the 20 or so years since then, traditional film cameras have virtually

disappeared. Hard disc drives had a maximum capacity of about 10 MB in 1985, 100 MB in 1990, 1 GB in 1995, 10 GB in 2000, 100 GB in 2005 and 1 TB in 2010. Since then revolving hard discs have been replaced by solid-state hard drives (SSDs), capable of much faster data transfers and being smaller than equivalent hard disk drives.

These developments in music, photography and computing give some idea of the rate of technological change throughout the business world. Add to these: changes in fashion; the extraordinary economic events following the US "credit crunch" in 2008; huge economic growth in many Asian and South American countries; rapid growth in the availability of information through the Internet, cellphones and smart phones, and we see a business world that has changed and evolved rapidly over the past ten years. It is difficult to forecast what it will be like in one year's time let alone what it will be like in five years.

In order to survive, most businesses have to keep up with current thinking or developments. They have to be dynamic.

What businesses need to succeed

Activity

In groups discuss the question "What makes a successful business?" Present your results on a wall chart.

If you completed the activity you might have started by identifying examples of successful businesses. The examples will, of course, depend on where you live. However, in many countries businesses such as Coca-Cola, McDonald's, Google, Microsoft, Nestlé, Toyota, Canon and Shell could all appear in the list. When you start exploring why these businesses are successful you might note some similarities but also enormous differences. Some of these businesses are retail services, some manufacture products and some extract minerals. Some employ large numbers of people; some rely on expensive facilities such as oil refineries.

However, the one thing that they all have in common is that they provide something that customers want and are prepared to pay for.

In trying to describe factors for success and failure, it is impossible to come up with models to suit every situation. An approach that works for McDonald's may not suit a fast-food outlet in China, India or Pakistan. The mass car market that has underpinned Toyota's success is quite different from the executive car market that is targeted by BMW.

However, even if each business has its own unique approach there are several factors most businesses need to consider:

- Market need for their products or services
- Finance
- Suitable location
- Effective management
- A workforce with appropriate skills
- Good relationships with customers
- The ability to compete with competitors

- Entrepreneurial skills including, usually, the desire to make profits
- Luck.

Why many businesses fail early on

Many later chapters discuss in detail the various issues in managing businesses. However, it is useful to give a broad idea of why many business ideas do not develop into flourishing concerns.

Many businesses fail in their first year of operation. Some of the reasons may be within the business's control; other reasons may be beyond its control.

Some examples of problems that could contribute to failure and that are within the control of the business include:

- Weak business idea
- Lack of managerial skills
- Lack of suitable employees
- Lack of sufficient finance
- Lack of entrepreneurial skills
- Poor initial research
- Over ambitious ideas
- Poor decisions.

Some examples of problems outside the control of the business include:

- Anticipated customers do not materialise
- Changes in the business environment affect customers
- Unexpected competition, or changes in the competitors' behaviour.

These are only typical suggestions at this stage. As you go through your Business Studies course there will be many opportunities to reflect on the reasons why some businesses succeed while many others fail early on.

Activity

Identify a business that has failed in your country. Find out what the main causes were. Were they internal or external? Discuss how the business could have avoided failure.

The role of the entrepreneur in the development of a business and a country

All business enterprises started with an idea and, usually, with one person or a small number of people prepared to put the effort in to get the business started. These people are known as entrepreneurs, and they have shown the skills of entrepreneurship which include:

- Having an original idea
- Developing the idea into a feasible business proposition
- Providing finance using their own savings and capital and/or, possibly, persuading others to do so
- Accepting the responsibility of owning the business

Key term

Business enterprise: an organisation set up for the purpose of carrying out business activities.
Entrepreneur: a person prepared to take the risk of engaging in a business enterprise.

- Recognising the risks involved including the possible risk of failure
- Taking the risk.

TV stations around the world have TV programmes that put new entrepreneurs to the test, including *Dragons' Den* (which is called *Tu Oportunidad* in Spain, *Candidate* in Russia, *Leijonan luola* in Finland) and *The Apprentice* (known as *The Apprentice Africa*, *The Apprentice Asia*, *Big Boss* in Germany and *O Aprendiz* in Brazil) which are both broadcast widely around the world in various forms. These provide an excellent insight into the business decision-making processes and the skills needed to succeed in business. These skills include:

- Innovation: the ability to come up with new ideas, and to see their potential value
- Persistence: the ability to keep trying even when there are problems and a project looks as if it might fail
- Leadership: taking decisions and persuading others of their merit
- Assessing and taking risks: most businesses start up with uncertainties so there is always a degree of risk involved.

Most countries need entrepreneurs. Countries need to grow and develop to meet the needs of the population, and entrepreneurs are often the engine for that growth. Small, new businesses are often more able to recognise needs and to produce innovative solutions. Existing large businesses are often slower to respond as will be seen later on.

Entrepreneurs create new businesses and new businesses can create:

- **Employment**: A major difficulty facing many countries is unemployment, particularly amongst young people. Unemployment can cause social problems, so creating employment may help improve social conditions through reduced unemployment and increased tax revenues to help with social projects. When an entrepreneur starts a new business, they will often not be able to do everything themselves and will employ people to help.
- **Large businesses usually start small**: Tomorrow's large businesses may be today's new businesses. Most businesses started from very humble beginnings. As some old, large businesses eventually decline, new businesses will replace them.
- **Economic growth**: Most countries rely on economic growth to provide greater funding for essential services such as education, health and defence. Small businesses are often the first to react to improved economic conditions and provide the "engine" that drives growth.

Progress questions

8 Define the term "entrepreneur".
9 Name three qualities you would expect an entrepreneur to have and explain why you think they are important.
10 Why do entrepreneurs usually have to take risks?

Case Study

Jumpstart Our Business Startups Act (JOBS)

The United States Federal Government has introduced legislation to help new businesses to start up and to make finance more readily available to small businesses to help them grow more rapidly. Banks tend to prefer lending money to large, well-established businesses rather than small, new businesses. The government argues that small businesses are essential to the US economy and necessary to reduce unemployment in the country. Before the legislation it was too difficult for small businesses to raise finance through the sale of shares.

The legislation will:

- Increase the number of shareholders a company may have before full regulation by the stock exchange
- Allow greater advertising of the sale of shares for small businesses
- Make it easier for small businesses to offer new shares
- Make it easier for very small investments to be made in share purchases.

1 Why would banks prefer to lend to large, well-established businesses?
2 How could the legislation help reduce unemployment in the US?
3 How could small businesses contribute to growth in the US?
4 Why would small businesses find it difficult to grow if they cannot raise finance through the sale of shares?
5 If your business exported electronic components to the US, how might you react to the announcement of this legislation?

Link

See AS Level Chapter 1.2 Business structure and AS Level Chapter 1.4 Business objectives.

Key terms

Social enterprise: a business venture whose main aim is helping people and/or the environment as opposed to making a profit.
Triple bottom line: the 3 Ps of People, Planet and Profit as the aims of a social enterprise.

Link

See AS Level Chapter 1.4 Business objectives for more on CSR.

Getting it right

Remember: social enterprises are not necessarily charities.

The range and aims of social enterprises

There are many different types of business and business objectives. Chapter 1.2 will look closely at different types of business, and Chapter 1.4 will look at business objectives. Most of the businesses you will meet in these chapters were started by entrepreneurs who are often motivated by profit. It is therefore useful to look at the social entrepreneur who has the same drive and determination to start a new business but whose over riding objective is social rather than financial. A business started by a social entrepreneur is known as a social enterprise.

Triple bottom line

The objectives of a social enterprise might include:

- People. Social: to provide opportunities for disadvantaged communities or for local people
- Planet. Environmental: to operate the business in an environmentally sustainable way
- Profit. Economic: to provide a return for the owners, but not necessarily as the over riding priority.

These 3 Ps – People, Planet and Profit – are known as the triple bottom line. This concept is closely related to Corporate Social Responsibility (CSR).

Social enterprises are not charities. Charities do not have any profit motive.

Many businesses, even those with the profit motive, seek to fulfill, at least in part, the 3 Ps through CSR policies; however, social enterprises will usually place People and Planet above Profits in their order of priorities.

Case Study

Social enterprises in Africa and South Asia

Alive & Kicking (A&K) is an example of African social enterprise. By manufacturing sports balls, A&K creates jobs for adults and promotes health education through sport. It states its vision as being of "an Africa where every child can play with a real ball, where thousands of jobs are sustained in the production of balls, and where sport contributes to the eradication of deadly disease." A&K operates in Kenya and Zambia.

Another example of social enterprise is the growing microcredit market in South Asia, particularly in Bangladesh. With technology becoming steadily cheaper and more widely available, it is becoming economically efficient to lend tiny amounts of money to people with even tinier assets. This is known as micro-finance, which aims to help the poor while allowing banks to increase their business.

Some microcredit markets are aimed particularly at helping women, who usually find it much more difficult to borrow from traditional banks. The Grameen Bank in Bangladesh is particularly well known as a social banking enterprise.

1 Why might A&K have to make a profit?
2 In what ways is A&K concerned about the well-being of its stakeholders?
3 Why must micro-finance banks make a profit?

Activity

Find out about a social enterprise in your country. In what ways does it benefit the community?

Progress questions

11 Define the term "social enterprise".
12 Explain how social enterprise differs from other business ventures.
13 Explain the term "triple bottom line".

Exam-style questions

1 Discuss the problems that a new clothes shop might face in its first year of trading. [12 marks]
2 "An entrepreneur is only interested in making a profit." Discuss the relevance of this statement to someone about to launch a new business. [12 marks]
3 Evaluate the role of the entrepreneur in your country. [20 marks]
4 Explain the benefits that new business start-ups can bring to your country. [8 marks]

Key concepts

AS **Change** can be considered in the context of the dynamic business environment.
AS **Management** can be illustrated through the role of the entrepreneur.
AS **Innovation** is central to the development of business ideas.
AS **Strategy** can be introduced through discussion of "how to succeed in business".

Progress check

You should now be able to:

AS explain the nature and purpose of business activity
AS explain the concept of "creating value"
AS apply the concept of opportunity cost
AS analyse the dynamic nature of business
AS discuss what a business needs to do to succeed
AS discuss why many businesses fail
AS discuss the qualities an entrepreneur needs to succeed
AS evaluate the role of business enterprise in the development of a business and a country
AS explain the range and aims of social enterprise
AS use the concept of triple bottom line.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- AS classifying businesses: primary, secondary and tertiary sectors
- AS public and private sectors
- AS main features of legal structures for business ownership including ability to raise finance
- AS appropriateness of legal structure: sole trader, partnership, private limited companies, public limited companies, franchises, co-operatives, joint ventures
- AS the concept of limited liability and its importance
- AS choosing an appropriate legal structure
- AS problems resulting from changing from one legal structure to another
- A multinationals and local/national businesses
- A privatisation

Activity

Identify as many different types of business as you can in your area. List what they do and who owns them. Do the businesses manufacture products or provide services or both? Who are their customers? Which do you think are successful?

Getting it right

Businesses in case studies are likely to come from any of these sectors. It is important to recognise who their suppliers are likely to be and who are their customers.

1.2 Business structure

Introduction

This chapter explores the impact that businesses have on the structure of the economy and then develops the various types of ownership structures for businesses. These are known as "legal structures".

There are many different types of business both in their nature and their size. It is important to be able to recognise the various types of business to understand how they might have different objectives and how they might behave differently. It is easy to understand that a very large multinational business such as Coca-Cola might behave differently from a small family business, but it is not so easy to see why a government-owned airline might behave differently from a privately owned airline. This chapter explores different types of business, where they fit in a country's economy and how they are owned.

Classifying businesses

It is useful to classify businesses in terms of what they *do*. People frequently talk about different types of industry – the airline industry, the oil industry, the banking industry etc. – and most people know what these terms mean. However, it is useful to have much broader categories to describe the activities that a range of industries undertake. The broadest category is achieved with the concept of "economic sector".

Classification by economic sector

The economic sector can be divided into three categories.

- Primary sector: This sector consists of all those businesses directly related to the extraction and exploitation of natural resources. Primary sector industries include: farming, fishing and extracting minerals such as oil, copper and iron ore. The products of these industries are sometimes sold to final consumers but are often sold to customers in the secondary sector to be processed.
- Secondary sector: Businesses in this sector manufacture products. They convert a variety of inputs (often including products from the primary sector, labour and products from other secondary sector businesses) into products that are sold to customers. These customers may be final consumers or other businesses.

Key terms

Primary sector: businesses engaged in the first stage of production, that is developing natural resources through, for example, farming, mining, fishing, oil production etc.

Secondary sector: businesses that manufacture and process raw materials, including those from the primary sector, for example producing electricity from coal, producing petrol and diesel from refining oil, the car manufacturing industry, cotton making etc.

Key term

Tertiary sector: those businesses that provide services such as banking, retail, transport, tourism etc.

Key terms

Consumer market: a market whose customers are final consumers such as members of the public.
Industrial market: a market for which customers are other businesses and they buy products/services as inputs to their own processes.

Getting it right

Case studies are just as likely to involve business-to-business (B2B) businesses as businesses that trade with end customers (B2C). It is important to think about who a business's main customers are as that is a major factor in how it is likely to behave.

Key terms

Public sector: that part of the economy that is owned by the government.
Private sector: that part of the economy owned by private individuals.

Link

For A Level students, privatisation is discussed in more detail towards the end of this chapter.

- Tertiary sector: These businesses are not involved with natural resources or manufacturing. They provide services. These services might be provided to final consumers (e.g. a train service or a retail outlet) or to other businesses (e.g. writing computer software for a large insurance company) or both.

Historically, it has been the case that as countries grow they progress from being predominantly agricultural economies (primary sector) through manufacturing economies (secondary sector) to principally service economies (tertiary sector). A good example of this is the UK, which, prior to the industrial revolution, was agricultural and is now predominantly service-led with businesses clustered around banking, finance, media etc. Many countries in western Europe have similar economies.

Types of market

Some businesses create products or services that are of immediate benefit to customers who are final consumers, usually ordinary members of the public. Products include ice creams, newspapers, cars, petrol etc. The markets that these businesses sell in are known as consumer markets.

Other businesses are more concerned with products and services that are of benefit to other businesses, such as providing steel for making cars, microchips for making computers, and lorries for transporting products around. These businesses operate in industrial markets.

In your life you are more likely to encounter business-to-customer (B2C) activity rather than business-to-business activity (B2B). The two types of business behave very differently in their relationships with their customers.

Difference between public and private sectors

Traditionally economists have drawn a distinction between the public sector – those businesses and business activities owned by the government – and the private sector – those businesses owned by individuals or groups of individuals.

The public sector has declined significantly in size and importance in most countries over recent years and is likely to continue to do so as governments around the world focus on increased competition and entrepreneurship. The study of why and how this change of emphasis has happened is an A Level topic. Despite this change, the public sector continues to make important contributions to most countries through businesses such as state-owned schools, universities and hospitals, which may not operate as effectively in the private sector. Useful examples of public sector businesses include the US railway company Amtrak, the US postal service USPS, the BBC in the UK, the Indian Oil Corporation and Pakistan International Airlines.

In the banking crisis of 2008, many banks around the world were effectively privatised – taken into public ownership.

Activity

In your country identify businesses that are in the public sector. Find examples of private sector businesses.

Getting it right

At AS you are expected to know what the term "multinational" means. An AS case study may contain a business that is a multinational. However, the study of multinationals and their impact on a country is an A Level topic only.

Key terms

Local businesses: businesses that operate only in a specific area of a country. This may be as small as a village or as large as a region of the country.
National business: a business that operates on a wider scale throughout a nation.
Multinational businesses: businesses that have their head offices in one country (home country) and that operate, possibly manufacturing or assembling, or delivering services in a range of other countries (host countries).

It is important to recognise the distinction between public and private sectors as it has an impact on business objectives and behaviour.

Progress questions

1 Give examples of businesses in the primary sector.
2 Explain the difference between the public sector and the private sector.
3 In what sector would a supermarket business be?

Local, national and multinational businesses (A Level)

Although this classification is an A Level topic it is useful to understand definitions at AS. You will not be examined on the definitions themselves but there will be case studies drawn from the different types of businesses.

The various categories are local, national and multinational.

Examples of local businesses might include a family business that has one shop in a town, the local firm of solicitors, a family run garage.

An example of a national business might be a chain of supermarkets that operate throughout the country but not overseas. Sometimes a business might operate in a region rather than nationally and these are known as regional businesses. It is also possible to have regional businesses that serve areas larger than local businesses but smaller than national businesses.

Examples of multinational businesses would include chocolate manufacturers Thornton's (UK), Cadbury (now part of Kraft) (US), Milky Way (US) and Ferrero Rocher (Italy). Nestlé (originating in Switzerland) would regard itself more as a transnational business – it has autonomous headquarters in many countries.

Legal structures and business ownership

Different types of private sector businesses

We need to study the different ways in which businesses are owned and the impact that this has on legal structure.

If you observe local businesses you will notice differences not only in the size and type of businesses but also in the way the businesses are owned. You will probably have come across examples of family-owned businesses (often shops or restaurants) but also examples of businesses whose owners are unknown or unseen (such as supermarkets, petrol stations and fast-food outlets). Often the owners of these businesses live in other countries.

We need to understand reasons for these differences in ownership. The choice of how a business is owned has implications for the way it is treated legally – its legal structure.

The two simplest forms of business are: sole trader and partnership. However, before we can study sole traders and partnerships we need to understand the concept of unlimited/limited liability.

Risk, ownership and limited liability

One of the important reasons why businesses choose different ownership types (legal structures) arises from the consideration of business *risk* and the consequences of things going wrong.

One of the roles of the entrepreneur is to take risks, for example:

- Business ideas may not work in practice
- Unforeseen events may disrupt plans
- Money (investments) can be lost. In some circumstances entrepreneurs can lose more than their original investment.

Imagine you own your own window-cleaning business. Your investment would be a bucket, a ladder and some other small items. Let us suppose you accidentally drop a bucket on a famous person's head! If they sued you for damages you would stand to lose far more than your investment and far more than you could afford even if you sold everything you had – if you owned a house you would probably have to sell that.

Key term

Unlimited liability: a situation in which an individual or group of individuals are totally liable for the consequences of a course of action.

This is the concept of unlimited liability – whatever goes wrong is the liability of the owner of the business, and this could be disastrous.

One of the major weaknesses of this type of business is the fact that the law does not distinguish between the business and the owner of the business – "the person is the business and the business is the person". While it may be possible to get some kind of insurance to cover accidental problems like dropping a bucket, no insurance company would insure you for making the wrong decisions.

The way to solve this problem is through the concept of incorporated businesses and limited liability. This topic is covered later in this chapter.

Sole trader

Key term

Sole trader: business owned by one person. The owner controls the business, often manages it and has usually provided all of the finance. There are no legal formalities needed to start up as a sole trader.

Often when businesses start up, one single entrepreneur comes up with the original idea and owns and controls the business after it has started operating. This type of owner is called a sole trader. This is the simplest type of business organisation and it has no formal legal structure as it is, legally, no different from its owner. It is easy to set up and manage. It is important to remember that although there is only one owner, that owner can employ other people.

This type of business has the advantage of the owner being in charge of everything, and he or she can make decisions without having to consult anyone else. However, there are three major drawbacks of being a sole trader:

- Any finance (money) required to start up the business or to expand it will be limited to whatever the sole trader can get hold of.

Getting it right

It is easy to make the mistake of thinking that a sole trader business is a business with only one person. There is only one owner, but that owner can employ other people. Indeed there are some quite large sole trader businesses.

Figure 1.2.1 Window cleaners are often sole traders ▲

Key term

Partnership: business that has more than one owner. The owners share responsibility for running the business and also share the profits.

Activity

In your area find examples of partnerships. What sort of businesses do they operate? Why do you think that they have chosen to be partnerships rather than sole traders?

- The sole trader may have insufficient skills. Although he or she can buy in additional skills by employing people, the sole trader may not want to trust employees with responsibilities such as making decisions about running the business and its financial matters.
- A sole trader has unlimited liability; that is, if the business gets into debt the owner is liable for those debts and may have to use all his or her assets to pay them.

Progress questions

4 Give two advantages of operating as a sole trader business.
5 Why could a sole trader business have more than one person working in it?
6 Why is unlimited liability a problem for a sole trader?

Partnerships

One solution to the constraints of being a sole trader is to go into partnership with other people. This can be done informally or formally with a Deed of Partnership.

Doing this enables:

- The injection of more capital: it is usually a requirement that any new partner puts money into the business.
- Additional skills to be brought into the business. For example, one partner could be very good at the financial side of a business while another could be better at dealing with customers.
- The heavy workload associated with running a business to be shared between the partners.
- Decision-making to be easier when it is shared.
- The possible losses to be shared.

However, there are two major problems:

- Most partnerships have unlimited liability. This is even more problematic than for sole traders as each partner is liable for any business debt created by any of the other partners. This is a big risk for anyone to take on.
- The number of partners is limited (the exact number varies from country to country) so only a limited amount of finance can be raised.

Progress questions

7 Give three advantages of becoming a partnership.
8 Give three disadvantages of being a partnership.
9 Why are professional businesses, such as solicitors, often partnerships?

The concept of limited liability

For many centuries businesses survived and grew as sole traders or partnerships. Both are examples of what is known as "unincorporated businesses". However, as business enterprise became larger, and the risks often became too great for individuals or small groups of partners to take, the idea of limited liability was developed and became part of the business world.

Problem: The unincorporated business and its owner(s) are legally the same thing. The owner is liable for the debts of the business and the business is responsible for the debts of the owner.

Solution: Provide a mechanism to separate the legal identities of the business and the owners and that way separate the liability. The owner gets the benefit of limited liability.

The solution is known as incorporation, i.e. going through a legal process to create a legal entity for the business that is independent of the owner(s). The business then becomes known as a limited company and the owners of the business can only lose the money they put into the business: their share of the ownership. In return for this opportunity, incorporated businesses have to meet particular standards and abide by rules and regulations.

Limited liability enables businesses to grow without placing too much risk on the owners.

In incorporated businesses the owners are the shareholders.

Progress questions

10 Explain why limited liability is important.
11 Why should a partnership not be called a company?
12 Give one disadvantage of becoming incorporated.

Getting it right

The term "company" has a very specific meaning. It refers to an incorporated business. Avoid using the term when referring to unincorporated businesses such as sole traders and partnerships.

Key terms

Unincorporated: a private sector business that has not been registered as a company. Sole traders and partnerships are unincorporated.
Limited liability: a situation in which the owners of a business can only lose the money they have put into the business and not their own personal wealth. This is achieved through incorporation.
Incorporation: a business that has been registered as a company in order to set up a separate legal entity and achieve limited liability for its owners, e.g. a private limited company.
Company: a private sector business that has been incorporated.
Shareholders: the owners of a limited company and other incorporated businesses.

Incorporated businesses

Private limited companies

Often as smaller businesses grow, sole traders or partners will want to protect themselves from the increasing risks associated with larger businesses. They will protect their own wealth by going through the process of becoming incorporated. The usual first step is becoming a private limited company.

The owners of private limited companies, who are often friends, relatives or business associates, will go through the legal procedures to set up the company (these will differ from country to country so details are not provided here). Owners invest money into the business by buying "shares" which gives them a share of the ownership in proportion to the number of shares that they own. Ownership is restricted to an agreed list of owners, which can only change if the other shareholders (owners) agree. This restriction distinguishes private limited companies from public limited companies.

Key term

Private limited company: an incorporated business in the private sector where share ownership is limited to specified people, institutions or businesses. Shares are not available to the general public.

Being a private limited company means that:

- Owners (shareholders) are more likely to risk their money as they have limited liability
- More capital (finance) can be raised than for sole traders or partners because more shares can be sold to existing and new shareholders if and when the shareholders agree
- The business can continue even if one of the owners dies because it is a legally separate entity
- Profits have to be shared between a much larger number of owners
- Incorporated businesses have to produce publicly available financial accounts
- Sale of shares is restricted, which may restrict the amount of capital that can be raised.

Setting up an incorporated business takes time and money.

Public limited companies

To overcome some of the difficulties facing private limited companies – most notably the restrictions on the amount of capital available – a private limited company can, provided it meets certain strict criteria, become a public limited company. This widens the potential ownership of shares to the general public rather than the agreed restricted list of permitted shareholders that applies to a private limited company. The process of converting to a public limited company is known as flotation.

Clearly, members of the public who buy shares in a public limited company cannot run the business on a day-to-day basis so, once a year the shareholders elect a board of directors to manage the business within very broad guidelines agreed at the Annual General Meeting (AGM) and specified in the legal documents governing the business.

Key term

Public limited company: a private sector incorporated business with the right to sell shares to the general public.

Table 1.2.1 Advantages and disadvantages of being a public limited company ▼

Advantages	Disadvantages
• Potentially a great deal more capital can be raised because shares can be sold to the general public. • A higher public profile for the business as the shares can be traded on the stock market. • A better image because a public limited company has to meet strict criteria for governance and operation and should be under constant scrutiny.	• Forming a public limited company is a lengthy and very expensive process. • There is much greater scrutiny of business activities by the government authorities, the stock market and the public. • Much more financial information about the company is available in the public domain. • There is a separation between ownership (general public) and control (board of directors). • Since anyone can buy shares on the stock market there is an increased risk of a takeover. • Shareholders might want short-term speculative gains that are not to the long-term benefit of the business. • Directors might see re-election at the AGM as their priority rather than considering the interests of other stakeholders or the company.

Getting it right

Not all large businesses are public limited companies and some public limited companies are relatively small.

Activity

In your country, find examples of public limited companies. What distinguishes them from other types of business?

Case Study

Facebook in 2012

Facebook, the world's largest social networking site, had announced plans for a stock market flotation. It planned to raise $5 bn. Facebook was only 8 years old, but it had 845 million users worldwide and made a profit of $1 bn in the most recent year. It was started by Mark Zuckerberg and other students at Harvard.

As a private company Facebook did not have to release much information about its operations. "That will all change", said one media commentator at the time of the flotation. "Releasing information about the company will become part of Facebook's duties as a publicly listed company. In addition, Facebook will be heavily influenced by shareholders' needs whereas it is the users and employees who are currently determining its development."

Facebook wanted to expand into new markets and to produce new products. The flotation also rewarded the existing shareholders who were largely the founders and employees, and realised value for its then owners who were able to trade some of their shares but still retain overall control.

The flotation only made a very small proportion of share capital publicly available – it is thought that the business was then worth at least 20 times the flotation amount.

Facebook users did not notice much difference following the flotation.

1 What is meant by the term "flotation"?
2 Why might the owners of Facebook have been concerned that Facebook would have to be more open about the operations of the company?
3 Why might Facebook have wanted to float shares that only represent 5 per cent of its value?

Key term

Franchise: a business that is allowed to use an existing business model (name, product, trading systems, logos etc.) in return for payments (royalties). It involves agreeing to strict conditions.

Figure 1.2.2 An example of a franchise business ▲

Link

See A Level Chapter 3.5 Globalisation and international marketing.

Progress questions

13 Give three benefits of converting from a private limited company to a public limited company.
14 Why might a new business not seek to be a public limited company from the outset?

Franchises

A franchise is more about the legal relationship between two businesses than about the legal ownership of a single business. However, it is a useful and rapidly growing type of business organisation around the world. International examples of franchises include McDonald's, 7-Eleven, Quanjude (Roast Duck) restaurants, KFC, Hualian supermarkets and Malan Noodle.

Many people start in business as sole traders. However, recognising the shortcomings that arise from being a sole trader, these people may see the benefits of working in conjunction with an already established business. One way of achieving this is by setting up the business as part of an existing franchise.

A franchise is a legal agreement between the franchisor (an existing business with a successful business model, idea or brand) and a franchisee (a much smaller business that is able to use the successful business model, idea or brand under an agreed licence).

Typically, the franchisee will provide most of the investment for a small-scale operation, such as a single restaurant. In return for a payment to the franchisor, usually a royalty on revenue, the franchisee will be able to use the name and logo of the franchise as well as benefiting from the marketing, operations and human resource functions of the franchisor. The franchisor often lays down strict rules for the operation of the franchise in order to protect the brand.

Franchisees can be either incorporated or unincorporated businesses.

Table 1.2.2 Advantages and disadvantages of franchising ▼

Advantages to the franchisee	Advantages to the franchisor
• A way in to an established and successful business model. • Access to benefits of economies of scale such as centralised buying, marketing, accounting and administration. • Access to expertise that would not normally be available to a new business. • Likely to be smaller initial investment and lower risk than an equivalent "stand alone" business.	• Guaranteed and regular income from franchisee. • Easy, relatively risk-free way of expanding a business. Can take advantage of local knowledge when expanding nationally or internationally. • Relatively easy to manage through strict conditions of franchise. • Some degree of control over businesses that may otherwise have been competitors.
Disadvantages to franchisee	**Disadvantages to franchisor**
• Proportion of revenue is paid to franchisor, even if a profit is not being made. • Rigid business model, which may inhibit entrepreneurship of franchisee. • Franchisor could withdraw franchise if conditions not met. There is a potential loss of a large investment. • Position of relative weakness in negotiations with franchisor.	• Poorly managed franchises could damage the brand name, affecting many franchises. • Potential management issues as the network of franchises grows, including more difficult co-ordination, communication and quality control. • Franchisees could become powerful as they open more franchises. • Difficult to monitor a very large franchise network to ensure consistency of standards.

Activities

Find examples of franchise businesses in your local area.

1 Where is the franchisor based?
2 What industries are the franchises in?
3 Can you find examples of similar businesses that are not franchises? How do they compare?

Case Study

Developments of franchises in China

According to recent statistics there are over 4500 franchise systems in China with a total of more than 400000 outlets. Total sales in 2010 were estimated to be more than 300 billion yuan ($30 billion), a growth of 8.9 per cent in the year.

"Ever since 1999, when franchising gained popularity in China, people have favoured this business model either to build up their own business or expand a business to a larger scale. Expansion through franchising is low cost and fast" said an expert for developing business in China.

As early as 1993 China Quanjude Co., a restaurant famous for its roast duck, had already started franchising. "It was the fastest way to expand" said a director. "In large cities like Beijing and Shanghai we are focusing on outlets we own ourselves. But in smaller towns and cities we prefer franchises. Local franchisees are more familiar with the markets." The company now has businesses in 38 Chinese cities as well as in Japan, Australia, Hong Kong and Myanmar (Burma).

1 Identify two reasons why a business might choose to franchise if the owners want the business to grow.
2 Identify two likely benefits to a franchisee of a franchise business.
3 Discuss why franchises may have grown so rapidly in China. Use Internet research if necessary.

Progress questions

15 Who owns a public limited company?
16 List three benefits of operating as a franchise.
17 Describe the main features of a public limited company.

Co-operatives

Co-operatives are organisations that are owned by their members. Membership can be achieved in several ways:

- In a consumer co-operative the members will be the customers. Some retail outlets are run as co-operatives.
- In worker co-operatives the members are the employees.
- In agricultural co-operatives the members are the farmers.

By working together members hope to achieve greater power in the market through:

- Economies of scale: members can buy bigger quantities (e.g. seeds for farmers, products for shops) than if they operated on their own.
- Wider groups influencing business decisions. For example, employees may want to take strategic decisions themselves and they can do that in a worker co-operative.
- Greater power in markets than operating individually. For example, farmers joining forces to sell their produce to buyers will have more power to negotiate with customers such as large supermarket chains and multinational food manufacturers.

Co-operatives have proved quite successful in some circumstances, preventing, for example, the exploitation of poor farmers. However, their use is not widespread and their usefulness is limited by:

- Access to finance: Money from members is likely to be limited compared with a public limited company
- A lack of business expertise of members
- The potential complexity of decision-making if all members have to be consulted.

Good examples of co-operatives can be found in the banking sector. For example, the Co-operative Bank in New Zealand gained a very high customer satisfaction rating of 96 per cent. It was also named the inaugural winner of the 2011 Canstar Blue Customer Satisfaction Banking award, obtaining the maximum five-star rating in every category.

Key term

Co-operative: a business owned by its members who could be employees, customers or groups such as local farmers.

Link

See AS Level Chapter 4.2 Operations planning for more on economies of scale.

Joint ventures

Circumstances can arise where it makes sense for two or more business organisations to work together on a particular large project, such as developing a new type of aircraft. Sometimes this can be achieved by means of a strategic alliance where each business retains its own individual commercial and legal identity, but often it is necessary to set up a joint venture. This is a completely new company, owned by the businesses that want to work together. A joint venture (JV) is a business agreement in which the parties agree to develop, for a finite time, a new corporate entity and new assets by contributing equity. All parties exercise control over the enterprise and consequently share revenues, expenses and assets.

Key term

Joint venture: a business agreement in which organisations agree to develop a new corporate identity, separate from their own, for a finite period of time.

Case Study

VW in China

There is a whole range of factors that makes it difficult to break into a new market in a different country. Language, culture, business practices, currency and legislation can all provide obstacles to a successful launch. The major consideration for starting business in China is that under Chinese law foreign companies must have a minority ownership in some specific industries. This is often achieved by a joint venture with existing Chinese businesses.

Volkswagen Group China is the largest, earliest and most successful international partner in China's Automotive Industry. It started its connection with China as early as 1978, and has been taking the leading position in the Chinese automotive market for more than 25 years. Its first joint venture in China, Shanghai Volkswagen Automotive Co. Ltd (SVW), was established in October 1984 with the VW and Shanghai Automotive Industry Corporation, who are a Chinese state-owned corporation (now SAIC Motor). The joint venture is to last until 2029. The arrangement enabled the sharing of the large costs of setting up the car factory as well as giving VW access to one of the world's largest markets for cars. In return, China got a "ready-made" car industry able to meet the country's growing demand for cars. By October 2009, SVW had turned out over five million cars in total, becoming the carmaker with the biggest population of cars in China.

Figure 1.2.3 ▲

1 What benefits are there to VW arising from the joint venture with SVW?
2 What benefits are there to China arising from the joint venture?
3 Why do you think the joint venture has a finite life?
4 What problems can you foresee from a joint venture such as SVW?

Activity

Compare different types of private sector business by producing a table that shows the advantages and disadvantages of the main types of business ownership. Then compare your table with tables produced by other students.

Getting it right

In any particular situation, for example when answering case study questions, use all the information you are given about the business and its owners to assess the usefulness of each legal structure in order to choose the best one.

Choosing an appropriate legal structure

The right choice of ownership and legal structure will depend on a number of factors. It is a question of examining these factors against the advantages and disadvantages of each type of legal structure.

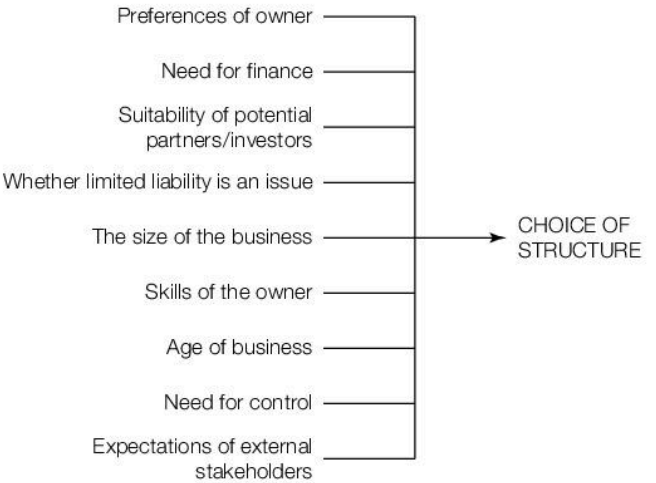


Figure 1.2.4 Choice of ownership/legal structure ▲

Problems relating to changing from one legal structure to another

As a business grows it is likely to need to change its legal structure, possibly to gain additional finance or to gain limited liability.

The usual progression for change of legal structure is shown in Figure 1.2.5.

Figure 1.2.5 Changing the legal structure of a business ▶

When any of these progressions take place the outcome is likely to be the loss of the advantages of the current ownership structure and the gain of the benefits of the new ownership structure.

So, for example, when a sole trader takes on a new partner, the sole trader loses the advantage of independence and being able to make all the decisions themselves, but gains the benefits of any additional finance and the skills of his or her new partner. Your work on advantages and disadvantages of each structure will help you identify the impact of changing structures.

In any given situation it is important to look at the present position of a business, in particular what the constraining factors are, and then look at the consequences of changing the legal structure, how the constraining factors change and whether any disadvantages have been introduced. In assessing the consequences of changes it will be important to consider a variety of stakeholders.

A particular issue is the cost involved in any transition. It is very expensive and time consuming to convert from a private limited company to a public limited company.

Local, national and multinational businesses (A Level)

Getting it right

Remember: At AS Level you are expected to know the meaning of the term "multinational". At A Level you need to know about benefits and disadvantages of multinationals.

You have seen the distinction between local, national and multinational businesses (see page 22) as well as examples of multinational businesses.

At A Level you need to know the impact that multinational businesses could have on a country and why many businesses choose to operate as multinationals.

Multinational businesses are businesses that operate in a variety of different countries. They are often very large businesses that benefit from free trade globalisation. They do more than just import and

export. Multinationals are based in one country, the *home country*, and have operations such as manufacturing, assembling or providing services in other countries, *the host countries*. There has been enormous growth in multinational business in recent years. This can be explained by:

- A greater emphasis on globalisation by nations and trade agreements such as GATT
- Reductions in barriers making it easier to set up operations in other countries
- Cost savings by operating in low-cost countries
- Growing markets in many countries.

In assessing their value it is important to examine the benefits and disadvantages from both the host country's point of view and that of the multinational business itself.

Table 1.2.3 Benefits and disadvantages of multinationals ▼

	To host country	To multinational company
Benefits	• Availability of products and/or services that would not otherwise be available. • Knowledge and expertise brought to the host country. • General benefits of international trade, possible decrease in imports. • Investment in host country and creation of jobs.	• Closer to markets. • Benefits of economies of scale. • Can gain better recognition by undertaking activities that are more than simply importing. • Better access to local information. • Potentially lower costs if nearer raw materials or cheaper sources of labour. • May avoid import restrictions.
Disadvantages	• Local industries overwhelmed and may fail. • Some multinationals are very powerful. • May decrease competition and become monopolies. • Management appointments may be from home country causing resentment amongst local workers.	• Can be difficult to manage – diseconomies of scale. • Co-ordination might be difficult over long distances. • Cultural differences between host country and home country.

Whether or not a multinational brings a net benefit or net disadvantage to a country depends very much on the individual situation. Large multinationals may have a huge impact on small countries, smaller multinationals may have little impact on large companies. The nature of the business and its competition will have an effect on the level of impact.

Privatisation

A further possible type of change is the change from public sector to private sector (privatisation), and from private sector to public sector (nationalisation).

Apart from some banks, following the financial crisis in 2008, there are very few instances of nationalisation in the world today, the needs

Key terms

Privatisation: the process of converting a public corporation into a private sector business, usually a public limited company.
Nationalisation: the process of converting a private sector business into a public corporation.

of the global economy favouring private rather than public enterprises. Therefore we will focus on privatisation.

The main impacts of changing from public to private ownership are:

- A change in emphasis of objectives with a greater role for profits as a key objective
- Freedom to introduce new products and services, and to diversify
- Opportunity to restructure the workforce and working practices – this may, however, lead to redundancies
- Greater freedom for management so that major investments may follow privatisation
- Possibility of introducing greater competition so prices to customers may reduce.

However:

- Privatisations can be expensive
- It is less likely that private sector businesses will continue to provide a loss-making service to the community, e.g. postal services to remote communities
- Some businesses are natural monopolies and might be better controlled if they are in the public sector.

Nationalisation tends to have the opposite effects to those listed above.

Case Study

Water industry – Mauritius

Mauritius plans to privatise its water sector. Rain is becoming rare and almost half of the available water is leaking out of century-old pipes. Added to that are problems such as waste and over-consumption by the population, and mismanagement of the sector. "We can have plenty of water, we haven't planned properly. That is the problem," the prime minister said.

The challenge is big. The government has unveiled plans to replace part of the 2,000 km long pipeline network and build two more dams.

Demonstrating in front of the offices of the water company, the general secretary of the Consumers Association of Mauritius (ACIM), said neither a rise in rates nor privatisation is justified "since a good part of the population does not get enough water because of the leakages in the pipes. Water belongs to everyone, not profit-making businesses."

But supporters of the government's plans to privatise the industry and to increase water rates on grounds of transparency and good governance, cite as examples the banking, insurance and financial services sector and the sugar industry that are well managed in private hands. Political intervention has ruined all public bodies in Mauritius.

1 What disadvantages are there of public ownership?
2 What benefits might privatisation bring to the Mauritius water industry?
3 What arguments are there against the privatisation?

Activity

Find out about privatisation programmes in your country. Were any banks nationalised following the credit crunch? Produce a table showing advantages and disadvantages of privatisation.

Exam-style questions

Sunshine Farm (SF)

SF is run by Sadiq and Asmir. Sadiq owns the business as a sole trader. The farm grows a variety of fruit to the highest standards. For the past ten years this fruit has been sold to Fastcan (FC), a manufacturing company that produces canned fruit. Asmir, the manager, has had the idea to pack the best-quality fruit in boxes, and to sell the boxes under the brand name "Our Choice". SF would have to spend $1000 on new machinery to clean and package the fruit. Asmir estimates that this project would provide an estimated income of $500 a year. Asmir wants to lease a shop in the city for this venture. Asmir has the money to enable this venture to go ahead and has suggested changing the business to a partnership.

1 Discuss the problems that Sadiq could face if he changes from a sole trader to a partnership. [11 marks]

Obelisk TV (OT) (A Level)

Obelisk Television (OT) is a multinational manufacturer of televisions (TVs). It has production facilities in four countries and markets its products throughout the world. The table shows its main locations.

Location			
Headquarters	Country J	A fully developed economy, high skills, large market.	Products imported.
Factory 1 (main factory)	Country T	Rapidly growing country with large electronics industry. Low unemployment.	Large sales in country T as well as large exports to nearby countries.
Factory 2	Country X	Developing economy, near to major markets, but with rising costs due to rapid growth.	Products exported to several nearby large countries.
Factory 3	Country Y	Low cost, developing economy with low skills. Cheap supplies of electricity etc.	Exports to all other countries worldwide.

Obelisk needs highly skilled employees so it has large training programmes in low skill countries.

(A Level)

2 Discuss the extent to which being a multinational is a benefit to both OT and the countries within which it operates. [10 marks]

Key concepts

- AS **Change** can be developed by considering why business structures need to change.
- AS **Management** can be viewed from the perspective of decisions about business structure.
- AS **Strategy** can be developed in relation to choosing a structure relevant to business aims and objectives.
- A **Change** can be considered in relation to the growing impact of multinationals.
- A **Management** can be developed through consideration of the impact of the different types of structure on how they are managed.
- A **Customers** can be developed through consideration of the impact of different types of business structures on customer choice and behaviour.
- A **Strategy** can be considered through the government's attitude to privatisation.

Progress check

You should now be able to:

- AS identify and apply the various business classifications
- AS explain the difference between the public and private sectors
- AS discuss the various types of business ownership and legal structures
- AS explain the importance of limited liability
- AS evaluate the appropriateness of a legal structure/recommend a structure in a given circumstance
- AS discuss the problems of moving from one legal structure to another
- A evaluate the role of multinational businesses
- A discuss privatisation in a given situation.

You should be able to relate these to a range of businesses in different situations.

In this chapter you will develop your knowledge, understanding and ability to analyse and evaluate:

- **AS** different methods of measuring the size of a business
- **AS** the advantages and disadvantages of being a small business
- **AS** the strengths and weaknesses of family businesses
- **AS** the importance of small businesses and their role in the economy
- **AS** the role of small businesses as part of the industry structure in some industries
- **AS** why and how businesses grow internally
- **A** the different types of merger and takeover
- **A** the impact of a merger/takeover on the various stakeholders
- **A** why mergers/takeovers may not succeed, e.g. as a result of lack of synergy
- **A** the importance of joint ventures and strategic alliances as methods of growth

1.3 Size of business

Introduction

In most countries there are many thousands of different businesses ranging from the very small, one person businesses, such as the window cleaner or street stalls, to huge multinational businesses, such as McDonald's, Canon and Volkswagen. We talk about small, medium and large businesses, and governments sometimes distinguish between businesses of different sizes for taxation and other purposes. But what is the difference between "small" and "large", and how is size measured?

Different methods of measuring the size of a business

A variety of methods is used for measuring business size, including sales turnover, market capitalisation, number of employees and market share.

Sales turnover

Sales turnover is a measure of the value of sales for a business in a given time period. It would be expected that, in general, large businesses have higher sales turnovers, and so sales turnover is often used as a measure of size. However, the size of the turnover will depend on the nature of the business. It is difficult to compare businesses in different markets. For example, Exxon-Mobil, which is relatively unknown as a company but trades in many countries under the brand names Esso and Mobil, had an annual turnover of over $420 billion in 2013. Contrast this with Microsoft, which has a turnover of $78 billion, less than a fifth of Exxon's, but Microsoft is probably better known. On the other hand, if number of employees was used to compare size, Microsoft would come out larger.

Market capitalisation

Market capitalisation is a valuation of a business using the total value of the business's shares (share price multiplied by number of issued shares). In 2012 Exxon had a market capitalisation of around $400 billion whereas Microsoft had a capitalisation of around $265 billion.

Only incorporated businesses can be measured in this way. Saudi Aramco, the Saudi oil company, could be worth up to $7000 billion if it were publicly listed. Some well-known businesses, for example the Virgin group, which is largely owned by Richard Branson, and Ikea, the Swedish furniture group, are private limited companies so the measure of market capitalisation is not available. It is also impossible to use this measure to put a market value on businesses owned as sole traders, partnerships, co-operatives and franchises because these types of business do not sell shares to the public. Another problem with using market capitalisation to measure the size of a business is the fact that share prices can fluctuate a great deal.

Key terms

Sales turnover: a measure of the value of sales for a business in a given time period.
Market capitalisation: a valuation of a business using the total value of the business's shares (share price multiplied by number of issued shares).

Number of employees

Often, businesses with large sales turnover or market capitalisation employ large numbers of people, but it is not always the case. Capital-intensive businesses, such as in the oil industry, are often able to generate large revenues with a only very few employees. Similarly, high-tech businesses, which have a high sales turnover and create a large amount of value added, need small numbers of employees. However, some service-related industries, such as Walmart (the US supermarket group), Indian Railways and Deutsche Post all employ very large numbers of people.

Table 1.3.1 shows some different ways to compare business size.

Table 1.3.1 Different methods of comparing the size of businesses ▼

Company	Employees	Sales turnover	Date of information
Walmart	2.2 million	$466 billion	April 2014
Microsoft	101 914	$77.85 billion	April 2013
Exxon	75000	$420 billion	April 2013
Indian Railways	1.3 million	$21 billion	April 2012

The major problem with using number of employees as a measure of the size of a business is that it does not reflect the nature of the business and the extent to which it is capital intensive.

Market share

Suppose that company A has a market share of 70 per cent of the market for sports cars whereas company B has a market share of 20 per cent of family cars. It might look like company A is larger than company B. However, the relative sizes of the two markets – sports cars and family cars – probably mean that company B has a higher turnover than company A. In addition, market share can be difficult to measure. It is also largely outside the control of the business, depending greatly on the behaviour of other competitor businesses in the same market.

Key term

Market share: the sales (either quantity or value) of a business compared, as a percentage, with the sales of the market as a whole.

Getting it right

Profit (the surplus after costs have been subtracted from revenue) is not considered an acceptable measure of size.

Progress questions

	Production	Employees	Turnover	Investment
	Thousand units	Thousand	€ million	€ million
A	7308	2.17	228	358
B	5695	1.64	128	178
C	7278	3.99	140	113

1 Order these businesses using the available measures of size. Comment on your findings.
2 What disadvantages are there of using "profit" as a measure of size?
3 Why is market share difficult to measure?
4 What sort of business cannot be classified by market capitalisation?

Figure 1.3.1 One market stall can be a small business or part of a larger business ▲

The advantages and disadvantages of being a small business

One of the reasons that businesses remain small is that there are disadvantages to growing a business. Some businesses go for years without needing to grow, while others are constantly looking for ways to expand. However, there are also advantages to growth.

Table 1.3.2 Advantages and disadvantages of growing a business ▼

Advantages	Disadvantages
• Being a larger business means the business can take advantage of economies of scale. Larger businesses can often get discounts by buying in bulk and get better credit terms from suppliers. • Some people believe that larger businesses are more secure than smaller businesses. They are more likely to be around throughout the lives of their products to supply spare parts and consumables, and honour guarantees, etc. • If a business grows it is likely to sell more products and services. • A larger turnover can also mean a greater potential for profit, although this depends on costs and profit margins.	• Larger businesses tend, inevitably, to be more complex than smaller businesses. This can make the management of the business more time-consuming and expensive. • Owners can lose some direct control of a business when it starts to grow. • It can be more difficult to give a personal service as a business grows. A small business can provide a one-to-one service to all of its customers. Recruiting extra customer services staff, or providing extra training for your existing staff, may be needed if a business grows. • There can be cash flow problems if a business grows. A company that wants to grow may need to borrow money to buy new premises and equipment, and more money to make the extra products that may result from growth.

Key term

Family businesses: businesses in which all of the owners are related members of one family.

The strengths and weaknesses of family businesses

Many small businesses are also family businesses. Family businesses are often partnerships or private limited companies in which all of the owners are related members of one family. Perhaps surprisingly, family-owned or family-controlled businesses account for over 80 per cent of all businesses in the US, approximately 80 per cent of employment within Pakistan is generated by family businesses, and about 85 per cent of private sector businesses in China are family owned.

Not all family businesses are small. Some very famous international businesses have developed from being owned by families, including Ford in the US, Samsung in Korea, Tata in India, Waterstones in the UK, Kuok Brothers in Malaysia and the Fecto Group in Pakistan.

The success of family businesses is often related to the culture of the country in which the business is based. Some cultures emphasise individualism whereas others encourage family bonds.

The benefits of family businesses include:

- Employees and owners have a more obvious personal stake in a business through family ties

- A business has a better sense of direction when strategy has been agreed by family members
- There is a common sense of purpose
- They are often able to take a longer-term view, in contrast to most shareholders who often want quick returns
- Family members will work hard to avoid problems which might, in some cultures, lead to "shame on the family"
- Trust, paternalism and altruism, which can all be of benefit to a business, may be easier for family members than for groups of unrelated people.

However, family businesses can be adversely affected:

- By family disagreements, which can damage a business
- By lack of access to capital, particularly early on
- Division of tasks may create conflict, friction and a less clear sense of direction
- Nepotism can lead to inappropriate appointments to key positions
- Contributions by professional managers from outside of the family can be inhibited
- The fact that it is possibly easier to misappropriate profits and resources etc.
- Family loyalties may cause problems to be "covered up".

Activity

Identify a family-owned business in your area. Talk to the owner. What does the owner like about being a family business? What problems does the owner identify with being a family business?

Case Study

The Gazania Organization

The Gazania Organization is a limited liability company based in Mauritius. The organisation owns and operates holiday resorts in Mauritius as well as owning several hotels in Europe.

The organisation is owned and managed by the Medici family with Donald Medici as its major shareholder and managing director. The three children – Djamel Medici, Aureli Medici and Eric Medici – serve as directors within the organisation and are the other shareholders. Djamel manages the overall running of the business, Aureli manages accounts and Eric manages the European properties.

The three adult children have forged a formidable team leading development and acquisitions of new hotels for the Gazania Organization. Djamel was the first to join his father's company in 2001, followed by Aureli in 2005 and Eric in 2006. All three are working together to expand the company's real estate, retail, commercial and hotel interests internationally. The children are expected to continue with efforts to achieve Donald's growth objectives. With thoughts of one day inheriting the business, the children work very hard to achieve those objectives. Djamel is regarded by everyone as the senior of the three children but there are signs that Aureli would like a bigger say.

Donald Medici is known for his eccentricity and unconventional businesses practices. He exhibits an unconventional leadership style, which has many characteristics. One of those is the need for power. This is exhibited on every piece of real estate Mr Medici owns. Every casino, building or golf course has his name on it. He is eccentric and powerful, yet he makes very smart business decisions. He is also a risk taker.

1. Identify factors leading to the continued success of the Gazania Organization.
2. Donald Medici's personality seems to have worked in this family business. Why might his approach have created problems in other organisations?
3. The children have joined the business in stages. Why might this have avoided some of the problems associated with family businesses? What additional problems could have arisen?

Key term

Small business: a relative term referring to the size of a business. Definitions differ from country to country.

The importance of small businesses and their role in the economy

It is difficult to be precise about what constitutes a small business. The legal definition of "small" varies by country and by industry, ranging from fewer than 15 employees in Australia to fewer than 50 employees in the European Union. In the US a business has to have fewer than 500 employees to qualify for many US Small Business Administration programmes. We have also seen that small businesses can be classified according to other methods such as sales, assets etc.

Nevertheless, the importance of small businesses cannot be understated. In the US, for example, where small businesses are those that employ fewer than 500 people, there are 28 million small businesses. These employ about 50 per cent of the working population and created 65 per cent of new jobs in 2012 (based on US Census 2013). In India, small businesses generate more than 65 per cent employment across the country.

Governments are often very keen to encourage the setting up and continuation of small businesses. This is because small businesses bring great benefits:

- Small businesses are often more innovative than large businesses
- Small businesses can respond to change more quickly than large businesses
- An increase in the number of businesses often increases competition, which is good for customers and for the economy (because it causes downward pressure on prices and inflation)
- Small businesses often create jobs.

Owners sometimes like remaining small because not everyone wants to run a large business. Small businesses often operate in niche rather than mass markets and niche markets sometimes have little competition.

Customers often like small businesses because:

- They provide a more personalised and therefore better service.
- They may provide products and services for niche markets. Larger businesses often focus on mass markets.

Small businesses often do well because it is easier for them to be responsive to changes in technologies, markets and customer preferences. Financial support from governments and banks and less government interference all help to improve the chances of success for a small business.

Developments encouraging small businesses

Although small businesses are traditionally found in certain industries – shops, dressmaking, tailoring for example – the move by large businesses towards focusing on the core activities that are central to their operation and buying in peripheral activities has often created opportunities for small businesses.

Activity

Research the ways your school/college uses small businesses.

Link

The concepts of contracting out and outsourcing are covered in A Level Chapter 4.4 Capacity utilisation.

Examples include:

- Large businesses used to develop their own information technology systems, employing IT staff who produced software to the business's requirements. Now these IT staff are often self-employed, providing their services on a contract rather than an employed basis.
- Large businesses used to provide all their own transport services. These are now often contracted out to a variety of smaller businesses, providing new business opportunities for transport companies.

The role of small businesses as part of the industry structure in some industries

It is easy to overlook the important contribution made by small businesses, however they are measured. The common perception is that our countries are dominated by large, often international, businesses. In many countries there are supermarket chains, car manufacturers, oil companies, soft-drinks manufacturers, fast-food chains and so on, all of which are classified as "large" by most measures.

It is important to notice that a major contribution is made by the many small businesses acting in support of large businesses. These may be:

- Component manufacturers who support major manufacturers such as in the car industry
- Self-employed software specialists who subcontract for larger businesses, particularly in the defence industries
- Providers of meals for airlines.

Progress questions

5 Give three benefits of remaining a small business.
6 Give three benefits of being a family business.
7 Why would governments want to encourage small businesses?

Internal growth

There are many reasons why businesses might want to grow, including:

- Economies of scale
- A reduction in average costs as the levels of production/sales increase
- Greater security arising from a stronger market position
- The possibilities of diversification to spread risk
- The desire to create career opportunities for employees
- To ensure there is less chance of being "squeezed out" by larger businesses
- To be more able to compete in markets
- To be able to access new markets and new customers

Link

Economies of scale is dealt with in AS Level Chapter 4.2 Operations planning.

- To increase revenues
- To create a larger public profile
- To increase the potential value of the business.

Key term

Internal growth: the development of a business by growing its existing operations with its own finances, as opposed to acquiring other businesses.

Businesses can grow by merging with another business (combining the two businesses) or taking over another business. These are types of external growth. At AS Level we are concerned only with internal growth. This is when a business expands without the involvement of other businesses, i.e. the business relies on its own resources and momentum to grow.

Internal growth can happen in any of four ways:

- A business sells more by entering new markets
- A business sells more through increased marketing activities
- A business expands production capacity through investment
- A business develops better production techniques to produce more products/services, reduce costs and gain through reduced prices.

Link

External growth is discussed in the A Level section of this chapter.

Internal growth can sometimes be relatively cheap and avoids some of the problems that may arise from takeovers.

Link

Takeovers are covered in more detail in the A Level section of this chapter.

However, the problems with internal growth, which might be quite significant, are:

- It may take a long time for results to be achieved
- The extent of the growth may be limited
- Desired outcomes may not be achieved.

Progress questions

8 The partners in a firm of solicitors would like to expand the size of their business. Explain three possible reasons why they might want to do this.

9 A farmer has a small field. What benefits could there be if he bought more land to expand the business?

External growth (A Level)

Key terms

External growth: the growth of a business by buying other companies, rather than by expanding existing sales or products.

Merger: a merger happens when two businesses agree to go forward as a single new company rather than remain separately owned and operated.

Internal growth can be slow and is often not predictable or guaranteed as it depends on the reactions of markets and customers as much as it does on the decisions of the business. It can also be expensive.

The more usual route to growth involves choices external to the business, i.e. external growth:

- Injections of capital/expertise through changes of ownership (e.g. taking on a new partner or raising additional share capital)
- A merger with another business through mutual benefit and agreement

Key terms

Takeover: one business acquires the ownership of another business or businesses with (friendly) or without the consent (hostile) of the other business. For incorporated businesses it happens through purchase of shares.
Joint venture: a business agreement in which organisations agree to develop a new corporate identity, separate from their own, for a finite period of time.
Strategic alliance: agreements between businesses to commit resources to achieve an agreed set of objectives. They remain independent businesses.
Friendly takeover: both businesses agree to merging via a takeover.
Hostile takeover: the business being taken over wants to remain independent.

- A takeover of another business (sometimes known as acquisition)
- A joint venture or strategic alliance.

Often the terms "merger" and "takeover" are used interchangeably, but it is useful to think of a merger as being something agreed between two or more businesses, with a new business being the outcome, whereas a takeover means one business becomes owned by the other without necessarily full agreement. In one case the result is a change in legal structure of the businesses so that two (or more) businesses become one legal entity – in contrast with a joint venture (see below) – but in a takeover it is the ownership not the identity that changes. Sometimes takeovers are "friendly", that is both businesses agree to join together because they recognise mutual benefits. In other instances they can be "hostile", that is the directors of company A oppose the takeover, but company B actively buys as many shares as possible from shareholders to get to a sufficient number to force the board of company A to agree to the takeover.

The different types of merger and takeover

As seen above, businesses seek to grow for a number of reasons.

To achieve the desired objectives businesses have four basic ways of merging with or taking over other businesses:

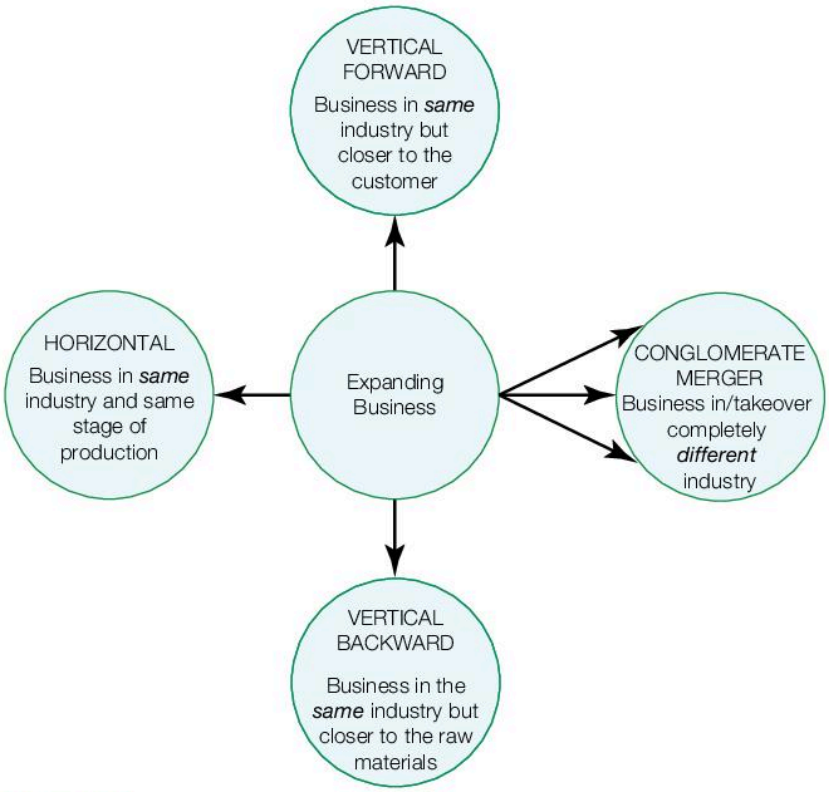


Figure 1.3.2 Types of merger/takeover ▲

Impact of a merger/takeover on the various stakeholders

These different types of merger/takeover can be used in differing situations with a range of outcomes. Examples are shown in Table 1.3.3.

Table 1.3.3 Types of merger/takeover with possible outcomes and impacts ▼

	Desired outcome	Further impact on stakeholders
Horizontal takeover	• Gain market share • Greater market strength • Gain economies of scale • Greater bargaining power with suppliers, governments • Possibilities of cost cutting • Access to different markets	• Customers may benefit from lower prices, but customer choice might be reduced • Jobs might be lost • Business could be centre of government attention if it gets too large
Vertical forward takeover	• Obtain control over the retailing of a product/service • Access to next stage of production/distribution chain • Greater marketing influence	• Closer relationship with customers • More job opportunities • Customers may have less choice as competitors' products may no longer have prominence • Managers have greater control but less experience
Vertical backward takeover	• Control over suppliers • Better cost, inventory and quality control	• May limit competition in supplies • Customers may get reduced prices and better quality • Easier for management to monitor and control processes
Conglomerate takeover	• Spread risk to another industry • Widen impact of brand name	• Risk for all stakeholders will change • Management more difficult to co-ordinate • Corporate objectives may become diverse • Wider customer base • New job opportunities, new skills needed

Key terms

Horizontal takeover: taking over a business in the same industry at the same stage of production.

Vertical takeover: taking over a business in the same industry at a different stage of production.

Conglomerate takeover: taking over a business in a completely different industry.

Key term

Synergy: in a business context, the idea that combining two businesses together in some way can lead to benefits greater than those of the individual parts.

Another outcome that is often hoped for is that of synergy, the idea that "two plus two can be more than four". In a business context a new, larger business will be more successful than the two individual businesses before they merged. Successful sports teams often get more out of the team than the sum of the skills of individual players through effective management and teamwork. Combined marketing activities of a larger, merged business may be more effective than smaller campaigns by the individual businesses.

Why mergers/takeovers may or may not achieve objectives, e.g. synergy

Successful mergers/takeovers are likely to be achieved if there is:

- Maintenance of a clear focus on the key objectives of the merger/takeover to ensure that core strengths and competences of the two organisations are not damaged.

Getting it right

Although the terms "merger" and "takeover" have distinct meaning, the term "takeover" is often loosely used to cover either situation. When you read about a situation make sure that you know which way the term "takeover" is being used. A better general term is "integration".

- Compatibility between the two organisations.
- Careful planning to ensure that problems are foreseen and that solutions are developed.
- Care taken to carry the workforce along by keeping them informed, consulted and considered. This will require close involvement of human resource managers as well as an atmosphere of openness and honesty.
- A professional approach from senior managers to avoid big egos getting in the way of progress.
- An acceptance by customers so that they do not move to a competitor.
- Careful integration and exploitation of organisational cultures.
- Recognition and exploitation of opportunities for synergy.
- A development of a "change" culture.
- Quick implementation of organisational change to prevent demoralisation and confusion.

If some of these factors are not present the new business might struggle to achieve the original objectives for the merger/takeover.

Many mergers/takeovers achieve the objectives of their owners; however, some do not. Indeed there have been some very notable failures. Usually these arise because of some mismatch between the two organisations, often people-related but sometimes related to incompatible product ranges or a failure to meet customer requirements. It is often expected that when two businesses are joined together there will be benefits above and beyond the individual benefits of each separate organisation, in other words the merger/takeover will achieve synergy. Sometimes the anticipated synergy does not occur.

Figure 1.3.3 Skype and eBay merge ▲

Case Study

eBay merger with Skype

In 2005 eBay, the Internet online auction giant, merged with Skype, the Internet telephone company which uses video technology. The merger lasted four years but never achieved its aims.

The idea was that buyers and sellers using eBay would communicate better with each other through video contact and would build better business relationships.

However, it turned out that buyers and sellers were happy to communicate through email alone, which was a satisfactory means of communication and more convenient as it did not rely on both parties being available at the same time. In addition there were considerable cultural differences between the two organisations. eBay has a traditional and strong management structure and behaves more like a bank than a cutting edge Internet trailblazer. Skype had a "level playing field" approach to both its customers and its business and is one of the trailblazing companies of its time. It also made major changes to its management team leading to a more flexible approach to business which did not help to generate possible synergies.

By 2009 it became clear that the merger was not going to bring the expected benefits so eBay put Skype up for sale and it was bought by an investor group.

1. Explain the potential benefits of the merger.
2. Identify three reasons why the merger was not successful.
3. What strategies might have improved the chances of the merger being successful?
4. What were the main obstacles to synergy?

In addition to lack of synergy, some of the other problems and issues arising from mergers/takeovers are indicated in Table 1.3.4.

Table 1.3.4 Problems and issues arising from mergers/takeovers ▼

Managerial problems	Marketing issues	Financial issues	Influence issues
• Managers may not have skills to cope with a more diverse organisation • Managers may find it difficult to manage a larger organisation • Two organisations may have completely different cultures • Co-ordination and communication will be more difficult especially early on	• Marketing strategies may not be consistent between constituent parts • Marketing strategies may not achieve the desired growth • Marketing a wider range of products/services may be more difficult • Having two or more marketing departments may be unhelpful. Merging the departments may cause friction	• Mergers/takeovers can be expensive • Businesses may have to borrow to finance the merger/takeover • Previously separate entities may use different finance systems	• Ownership structure is likely to change especially with a takeover • With a merger/takeover of incorporated businesses how is the new board going to be structured out of the old boards? • With non-incorporated businesses how is ownership going to be divided?
But: • Training and development of staff and managers should help • Carefully designed organisation structures may solve communication and co-ordination problems • Careful and well-planned management of change will be needed • Decentralisation, delegation and empowerment may be better than aiming for uniformity and may reduce senior management conflicts	But: • It may be appropriate to maintain separate marketing strategies • Marketing effort may have to be increased • Strong leadership may overcome organisational issues	But: • Effective planning before the merger should ensure adequate sources of finance • Ensure the source of finance is appropriate to the situation (loans may not suit if there is already high debt, issuing new shares may not suit a business where ownership is an issue, retained profits may not be sufficient) • Common finance systems should be a priority for managing the merger/takeover	But: • In this respect a merger is preferable to a takeover as these issues will be discussed rather than imposed • Boards can be carefully chosen to reflect the relative strengths of the integrating businesses

Activities

Identify a recent merger/takeover in your country. Using newspapers/the Internet collect information about the integration. Create a presentation on the benefits and disadvantages of this merger.

What do you think is the main objective behind the merger?

Do you think the merger will achieve its objectives? Justify your opinion.

Progress questions

10 Explain the difference between a horizontal and a vertical merger/takeover.
11 Explain the difference between a hostile takeover and a merger.
12 Explain, using a diagram, why a merger between a television broadcaster and a holiday company would be called a conglomerate merger. Is there any way it could be considered a vertical merger?
13 Why might effective communication with employees help make a merger/takeover work well?
14 Give examples of how synergy could be achieved.

The importance of joint ventures and strategic alliances

Mergers and takeovers involve a change in the legal structure of the businesses involved, forming a new, combined business from the previously separate businesses.

It is possible to achieve many of the benefits of a merger/takeover while still retaining the individual identities and legal structures of the businesses involved.

This can be achieved using the features of a joint venture.

In a joint venture businesses agree to develop, for a fixed time, a new business entity and new assets by contributing equity. They exercise control over the enterprise and consequently share revenues, expenses and assets and maintain the integrity of the original businesses. The precise arrangements and regulations vary from country to country.

For example, Sony-Ericsson is a joint venture by the Japanese consumer electronics company Sony Corporation and the Swedish telecommunications company Ericsson to make mobile phones. The stated reason for this venture is to combine Sony's consumer electronics expertise with Ericsson's technological leadership in the communications sector. Both companies have stopped making their own mobile phones.

A less formal arrangement is a strategic alliance, which is an agreement between two companies. The relationship between two or more parties is to pursue a set of agreed upon goals or to meet a critical business need while remaining independent organisations. This is often used with airlines, for example Star Alliance involves 26 airlines including Air China, Egyptair, South African Airways, Air New Zealand and Singapore Airlines.

With both joint ventures and strategic alliances it is important that the business do not break a country's competition laws.

Businesses may prefer these less formal methods of working together because:

- Costs and risks are shared, but the cost and the risks of failure of the merger/takeover are avoided
- Companies involved may have different strengths which they are able to preserve.

However, some of the disadvantages of mergers/takeovers may remain:

- Incompatible management styles and cultures
- Benefits of synergy may not materialise
- Imbalance between participants.

Link

Joint ventures are covered in AS Level Chapter 1.2 Business structure.

Activities

1 Find out about the "oneworld" airline alliance. What do you think it aims to achieve?
2 What airline alliances are represented in your country? How could citizens of your country benefit from these alliances? What disadvantages can you see?

Exam-style questions

1 "Small businesses are essential to the development of an undeveloped country." Discuss. [20 marks]

Jet Airways merger with Air Sahara (A Level)

India's largest private airline, Jet Airways, says it has agreed to buy out its smaller rival, Air Sahara, for $140m. The merger gives the airline a combined market share of about 32 per cent. Jet Airways acquires the aircraft, equipment and landing and take-off rights at the airports Air Sahara had. "This deal is definitely going to be good news for Jet Airways shareholders," Jet Airways founder and chairman, Naresh Goyal, said at a press conference in Mumbai. Some analysts are predicting substantial synergy from this merger.

Better deals from aircraft manufacturers are expected. Streamlining the two head offices into one unit should reduce fixed costs. The interlinking of the different air routes should allow more passengers to be offered connecting flights with the new enlarged airline.

Before the merger could go ahead, it had to be approved by the Indian Ministry of Company Affairs. There was some concern that the merger could lead to a monopolistic position as Jet Airways will now enjoy a dominant position on many domestic air routes.

www.bbc.co.uk, 12 April 2007

(A Level)

2 Explain why a merger would be better than a hostile takeover in this situation. [4 marks]

3 Evaluate the factors that are likely to influence the success of this merger. [14 marks]

Key concepts

- AS **Change** can be developed through a consideration of internal growth.
- AS **Management** can be seen through the differing management needs depending on business size.
- AS **Strategy** relates to the various approaches to business growth.
- A **Change** can be viewed through the perspective of external growth.
- A **Management** can be considered from the point of view of the role of management in business growth.
- A **Customer** focus can be considered from the impact that mergers and takeovers might have on customers.
- A **Creating** value can be seen through the likely impact of synergy in external growth.
- A **Strategy** needs to be seen from the perspective of growth strategies.

Progress check

You should now be able to:

- AS compare different methods of measuring the size of a business
- AS analyse the advantages and disadvantages of small businesses
- AS discuss the strengths and weaknesses of family businesses
- AS assess the role and importance of small businesses and their role in the economy
- AS describe why and how businesses grow internally
- A analyse different types of external growth
- A assess the impact of a merger/takeover on various stakeholders
- A discuss why a merger/takeover may or may not achieve its objectives including the importance of synergy
- A discuss the importance of joint ventures and strategic alliances as methods of external growth.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- AS the nature and importance of business objectives at corporate, departmental and individual level
- AS corporate social responsibility as a business objective
- AS relationship between mission statements and objectives
- AS relationship between strategy and tactics
- AS the different stages of decision-making and the role of objectives in business decision-making
- AS how objectives might change over time
- AS translation of objectives into targets and budgets
- AS communication of objectives and their likely impact on the workforce
- AS how ethics may influence business objectives and activities

1.4 Business objectives

Business objectives in the private and public sectors

Case Study

Google

Google is the most widely used search engine today. It organises the huge quantities of information that is available on the Internet. Users can quickly find out information by carrying out a search. Google's mission statement is "to organise the world's information and make it universally accessible and useful."

Google knows that it is not perfect. One of the founders, Larry Page, states that "The perfect search engine would understand exactly what you want". Google hopes that one day it will be able to achieve this. Google's website states that its aim is "to provide a much higher level of service to all those who seek information, whether they are at a desk in Boston, driving through Bonn or strolling in Bangkok".

To achieve its goal of providing the world's best search engine, Google has set itself a number of manageable objectives. These objectives are the end purposes towards which the organisation works. Google wants to:

- Improve clarity of the user interface
- Provide faster loading pages.

1 What is the purpose of Google's mission statement?
2 How does its aim differ from its mission statement?
3 Who would find the objectives most useful?

Figure 1.4.1 ▲

Key terms

Aim: where the business wants to go in the future. It is a statement of purpose.
Strategy: a plan of action designed to achieve a long-term objective.

Objectives

Whatever we do in life it always helps to have something to aim for. If, for example, we aim to improve our performance in our examinations we stand a better chance of achieving a higher grade. Businesses have aims too. That way they can develop strategies to achieve those aims, improving the chances of success.

Business owners and managers need to have a clear sense of purpose to help them focus on what needs to be achieved. This will help to direct and control business activity and to make decisions. (The business decision model is discussed on page 56.)

Examples of private sector business aims could be:

- To be the largest car manufacturer in Asia
- To be the best-known brand name
- To lead the world in technology.

Examples of public sector aims could be:

- To provide the best health service in the world
- To provide an unbiased TV and radio service
- To provide everyone with a reliable and healthy water supply.

Key term

Objectives: business objectives are the stated, measurable targets that provide the means to achieve business aims.

On their own these aims give a business a sense of purpose, but there also needs to be some idea as to how these broad statements of direction can be translated into actual courses of action that might achieve the aims. This is where objectives have a role. Objectives use measurable targets as a way to achieve aims. Benefits of objectives include:

- A sense of direction
- Focus for individuals and departments
- Framework for decision-making
- Motivation tool at an individual level and for teamwork
- A means of assessing progress and performance.

Getting it right

Strictly speaking, corporate refers to incorporated businesses only, but the sense here is objectives that apply to the business as a whole, whether incorporated or unincorporated.

Corporate objectives

Objectives provide the means to translate aims into achievable targets. Table 1.4.1 illustrates the difference between aims and objectives.

Table 1.4.1 Aims and objectives ▼

Aim	Possible objective
• To be the largest car maker in Asia	• To manufacture 5 million cars by 2016
• To be the best-known brand name	• To have a brand recognised by 20 per cent of the population by 2016
• To lead the world in car technology	• To have the most fuel efficient car by 2016

Getting it right

One of the key functions of management is to direct and control a business. Without clear objectives the managers will not know what to do. So it is important in answers to identify objectives when discussing management strategies.

Experience and common sense tell us that:

The better the objective, the better the outcome.

That is why the concept of SMART objectives (see page 51) has been developed. Experience has shown that SMART objectives achieve good results.

The aims and objectives in Table 1.4.1 are all at the corporate level (i.e. they apply to the organisation as whole). Objectives can apply to any level of a business or organisation. These can be developed from the overall corporate objective (see Figure 1.4.3).

Smart	Objectives should focus on the business and its aims and be easily understood
Measurable	It should be possible to measure whether and when objectives have been achieved
Achievable	There is no point setting objectives that cannot be achieved. Unachievable objectives are likely to have a negative rather than positive impact
Realistic/ Relevant	Objectives should be useful in their context to the overall achievement of an aim
Time specific	Objectives should have a timeframe within which they should have been achieved

Figure 1.4.2 SMART objectives ▲

AIMS	Broad statement of where a business wants to get to in the future
↓	
MISSION STATEMENT	Overall principles on which the business operates
↓	
CORPORATE OBJECTIVES	Detailed goals for the whole business, which are set to achieve the aims
↓	
DEPARTMENTAL OBJECTIVES	Corporate objectives broken down as targets for individual departments
↓	
TEAM OBJECTIVES	Departmental objectives broken down for individual teams
↓	
INDIVIDUAL OBJECTIVES	Day-to-day objectives for each person

Figure 1.4.3 Developing business objectives ▲

Getting it right

Do not spend time *explaining* the SMART principles – show that you understand the principles by *using* the ideas. The identification of SMART objectives can sometimes help you demonstrate evaluation skills – if you can assess the extent to which a recommendation will meet objectives then that is evaluation in itself.

Getting it right

When referring to objectives in an answer arising from a case study you should try to identify the timescale for which the objective applies. This may help your analysis and evaluation of the recommendation.

Key term

Departmental objective: an operational objective at departmental level.

Typical corporate objectives relate to the concepts of:

- Increasing sales
- Increasing profits (sometimes maximising profits)
- Survival
- Growth
- Improving corporate image
- Improving quality
- Increasing market share
- Improving corporate responsibilities
- Improving service response times (often in the public sector)
- Making services available for all (often in the public sector).

Objectives at departmental and individual level

The discussion, so far, has been of corporate objectives, aims that apply to the general direction of the business as a whole. It is all very well for managers and employees at Volkswagen to know that VW aims to be the largest car maker in the world, but the managers and employees will need to have some means of helping the company achieve that. Each part of the company (e.g. product design, production, marketing etc.) will have a different role in trying to help VW in its aim. Each role can have its own set of objectives. When these apply to a department within a business these are known as departmental objectives. For example, for a car manufacturer departmental objectives might be:

Design:	Produce designs for a new range of cars that will appeal to the family car market
Production:	Improve production processes to increase production and reduce costs
Marketing:	Create a marketing mix in order to increase sales volume by 10 per cent per year.

Such departmental objectives will then enable each department to have a sense of direction and purpose, and also a means of monitoring its performance.

Although departments are made up of managers and teams of employees, it is often sensible to translate departmental objectives into individual objectives for each employee or group of employees. This helps ensure that each individual knows what they need to do to achieve departmental objectives and gives each employee a personal stake in meeting the business's targets. In many businesses these individual objectives are also used as the basis for assessments.

Key term

Individual objective: an objective set for an individual in an organisation.

Activities

1 Think of an overall objective for your school/college.
2 What objective might you set for the Business Studies department to achieve that overall objective?
3 Think of a suitable objective for your Business Studies teacher.

Progress questions

1 Give three examples of corporate objectives that might apply to a supermarket business.
2 Give three examples of individual objectives for a librarian.
3 Why is it important to have a timescale for objectives?

Corporate Social Responsibility as a business objective

Corporate Social Responsibility (CSR) (sometimes referred to as Corporate Responsibility) takes the idea of business objectives a stage further and develops the objectives into a statement of the business's duties to society. The duties usually extend to ethical rights and duties towards society and to stakeholders.

CSR can commit a business to a way of operating that goes beyond what is required by law. It also accepts the idea that "maximising profit" is not the only objective of the business; in other words there are people who are just as important as the shareholders.

CSR is of growing importance to businesses. Globalisation, greater accountability, increased interest of the media in business behaviour and changing values of society have made it more important for businesses to improve their image and to be seen to be acting "responsibly". If a business behaves in a corporately irresponsible way, the media is very efficient at sending adverse publicity information quickly round the world. Customers are becoming more demanding in relation to

Link

Stakeholder groups are covered in more detail in AS Level Chapter 1.5 Stakeholders in a business.

Key term

Corporate Social Responsibility (CSR): a set of policies designed to demonstrate the commitment of a business to the well-being of society and others by taking responsibility for the impact of business decisions on all stakeholders.

what "behaviour" they expect from businesses and much more aware of what is going on in the world of business.

It is becoming increasingly important for all businesses, not just the largest, to develop their CSR policies. High-profile businesses, particularly those trading in consumer products and services, will want to create the best image with customers and this can be helped through CSR. Many such businesses also expect strong CSR policies from suppliers, so the idea spreads throughout the supply chain.

CSR policies could include objectives relating to advantages and disadvantages.

- **The environment.** For example: "We do everything we can to ensure our company operates in harmony with the environment." *China National Petroleum Corporation*.
- **Human resource management including wages, recruitment, health and safety.** For example: "By fostering teamwork, nurturing talent, enhancing leadership capability and acting with pace, pride and passion." *Tata Steel, India*
- **Energy usage.** For example: "Our wind farms are in line with the global vision of eco friendly natural energy and FFC is spearheading this sector in Pakistan." *FFC Limited Pakistan*
- **Community programmes.** For example: "The remote location of our Cerro Corona mine in Peru means local communities are particularly reliant on Gold Fields for socio-economic development, as well as basic infrastructure, such as roads and telecommunications." *Gold Fields – South Africa*
- **Product/service quality.** For example: "Our clients' interests come first." *Maybank, Malaysia*
- **Business partners.** For example: "ANZ embraces a fair, safe and responsible approach to procuring and delivering goods and services." *ANZ Bank – New Zealand/Australia*

CSR can bring:

- Greater and improved public awareness
- Customer loyalty
- Customer reassurance
- Employees committed to the same values
- Reduced risk of negative publicity
- Goodwill to most stakeholder groups
- Marketing opportunities.

However, it can bring:

- Greater costs which may affect profits and, hence, shareholders
- Greater criticism and loss of loyalty if things go wrong

Activities

1. If possible visit websites of three leading businesses in your country. Find out if they have CSR policies.
2. Identify how the policies would affect you if you were an employee.
3. Identify how the policies would affect you if you were a customer.
4. Identify how the policies would affect you if you were a shareholder.

Getting it right

Remember, CSR is a statement of policies. It does not ensure that the policies will be followed. There have to be systems in place to ensure compliance.

- Conflict between stakeholders
- Cultural conflicts: different cultures may have different values, making CSR difficult for businesses trading internationally.

Relationship between mission statements, objectives, strategy and tactics

Mission statements and objectives

Modern businesses consider it important to have a clear view of what they want to achieve in the longer term. Such a broad statement about the longer term is known as a mission statement. The differences between an objective and a mission statement are vast but subtle. While the mission statement expresses the big picture, the objective is more grounded and more attainable than the mission statement. The mission statement is supported by objectives. The objectives are designed to make the broad-minded mission statement an achievable one. The purpose of mission statements (and vision statements) is to communicate to stakeholders (groups that influence or are influenced by the decisions of a business) the core values of the business. The idea is that stakeholders are then "brought together" with a common sense of purpose. Managers and other employees will know the values that they should aspire to and customers and investors will be able to decide whether such values are acceptable within their own sets of values.

Key terms

Mission statement: sets out a business's core purpose, identity, values and principal business aims.
Vision statement: sets out a broad aspirational view of where a business wants to be in the future.

Some mission statements are very simple and to the point, for example:

- "To provide efficient, reliable, safe and environmentally sensitive electricity services to Botswana" *The Botswana Power Corporation*
- "To be a top ranking National Bank of International Standards committed to augmenting stake holders' value through concern, care and competence." *Bank of Baroda, India*
- "An exceptional journey from start to finish" *Emirates Airline*

While others develop details for specific stakeholders, for example:

- "Every airport under AOT management will be operated with an exceptional service standard and be equipped with service-oriented personnel as well as the right technology for each customer group. AOT intends to accomplish this without compromising our accountability to all stakeholders including surrounding community, society and environment." *Airports of Thailand*
- "Develop the enterprise, Contribute to the country, Reward our shareholders, Serve the society and Benefit our staff —to respect and protect the interests of stakeholders." *Sinopec Corporation – China*

Mission statements are not limited to "for profit" businesses. Public sector and charitable organisations often have mission statements, for example:

- "Our mission: To use technology to challenge poverty, working with poor people to: build their capabilities, improve their access

to technical options and knowledge, and help them influence the social, economic and institutional systems for innovation and use of technology." *Practical Action*

Some mission statements make reference to Corporate Social Responsibility (CSR), for example:

- "Toshiba Group's Corporate Philosophy emphasises respect for people, creation of new value, and contribution to society. The Group slogan – 'Committed to People, Committed to the Future. TOSHIBA' – expresses the essence of our corporate philosophy. We recognise that it is our corporate social responsibility (CSR) to put our philosophy and slogan into practice in our day-to-day business activities. In doing so, we accord the highest priority to human life and safety and to compliance." *Toshiba*

Strategy and tactics

Setting mission statements and objectives gives a business a sense of purpose and direction. However, these do not guarantee success. Objectives have to be developed into actual courses of action known as strategies and tactics.

A strategy is a plan setting out how a business as a whole will achieve its overall long-term objectives.

A business objective of a car manufacturer could be: "To manufacture 5 million cars by 2015". The strategy could involve, for example:

- Building a new factory
- Increasing efficiency
- Improve productivity
- Designing new models of car.

Each of these could help the business achieve its objective of 5 million cars by 2015.

A tactic is a short-term plan for day-to-day operations of a business with the aim of contributing towards the overall strategy. For example, in order to achieve productivity improvements the workforce might get prizes for the teams that make the biggest improvements to productivity.

Activities

1. Find out if your school has a mission statement.
2. If it does, do you think it is achieving it?
3. If it does not, what do you think it should be?
4. What do you think is the main objective of your Business Studies teacher?
5. How does this fit in with the school's mission statement?

Key term

Tactic: a short-term course of action for the day-to-day management of a business or for trying to meet part of an overall strategy.

Progress questions

4. List three advantages of having a CSR policy.
5. Explain the difference between a mission statement and corporate objectives.
6. Suggest a tactic for increasing sales of a textbook.

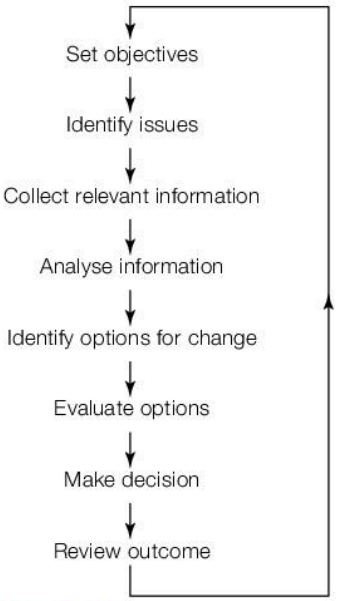


Figure 1.4.4 The business decision model ▲

Business decision-making

Objectives not only give a sense of direction to a business, they are essential for a key function of business – that is, making decisions. Although many decisions are made on intuition – a "hunch" – there is merit in approaching decisions systematically. That should lead to better and more consistent decisions. The "scientific" decision model is shown in Figure 1.4.4.

This model can be adapted to many business decision-making situations for example whether to:

- Develop a new product
- Enter a new market
- Take over a competitor.

What is important to note is the critical role that objectives have in the process. Objectives should be the first critical stage in systematic problem-solving. Without objectives there is no systematic approach or structure and solutions are likely to be based on intuition and guesswork. Using a systematic approach, a large part of which is careful consideration of objectives, improves the decision-making process.

Factors influencing changes in objectives

In order to consider how objectives could change for a business it is important to identify the factors that influence the choice of objectives. These factors are varied and include:

- **Size/Age:** When a business starts up, its owners will want to get the business established. There is a very high risk that a new business will fail so that the initial objective is likely to be survival. Once that has been achieved the objective might change to that of growth. As businesses get larger they are likely to focus more on levels of profit to provide finance for additional growth. Once they become large in their relevant market they may want to protect their position against competitors, so increasing or keeping market share will become important. Sometimes businesses can become too large (see AS Level Chapter 4.2) in which case they may go into decline and survival returns as a possible objective.
- **Owners' preference:** Some business owners, particularly sole traders and partners, may be content with the business as it is. Perhaps the level of profits is sufficient for the owners' and the business's needs. Maintenance of current levels of profits would be the objective rather than growth or profit maximisation.
- **Culture:** Some business owners may be highly competitive by nature and this will have an impact on the behaviour of a business. Highly aggressive people might be keen to compete with rival businesses (market share could be important) or even defeat them (takeovers might feature in their objectives).

Link

See AS Level Chapter 4.2 Operations planning for more on diseconomies of scale.

- **Sector**: Private sector business owners expect rewards for their risks so profits must feature to a greater or lesser extent in their objectives. Many public sector businesses are expected to put service before profits. So, for example, a government-owned school is expected to provide a good education rather than make a profit.
- **The economic conditions** facing a business: When economic conditions in a country are favourable to businesses many businesses could look to growth as a realistic option. In a weaker economy they might be less inclined to grow and be more concerned about survival.
- **The market conditions**: This might be related to economic conditions. A growing market (e.g a market for a new product/service) may provide opportunities for growth whereas a declining market could make survival a priority. A stable market might turn a business's attention to competition and hence market share. A highly competitive market might make survival a key issue.
- **The product**: A business is likely to change its objectives depending on the success or otherwise of its products/services and the stage they are at in the product life cycle.

Link
The product life cycle is covered in A Level Chapter 3.3a.

How and why objectives might change over time

Many of the above factors can change over time for any given business. This means that the objectives of a business could change over time in response to the changes in the factors shown in Figure 1.4.5.

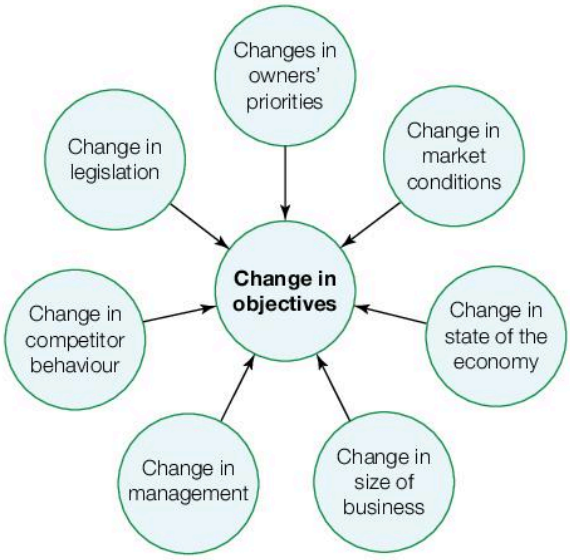


Figure 1.4.5 Factors influencing change in objectives ▲

Conflicting objectives

Situations can arise so that in trying to achieve one business objective another business benefit might be lost.

Objective:	• Increased growth	• Increased profits in the short term	• Greater CSR
Downside:	• Investments needed may reduce profits	• May damage long term prospects of business	• May reduce dividends to shareholders or increase prices to customers

This will involve senior managers/owners/directors prioritising objectives to suit prevailing circumstances.

Translation of objectives into targets and budgets

Key term

Target: a detailed operational objective for a specific area of a business to be achieved by a specific date.

Corporate objectives need to be translated into departmental and individual objectives so that the whole organisation is trying to reach the same aims. As mentioned earlier, objectives are best when, amongst other things, they are measurable. This can be achieved using performance indicators (sometimes known as key performance indicators or KPIs), otherwise known as targets. These targets can be set at individual, team, departmental or organisational levels and are the measurable bit of objectives.

By way of illustration, the aim of your Business Studies teacher could be to give your class a good business education. The objective could be to get better exam results than last year, the target could be eight "A" grades in a class of 20 students. The teacher can be measured against that target and reaching the target will have helped the teacher to reach the aims and objectives and you to get a better A Level result!

Once targets have been set for individuals or groups they can be monitored and adjusted to increase the chances of achieving overall objectives, and can be used as a motivational tool (see AS Level Chapter 2.2).

Targets can also be used in the budgeting process. A budget (see A Level Chapter 5.6) is a financial plan for a business for a future time period. Inevitably, because it is a forecast, a budget will have to be built around assumptions. Targets can be a good means of making and adjusting the necessary assumptions. However, unrealistic targets will lead to unobtainable and misleading budgets.

Table 1.4.2 Advantages and disadvantages of targets ▼

Advantages	Disadvantages
• An easy way to translate corporate objectives into individual and other subsidiary objectives • An easy way to ensure objectives are measurable • An easy way to assess and to monitor performance • An easy way to communicate to employees what is required of them • Can identify problem areas	• Can be demotivational especially if they cannot be achieved or an employee fails to achieve them – there can be many reasons for failing to reach a target • Can dehumanise a job – people are treated like machines rather than humans • Can lead to a "blame" culture • Can lead to "unintended consequences" – Some train companies get a financial penalty if a train is more than ten minutes late. If, at the beginning of the journey, it looks like the train will be more than ten minutes late they simply cancel the train and avoid the penalty! • Difficult and expensive to monitor

The communication of objectives and their likely impact on the workforce

Targets in business have been a valuable management tool for a long time. In the 1950s Peter Drucker developed the idea of Management by Objectives (MBO).

This is a method of managing staff by defining objectives for individual members derived from the overall objectives of the business. This process has evolved and since the 1990s it has become, in some countries, widespread practice to translate these objectives into targets. The use of these targets – key performance indicators (KPIs) – has become the successor to MBO.

Nowadays many businesses set performance indicators throughout their organisation to plan and manage operations and appraise and reward performances.

Managed properly, targets can have a positive impact on the workforce. The way business objectives are communicated to the workforce is key to their success or failure. If objectives are translated into individual targets for employees, this needs to be part of a discussion between a manager and the managed: otherwise targets can appear to have been arbitrarily imposed, which is often demotivating. Targets need also to be well designed, using the SMART principles, or they may not be achievable or meaningful. This is dealt with in greater detail in A Level Chapter 2.3b. Target setting is a positive, powerful, business practice when it tells your employees where the business and their role is going. Effective target setting also demonstrates what success will look like during the journey and upon arrival.

When not designed and managed well targets can be a great demotivator and have undesirable/unintended consequences.

Organisations often fail to achieve goals and strategic planning targets that are set top down, by executives who lack crucial information and are out of touch with employee challenges. The goals are then unrealistic and they fail to consider organisation resources and capabilities. Employees do not believe that the rewards they will receive for goal accomplishment will equal the energy they invest to achieve them. Frequently, managers are intimidated when they fear job loss for failure. Sometimes targets are too complicated or there are too many of them – employees do not know what targets should be their main priority.

One major problem faced by businesses, particularly those in the public sector, is that of unintended consequences. If an employee or manager thinks they are not going to achieve a target, and if they also think there will be some penalty for failing to do so, they might be tempted to devise methods that help them meet the target, but not in constructive ways. So, for example, if a call centre has a target of dealing with a complaint in less than two minutes an employee might only find out the basic details of a problem without taking the time to find out all of the facts. Although a target will have been met, the job will not have been done well.

Link

More on MBO can be found in A Level Chapter 2.3b Human resource management.

Activity

Find someone to talk to about their job – it could be a teacher, a parent, a relative or a friend. Do they have targets set for them in their job? If not, what would be a realistic target? Do targets help them in their work? Do they know of unintended consequences?

Link

See AS Level Chapter 2.2 Motivation for more on target setting.

Figure 1.4.6 Call centre workers usually have targets ▶

Progress questions

7 Why are objectives important in decision-making?
8 Why might the employees of a car manufacturer be unhappy with an objective to increase output?
9 A business sells clothes. What target could you set an employee if the business wants to increase its profits?
10 Give three reasons why targets might work in a car factory.
11 Give three reasons why targets might cause problems at a hospital.

Case Study

The Red Street Hospital

The Red Street Hospital, along with many other hospitals in the country, had come in for criticism from the general public as well as the government and the country's hospital monitoring services. Four years ago death rates were on the rise from a variety of hospital infections, complaints from patients were on the increase and patients had to wait longer to be seen by a specialist. The hospital increasingly spent more than was planned for and each year had to go to the government for emergency grants to prevent it going into liquidation. There were further problems in the accident and emergencies services of the hospital with severely injured people dying because they had to wait up to six hours before they were seen.

The senior management of the hospital set targets for staff to try and improve the situation, and the government set up a system of fines for hospitals that failed to meet their financial targets.

These targets included:

- Reducing the number of deaths from hospital infections of patients
- Reducing patient complaints
- Reducing waiting times to see a specialist
- Reducing waiting times in accident and emergency.

This year the hospital reviewed each of these targets to see how outcomes matched up with expectations. They found that:

- Infections picked up in the hospital had reduced very significantly following new procedures to maintain cleanliness and to disinfect the hospital.
- Patient complaints made to the hospital had also reduced following changes to procedures which made it more difficult to complain. However, the government ministry dealing with health had expressed immense concern at the number of complaints it was receiving about the hospital and the local newspapers contained increasing numbers of letters and articles about how the hospital was failing.
- The hospital was in an even worse financial situation as a result of a large government fine for failing to meet its target.
- Waiting times in accident and emergency wards halved following a transfer of staff from other wards and sending patients elsewhere in the hospital as soon as possible.

1 Which of the targets do you think have been successful?
2 For the other targets what unintended consequences can you identify?
3 Suggest and justify an improved target to achieve one of the objectives.
4 To what extent would you agree that these targets have worked at the Red Street Hospital?

How ethics (and CSR) may influence business objectives and activities

As we have seen, CSR policies define the boundaries within which a business should operate. It is a statement of intent for business behaviour that is aimed at satisfying stakeholder groups.

Key term

Business ethics: moral guidelines that govern business decisions and business behaviour.

The way that businesses *actually* behave within the CSR policies (rules and guidelines), or indeed for those businesses without CSR policies, is the concern of business ethics. Ethics are moral guidelines that govern decisions and behaviour. Business ethics apply to all aspects of business conduct and are relevant to the conduct of individuals as well as the entire organisations. This idea contrasts with CSR which contains policies that apply to the organisation *as a whole*, and only applies to those businesses that have stated CSR policies.

Ethics vary:

- From country to country
- From culture to culture
- From individual to individual.

So what may be considered unethical in one situation may be regarded as ethical in another!

Ethics involve the choices that people make. This creates another difficulty. Sometimes ethical issues are covered by legislation. If a business is not complying with the law is its behaviour governed by being ethical or being within the legislation or both? So, for example, if the law has a minimum wage is it unethical to pay below the minimum wage, or illegal, or both?

Link

See the Unilever case study in A Level Chapter 6.1 What is strategic management?

A useful way to think about this is that ethical behaviour involves choice and free will, and where laws are involved that free will and choice has, in effect, been taken away.

So ethical business choices can be made within the framework of the laws of a country.

What might be regarded as unethical? Well that is a matter of opinion, but here are a few suggestions which you can consider:

- Buying supplies from businesses that use child labour
- Exploiting suppliers in poor countries by demanding and paying low prices
- Lending to people and businesses who will struggle to repay the loans
- Knowingly selling harmful products
- Targeting advertisements for sweets at children
- Not paying a fair wage
- Avoiding paying taxes
- Polluting the environment
- Newspapers prying into people's private lives
- Making a large "carbon footprint"

- Getting business secrets from competitors
- Encouraging top employees to move from a competitor
- Giving good references for underperforming employees
- Paying bribes to get contracts
- Failing to give accurate information on a CV
- Testing cosmetic products on animals
- Testing medicines on animals
- Over charging tourists
- Selling unsuitable products to unsuspecting customers.

And you can add your own ideas to the list!

The relevance of these issue to objectives is that each of the above *may* provide a route to immediate higher profits (usually a key corporate objective), but may also lead to the loss of customers through the bad reputation that the business might get. So ethical considerations and CSR may be useful in moderating objectives in the interests of both the business and the wider community.

Activities

1 Using a survey find out from students at your school/college which five of the above list they regard as the most unethical business behaviour.
2 Carry out a similar survey on teachers.
3 Comment on the comparison.

Exam-style questions

1 a Explain why objectives should be SMART. [8 marks]
b Discuss the importance of a mission statement to a manufacturer of medicines. [12 marks]
2 To what extent do you think that Corporate Social Responsibility (CSR) is simply a marketing tool? [20 marks]

Key concepts

AS **Change** can be related to the need to review and change objectives over time.

AS **Management** can be developed through the need to translate objectives into workable targets, and by considering management response to the impact those targets have on the employees.

AS **Customer focus** can be considered through the impact customers may have on business objectives, and the impact on them of targets.

AS **Strategy** needs to be developed to choose and implement objectives.

Progress check

You should now be able to:

AS explain the importance of business objectives

AS recognise the need for objectives at corporate, departmental and individual level

AS evaluate the importance of corporate social responsibility as an objective

AS discuss the difference between mission statements and objectives and between strategy and tactics

AS explain the decision-making model and the role of objectives

AS discuss how objectives might change over time

AS understand the advantages and difficulties of translating objectives into targets and budgets

AS evaluate the likely impact on the workforce of objectives/targets

AS discuss how ethics may influence business objectives and activities.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **AS** the stakeholder groups involved in a given business situation
- **AS** the roles, rights and responsibilities of stakeholders
- **AS** the impact on stakeholders of a given business decision
- **AS** the need for a business to be accountable to its stakeholders
- **AS** how conflict might arise between different stakeholder groups
- **AS** how changing business objectives might affect stakeholders

Key term

Stakeholder: an individual or group who has an interest in a business. They can be affected by a business decision and/or have their views considered as part of the decision.

Get it right

Remember, competitors are not considered as stakeholders.

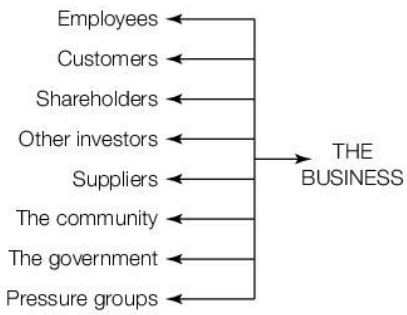


Figure 1.5.2 Business stakeholders ▲

1.5 Stakeholders in a business

Business stakeholders

Traditionally corporate business decisions have been made with the reaction only of the owners of the business (shareholders for incorporated businesses) at the forefront of the minds of those making the decisions. Gradually the idea has developed that it is important to recognise that:

- It is not only the owners/shareholders who could be affected by a decision
- Others connected with a business in some way or other will be affected
- The views of other interested groups are important inputs into major business decisions.

Any individual or group of individuals that has an interest in the outcome of a business's decisions is known as a stakeholder.

Figure 1.5.1 Mining can impact on the wider community ▲

Progress questions

Condor Copper (CC) is considering opening a new copper mine in a part of your country that has high unemployment. The project will involve building new roads as well as housing for the new workforce. Building the mine and roads will be dirty and involve moving large amounts of soil and rock. There will be a lot of disruption for the town in the first two years of construction. After that there should be large profits to be made and the area will benefit from new infrastructure. CC plans to get grants from the government to help towards the construction costs. CC is a public limited company.

1 Identify the stakeholders in CC.
2 Explain their interest in the copper mine project.
3 What role might each stakeholder have in the decision-making process?

Stakeholder groups involved in a business

Figures 1.5.2 shows the different stakeholders in a business and Table 1.5.1 shows the different types of stakeholders and their roles.

Getting it right

The term "stakeholder" is often confused with the term "shareholder". Make sure you know the difference and ensure that you read questions very carefully so that you understand which term is being used.

Table 1.5.1 Stakeholders and their roles ▼

Stakeholder	Role
Shareholders/owners	elect the board, invest
Employees	provide labour services to the business
Other lenders/investors (e.g. banks)	provide finance
Customers	buy products/services, use after-sales services
The community	provides local services, workforce, infrastructure
The government	possible support/advice/grants, impose taxes (local/national etc.), make laws, regulations
Suppliers and creditors	provide products and services, often on credit
Pressure groups	seek changes in business/consumer/government behaviour

Link

See AS Level Chapter 1.2 Business structure for more on shareholders.

Rights and responsibilities of stakeholders

Each stakeholder group (apart from the owners) will develop a different relationship with a business. This will be reflected in terms of "rights" and "responsibilities". These can be summarised as follows:

- **Employees:** Employees have the right to expect to be treated fairly. In some countries this is enshrined in legislation involving, for example a minimum wage, the right to belong to a trade union, and equal opportunities. The employee can expect a contract of employment to be honoured. In return the business can expect employees to behave within the conditions of the contract, to observe codes of conduct such as ethical codes (see AS Level Chapter 1.4) and to be honest. Employers also expect employees to co-operate with the reasonable requests of management.
- **Suppliers:** Suppliers have the right to expect to get prompt payment for their products or services within the time period that they specify. They will also expect an equitable relationship with the business even if the business is very large, in other words a small business should not be totally dominated and dictated to by a much larger business. Businesses, in return, can expect suppliers to supply the right products or services at a reasonable price on time. The quality should be at an agreed standard.
- **Customers:** Customers have the right to products and services that comply with the various laws of the land, for example regarding health, safety and advertising. Customers will expect that businesses do not get involved in unfair competition practices such as cartels and other price fixing. They will also expect a fair response if products or services are found to be faulty.
- **Local community:** The local community has the right to expect that the business will not severely affect people's lives through pollution or other forms of disruption. They would expect their needs to be considered when there are major business developments and, ideally, to be consulted.
- **Government (local and national):** The government has the right to expect businesses to abide by all relevant laws and regulations. They will want taxes paid on time. Governments may also expect imposed targets to be reached, e.g. vehicle emission targets for car

manufacturers. In return businesses expect governments to provide a fair and competitive environment, provide services for businesses such as export services and loan guarantees, and generally to treat businesses fairly, e.g. not expecting bribes for contracts, especially in the government's dealings as a customer of businesses.

Differing views of stakeholders

It is important to remember that the influence and expectations of stakeholders are usually different and often conflict. For example, shareholders may want higher profits while employees may want higher pay. In the short term higher pay may well lead to lower profits, although in the longer term higher pay may lead to higher productivity and eventually higher profits.

A successful business will need to have good relationships with all its stakeholders. This process is known as developing the stakeholder concept.

Different views of stakeholders come from each group's different expectations of the business. This also means that they can influence business behaviour and decisions in different ways. These are summarised in Table 1.5.2.

Table 1.5.2 Stakeholder expectations and impacts ▼

Stakeholder	Likely expectations/objectives	Can influence the business through/by:
Employees	• good pay, • conditions of work • safety • participation • job satisfaction • motivation	• industrial action • staff turnover • productivity • commitment
Shareholders	• profit growth • dividends • high share price • possibly Corporate Social Responsibility	• electing directors • selling their shares • voting at AGMs
Customers	• value for money • quality • reliability • customer service	• word of mouth (good and bad) • repeat purchases • moving to competitors • boycott
Suppliers	• prompt payment • trust • future contracts • growth	• pricing • quality • CSR • product availability
Banks and other lenders	• prompt interest and capital repayments	• can close loan and seize assets • can withdraw banking facilities, e.g. overdraft, credit
Community	• care of the environment • job opportunities • positive local impact	• opposition • pressure groups • influence on planning decisions
Government	• payment of taxes • obeying laws and regulations • jobs	• regulations • taxes and subsidies • political pressure • planning consents

Link

Increasingly the stakeholder concept is related to ideas of Corporate Social Responsibility (see AS Level Chapter 1.4 Business objectives).

Key term

Stakeholder concept: the idea that a business chooses to take into account a range of stakeholders in its decisions.

Activities

1 List ten businesses (ranging in size) in your local area. Identify the likely major stakeholders for each of them.
2 Ask two different stakeholders you can identify (e.g. employee, customer, owner etc.) what they think of the business.
3 Present your findings as a table. What conflicts between stakeholders have you found? What have you found in common between them?

Progress questions

4 Why might the employees in a car factory that is planning to introduce robots have a different view about this development than shareholders?
5 What is the difference between a stakeholder and a shareholder in a pharmaceutical business?
6 List three ways by which the community could influence an airline business.

Impact of decisions/actions on stakeholders, and their reactions

Some decisions will affect many stakeholders, others will affect few. Some decisions will have an enormous impact, others a small impact. It is important to consider a decision and think through its likely consequences.

For example, let us suppose a chocolate manufacturer decides on a new marketing campaign.

- The immediate impact is likely to be more work for the employees in the marketing department as they put the campaign together.
- This will probably mean more contracts for external suppliers of services such as advertising agencies.
- Once the campaign has been prepared, media companies could well be involved through TV, newspaper and magazine advertisements.
- Eventually there will be an impact on customers, who, hopefully, will be persuaded to buy the product. This would have an impact on competitors who may in turn try to attract customers away from the business.
- It will probably take some time before the marketing campaign has an impact on the business's profits (and hence shareholders) and the wider operations of the business (and hence employees).

Table 1.5.3 illustrates the various ways that each of the stakeholder groups might be influenced by different business decisions.

Activity

Here are some major business decisions. As a group, discuss which stakeholders are likely to be affected and how. Try to put the various stakeholders in order of relevance to the decision.

- Relocating a factory to another country
- Changing how cars are produced in a car factory
- Taking over a competitor
- Increasing efficiency of a shop by reducing the size of the workforce
- Building an oil refinery near to a town

Table 1.5.3 Some ways a business might influence stakeholders ▼

Stakeholder	Possible impact
Shareholders	• Change in levels of profits and dividends. *An increase may lead to a higher share price.* • Improved/decreased business prospects affecting share price. *A decreased share price may lead to investors selling.* • Bad/good publicity that affects share price. *Bad publicity is likely to reduce interest from shareholders and potential investors.*
Employees	• Changes in operations that can lead to possible redundancies. *Employees will not like redundancies.* • Changes of working practices that can affect jobs. *Employees will want to be consulted about changes.* • Developments that can lead to new job opportunities. *Employees may be pleased.* • Training schemes introduced by the business. *Employees may like the opportunity for more training.*
Customers	• The development of new products/services. *This might attract customers or increase sales to existing customers.* • New marketing initiatives. *This might have a similar impact as above.* • Developments affecting safety issues. *Bad publicity could lose customers.*

Stakeholder	Possible impact
The government	• Changed levels of profits and taxes. *Governments will welcome increased profits.* • Environmental, legal developments. *Governments will not want adverse publicity.*
Community	• Developments leading to increased job opportunities. *This may help the local community.* • Issues affecting the environment. *The local community will want to stop any developments that damage the local (and wider) environment.* • Contributions from the business, e.g. sponsorship. *The community will benefit from sponsorship.*

How and why a business needs to be accountable to its stakeholders

Key term

Accountability: the need for a person or parts of an organisation to provide information on the relevant activities and justify relevant actions.

Link

See AS Level Chapter 1.4 Business objectives for more on CSR.

Part of a CSR policy often includes being more accountable to stakeholders. Accountability in the business sense can have several meanings. In general terms it means answering for courses of action, perhaps to explain achievements, failures, blame or liability. It can mean the allocation of responsibility for various courses of action or management roles.

So, for example, a business might be accountable to its shareholders for its financial performance – shareholders should know what has happened and why.

An employee might be accountable to a manager for the work that is done.

A manager might be accountable to a director for decisions taken.

In the context of stakeholders, accountability usually means keeping stakeholders informed about decisions, performance and any other matters that could have an impact on the stakeholder.

The extent to which a business should be accountable to stakeholders has three main aspects:

- **Statutory/legal requirements:** Businesses will be required by law to provide information to the government. This may be for tax purposes or other purposes such as evidence of conformity with other laws such as the minimum wage, equal opportunities and health and safety. In addition, businesses that become incorporated will have a legal obligation to make available information about the business including accounts. For public limited companies this information *must* be publicly available. This information can also be of benefit to employees, customers and possibly suppliers.
- **Ethical:** Stakeholder accountability is a key part of Corporate Social Responsibility (see AS Level Chapter 1.4) and may be part of other stated commitments that a business makes to its stakeholders. It would be unethical to declare accountability as a commitment – perhaps to give a good impression of the business – and then to ignore this commitment.
- **Commercial:** A business can decide that it is in its commercial interest to be accountable to stakeholders.

The *ethical* dimension is clearly linked to Corporate Social Responsibility (CSR). The concept of stakeholder accountability has developed with ideas incorporated in CSR. CSR policies are statements that describe the extent

to which a business will take its legal responsibilities beyond that required by legislation.

However, there does not have to be a CSR policy in order for the business to be accountable in some ways to stakeholders. Businesses can still choose to behave ethically – in line with a community's generally accepted values – without the formality of a CSR policy.

A business that behaves ethically is likely to consider it important to keep all stakeholder groups informed, although it would be wary of some groups such as pressure groups that may be hostile to the business.

The extent to which *commercial* considerations influence accountability is often a cultural matter. Some businesses are very secretive by nature, other businesses believe openness and transparency helps improve relationships with the workforce, customers and the community. Customers increasingly are looking for businesses that are, for example, environmentally aware, and so businesses may want to keep customers and potential customers abreast of their environmental "credentials" or achievements. Therefore, it makes commercial sense for the business to be accountable to customers and others, or it may lose them to competitors.

Link

Ethics was discussed in more detail in AS Level Chapter 1.4 Business objectives.

Progress questions

7 A car manufacturer is about to stop making an old, and out of date model of car by closing the production line. Explain the likely impact on three stakeholders.

8 Why is it important that a business operating nuclear power stations is accountable to its stakeholders?

How conflict might arise from stakeholders having different aims

Some conflicts are inevitable. For example, it is impossible to build a new road that will benefit almost everyone without having a negative impact on people who live near where the road will be built. Perhaps the biggest conflict is that between shareholders – who seek high profits – and employees – who seek secure employment and good wages.

Figure 1.5.3 Protesters in Bangkok, Thailand ▶

Getting it right

When discussing stakeholders in the context of the impact of decisions it is worth considering the short-term and the long-term impact of those decisions.

Link

These ideas are encapsulated in the concept of Corporate Social Responsibility (CSR), see AS Level Chapter 1.4 Business objectives.

Some examples of other potential conflicts include:

- Customers who want low prices and high quality; businesses that want low costs and high profits
- Suppliers who want early payment; businesses that want to delay payments
- The community that wants minimal disruption; businesses that want to be free from regulation
- Shareholders that want high dividends now; managers who want to invest for the future.

However, businesses that recognise the stakeholder concept – that businesses have a wide range of responsibilities, not just to shareholders – can take actions that can help bring stakeholders together (see Figure 1.5.4).

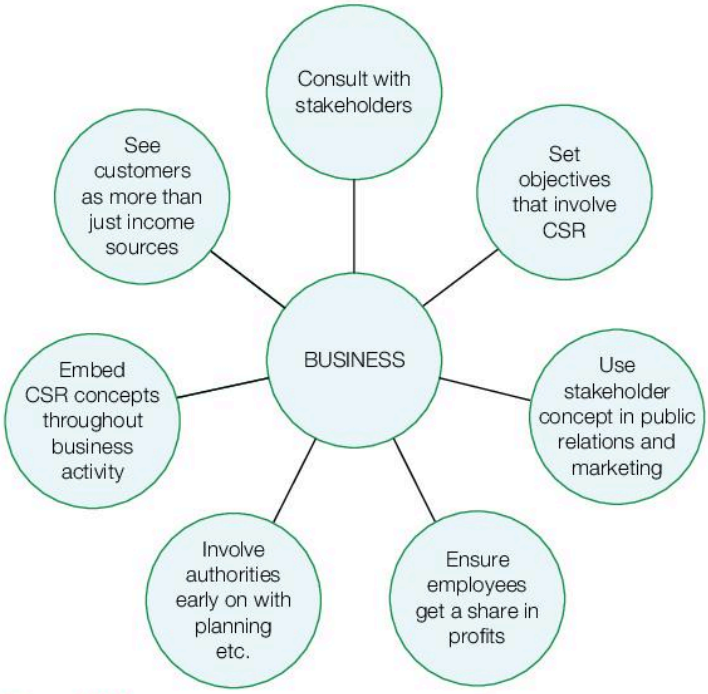


Figure 1.5.4 Resolving conflict with stakeholders ▲

Case Study

Airports in India

India has experienced a massive rise in air travel in recent years. The current growth rate in passenger numbers is around 20 per cent per year. This has meant that a number of new airports have been built together with massive upgrades to existing airports. These major upgrade projects have involved government spending but also large inputs from the private sector.

When work takes place there are major disruptions to airlines, passengers and staff, and also a negative impact on local roads. However, once the work is completed there are modern airports, with first-class facilities and at least double the airport capacity. The work on improvements at the airport have sometimes led to security check delays, frustrating passengers, especially business passengers.

Environmental groups are concerned not only with the immediate impact on the local community and environment but also with the long-term impact of far more planes flying over India. The

government, however, takes the view that increased air travel benefits the Indian economy through increased taxes and airport fees as well as increased economic growth.

1 Describe the advantages and disadvantages to the local community of the expansion at a nearby airport.

2 Identify three stakeholders (other than the community) who, in the long term, will benefit from the expansion of air travel in India.

3 How might the government reduce any adverse effects of the expansions on stakeholders?

How changing business objectives might affect stakeholders

Link

Objectives were discussed in AS Level Chapter 1.4 Business objectives. In particular there is some discussion into how objectives are likely to change over time.

Before we consider changes to objectives we need to remind ourselves of the various possible differing objectives of stakeholders because each objective will have a different impact on stakeholders.

As we have seen before, stakeholders have differing objectives. Shareholders and employees will want to see a business succeed and grow. So maximising profits and growth are likely to be the objectives these groups want. Suppliers would also want to see the business grow but may be more interested in financial security. The local community would want to see sound environmental and community objectives, perhaps related to CSR.

Business has to balance the needs of stakeholders and this may not happen when business objectives have to change. This brings into question *why* the objectives have changed and in response to which stakeholder group.

So, for example, shareholders may have forced a strategic change for the business to focus more on short-term profits than on long-term growth. Unions may have threatened the survival of the business and caused the business to have a greater focus on industrial "peace" than on shareholder value. Competitors may have taken action that has caused the loss of many customers so the business needs a complete change of direction.

So when a business changes its objectives it is likely to have different effects on the various stakeholder groups. Some of the possible impacts are listed in Table 1.5.4.

Table 1.5.4 The impact of some changing objectives on stakeholders ▼

Objective becomes:	Impact on stakeholder
• Growth – a higher growth target is set in response to falling profits and shareholder dividends	• Community and pressure groups may become more concerned about the environment • Shareholders might like the idea of the prospect of increased profits but may be concerned if the growth is too fast • Employees may feel more secure but would not want the costs of growth to erode future pay increases
• Increased profits – a higher profit target is set in response to shareholder demands	• Employees may worry about the impact on jobs – increased profits could come through decreased wages costs • Shareholders will be pleased • Government will anticipate increased revenues • Others may be concerned about likely reductions in costs • Customers might feel exploited if prices go up

Objective becomes:	Impact on stakeholder
• A reduction in staff turnover in response to a tighter labour market	• Employees may welcome this as it could lead to better working conditions • Shareholders may be concerned at additional costs and potentially lower short term profits
• Increased CSR in response to what customers want	• Most groups would welcome this provided that the policies were translated into action • Shareholders may initially be concerned about additional costs but may take the view that the policies will bring long-term benefits to the business and hence shareholders

Progress questions

9 Suggest three ways in which conflict between stakeholders can be avoided.
10 An insurance company decides that it wants to increase profits by 10 per cent per year. Which stakeholders will be affected and why?
11 Why might improved CSR be a difficult objective to achieve for a business that trades worldwide?

Exam-style questions

1 Explain the meaning of the term "stakeholder". [3 marks]
2 A business is planning to open a new factory near to where you live. Give an example of a stakeholder who would support such an idea and one who would oppose it, explaining your reasons. [4 marks]
3 "A business should always put its shareholders first since they own the business." Discuss the extent to which you agree with this statement. [20 marks]

Tata Steel has stated that:

We will achieve our vision through:

Our People

By fostering teamwork, nurturing talent, enhancing leadership capability and acting with pace, pride and passion.

Our Offer

By becoming the supplier of choice, delivering premium products and services and creating value for our customers.

Our Innovative Approach

By developing leading edge solutions in technology, processes and products.

Our Conduct

By providing a safe workplace, respecting the environment, caring for our communities and demonstrating high ethical standards.

Goals

The Tata Steel Group is proud of its performance culture. We are committed to the pursuit of challenging targets, and to safety, environmental protection, continuous improvement, openness and social responsibility in every aspect of our business around the world.

4 Evaluate the extent to which Tata Steel has considered the stakeholder concept in its operations. [10 marks]

Key concepts

- AS **Change** can be developed in relation to the impact of change on various stakeholders.
- AS **Management** can be illustrated through the rights and responsibilities of managers as stakeholders and through the relationships between managers and other stakeholders.
- AS **Customer focus** can be developed through consideration of customers as stakeholders in a business.
- AS **Strategy** can be developed through the influence of business decisions/strategies in stakeholders.

Progress check

You should now be able to:

- AS identify different stakeholders in a given situation
- AS explain stakeholders various interests in a business decision
- AS discuss the roles, rights and responsibilities of stakeholders
- AS evaluate the impact of a given business decision on stakeholders
- AS discuss how and why businesses need to be accountable to their stakeholders
- AS analyse how conflict might arise between stakeholders
- AS evaluate the impact of changing business objectives on stakeholders.

You should be able to relate these to a range of businesses in different situations.

2 People in organisations

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **AS** the difference between management and leadership
- **AS** the functions, roles and styles of management
- **AS** the qualities that make a good leader
- **AS** the purpose and roles of leaders
- **AS** the leadership/management styles in terms of their appropriateness in different situations

2.1 Management and leadership

What is the difference between a leader and a manager?

In some situations it is difficult to distinguish between a leader and a manager. However, there is a difference. A leader might be able to inspire people to move towards a business goal that those people would not have thought possible, but that same leader might not be able to effectively manage the day-to-day activities that actually make the achievement of the goal possible. This might be because the business is far too big for one person to manage effectively. That is why managers are employed. Good managers would be able to manage all of the required resources to work towards the goals or aims desired by the leader. While a leader might have a "vision" of what they would like a business to achieve in the long term, a manager will implement the measures to work towards it. A leader might outline an overall long-term strategic objective but the short-term goals which will move the business towards the longer-term objective will be undertaken and overseen by managers, i.e. the tactical decisions.

A good leader might also be a good manager. There are many good managers who do not have the charisma and vision of a good leader but who can manage all resources and can implement the decisions of a leader effectively and efficiently.

Key terms

Leader: someone who can inspire and "drive" a group of people towards a target or goal.

Manager: someone who controls and directs within a business and who will devise and implement the short-term tactical decisions necessary to achieve the overall objectives set by a leader.

Case Study

All change for Luigi and Anton

Fifteen years ago Luigi persuaded Anton that they should open a café. Within five years they had opened another five cafés in and around their home city. The number of staff employed rose quickly from 3 to 25. The cafés offer a variety of hot and cold drinks and food which customers can either eat in the café or take out. Over the first three or four years they expanded their menu mainly as a result of comments from customers. They added fruit smoothie drinks and freshly made soup and Anton developed some exciting recipes for snacks and meals that quickly became very popular with their customers. They stood out from their competitors because their food and drinks were different. Anton also excelled at purchasing excellent ingredients at minimum cost.

Five years ago Luigi announced that he thought they should only buy and use fair trade or organic ingredients. Anton was very surprised at how much more expensive this would make his ingredients but Luigi was not worried as he believed that they should increase their menu prices to at least cover the increased costs. Anton was convinced that they would lose customers as a result. He was wrong, in fact the opposite happened and the

Figure 2.1.1 ▲

number of customers using their coffee shop increased by 20 per cent.

Luigi now believes that they should take the business in a new direction. He believes that they should rent an industrial unit in order to produce Anton's recipes in larger quantities so that they can sell to other coffee shops and restaurants. Anton is afraid that this venture will fail and would prefer not to make this change to the business. Luigi is sure that he will be able to make a success of his proposed diversification. He has spoken to their employees about his idea and they are convinced by his arguments that this is a good plan.

1 What qualities does Luigi have that make him more of a leader than Anton?
2 What aspects of management are evident in what Anton does?

Management

The functions of management

The functions of management have been identified and analysed by people such as Henri Fayol and more recently by Henry Mintzberg. Fayol placed the various functions of management into five main categories.

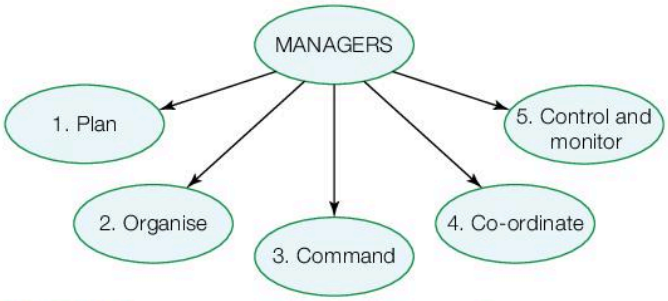


Figure 2.1.2 Fayol's five management categories ▲

Link

See also AS Level Chapter 1.4 Business objectives for more on objectives and corporate objectives.

Planning

It is the role of managers to set and implement the short-term objectives that will drive the business towards its long-term targets. They will outline the tactical strategies needed to achieve an overall business objective.

Organising

Managers also need to decide what resources will be needed to achieve the business objectives. For example, they will ensure that sufficient labour and materials are available. It is the role of the manager to organise and allocate the resources of a business in the most efficient way possible. Managers should make sure that the maximum benefit is gained from the available resources, i.e. that maximum outputs are obtained from minimum inputs. They need to ensure that resources are where they are needed when they are needed.

Part of planning is workforce planning, i.e. deciding how many employees will be required and what skills they will need to have. In addition managers must plan to make sure that the required employees will be in place at the appropriate time. In this way a business will have the resources required to be able to meet its objectives.

A finance department, for example, would need to ensure that sufficient money is available to enable a business to work towards its stated aim. It would need to make sure that sufficient money is available at the right time. A manager would also need to plan to reach the goal in a specific period of time.

Commanding

Employees will need to be given clear direction about what they are expected to do so that a business is able to achieve its objectives. Employees need to know what is expected of them and be motivated to work towards that goal. Employees cannot be expected to reach long-term goals and short-term targets if they do not know what it is that they are trying to achieve. If they do not enjoy their work or if they do not want to put the maximum effort into their work, achieving objectives might not be possible.

Co-ordinating

Without someone to guide and direct the overall activities of a business, there is a danger that some activities might be duplicated by different employees or departments. It is also important that all departments are working towards the same goal and, hopefully, within the same time scale. For example, if a business is about to launch a new product, it is no good if the marketing department is ready to launch their promotional events but the production department is still some time away from having a product that can be used in promotions. Alternatively, it is no good if the production department has got the product ready to launch while the marketing department is still planning the advertising campaign. The chance of a successful launch is reduced if the market is unaware of the new product. Also the business will have to bear the cost of storing the products until the marketing campaign is ready. A well-co-ordinated business would be sure to have the major advertising campaign timed for when the product is ready for sale. If the promotion occurs before the product is ready to be launched consumers might be disappointed that they cannot buy the advertised products.

It is vital that all sections and all of the employees in a business are working towards the same goal. This can be particularly difficult for a business as it gets bigger and more employees and departments are added. In some cases a larger business might have production facilities or outlets in various countries, which can add a further degree of difficulty to the co-ordination of all activities.

Controlling and monitoring

The managers must ensure that the business is on course to meet its objectives, therefore it is necessary to check progress and the extent to which targets are being met. Some businesses regularly appraise the workforce. The performance of the employees is judged against various targets (performance indicators) and if any employee or group of employees is not meeting the preset goals then appropriate action must be taken. This might involve some change to the motivational techniques being used or, in some cases, an element of retraining.

Link

See also AS Level Chapter 1.4 Business objectives for more about communication of objectives and their likely impact on the workforce.

It could also mean that the workforce plan must be reviewed because there are insufficient employees to make meeting that target possible.

Progress questions

1 Give an example of an action that a manager might take when planning, organising, commanding, co-ordinating, and controlling and monitoring. If possible link these to a business with which you are familiar.
2 Explain the importance of "controlling and monitoring" in a manufacturing business.
3 Explain the difference between a leader and a manager.

Mintzberg

Mintzberg identified three distinct functions of management:

- Interpersonal role
- Informational role
- Decision-making role.

He expanded on these three areas of management as shown in Figure 2.1.3.

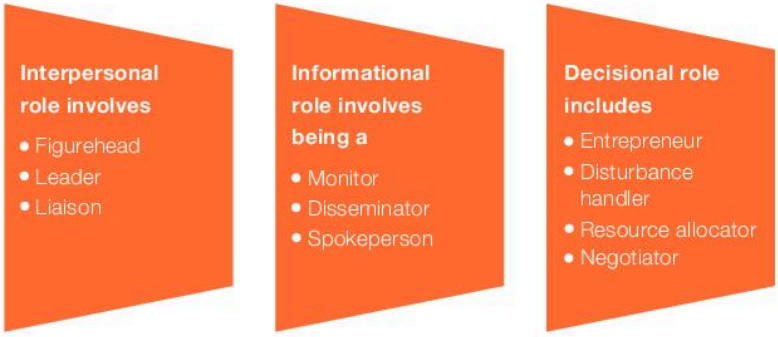


Figure 2.1.3 Mintzberg's three areas of management ▲

Activity

Taking each of Mintzberg's functions of management, outline an action or event that might occur under each identified role. For example, as a figurehead a manager might address the workforce during a period of change in order to convince them that their jobs are secure and to encourage them to work as hard as possible to ensure that the change is successful. This activity can be undertaken individually, in groups or as a class discussion.

Table 2.1.1 Interpersonal role ▼

Figurehead	• People will look to the manager for guidance, leadership and inspiration.
Leader	• The manager will provide direction for a team or a business by making clear what is required of everyone in the business.
Liaison	• A manager will need to communicate effectively within the business or on behalf of the business.

Table 2.1.2 Informational role ▼

Monitor	• Processing information related to their team perhaps related to their performance. • Processing information related to changes, both internal and external, that might affect the business.
Disseminator	• Information needs to be passed to the appropriate people as and when required. This must be at a suitable time and must use an appropriate medium.

Key term

Leadership: the act of directing and persuading others to support the leader by working towards a stated goal.

Getting it right

You can be asked to identify any of the roles outlined above and to link them to a business situation, e.g. a shop manager or a production manager. You should also be able to analyse possible consequences of a manager not fulfilling these roles effectively. You can choose Fayol's or Mintzberg's model if the question does not specify which one.

Spokesperson	• Passing information to interested parties, for example to inform local authorities about planned changes to the use of the buildings. • Informing trade unions of any proposed changes to conditions of service or regarding any planned redundancies for example.

Table 2.1.3 Decisional role ▼

Entrepreneur	• Generating and implementing new ideas. This might also involve solving issues arising as a result of an innovation and change.
Disturbance handler	• Resolving disputes within the business. • Dealing with threats outside of the business such as political or social unrest.
Resource allocator	• Effectively allocating resources whether they are finds, equipment or people.
Negotiator	• Negotiating agreement between employees or between departments. • Negotiating agreements with other businesses, e.g. a supplier or a customer. • Negotiating with trade unions.

Leadership

What are the qualities of a good leader?

- Self-confidence and self-belief. Leaders must believe that they have the ability to make sound decisions and to identify achievable long-term objectives for a business. Their confidence in their own decision-making ability must be supported by them having the other listed qualities.
- Intelligence. In order to be capable of determining a realistic new direction or goal for a business, a leader must have the intelligence to be able to assess the validity and significance of their ideas. Many people can claim to have bold and innovative ideas for a business, but they do not all have the intelligence to be able to distinguish between an achievable idea and one that is impossible to realise. This can also include being able to analyse the most complex problems and to arrive at a solution that will work. Sometimes a good leader can go straight to the heart of a problem; they are able to have a good overview that allows them to see what needs to be done.
- Creativity. Leaders need to be able to come up with ideas that others might not think of. In a competitive business environment it is often the business that is most innovative that becomes successful. The creativity of the leader allows them to make the business stand out from others in the market and gives them a competitive advantage.
- Charisma. Charismatic means having a personality that makes other people believe in you and be prepared to follow you and your ideas. A charismatic leader will be able to carry the people in a business along with them and will know that those in the organisation will willingly work towards objectives set by them.

Activity

Think of any person who you believe is a good leader and say why. This might be someone in your local community or a local business, or it might be someone from a global business that you are aware of from the news or from your class work.

Some people might also add the need to be multi-skilled so that the leader knows and understands all aspects of the business. However, that is not always necessary as an intelligent leader will have gathered around themselves a skilled group of people who, as a team, fully understand all sections of the business.

A strong leader is often seen as an inspirational figure by those in their organisation. Leaders will have a "vision" of what they want the business to achieve and will be able to engage the people around them in working towards that aim. They gain the trust of those working with and for them, to the extent that their colleagues and employees will follow them along whatever path they decide is right for the business at that time.

They usually have a strong self belief and this self-confidence will convince those around them to follow and to work with them. However, a strong leader does not always make the right decisions and there is a danger that a powerful leader can persuade the other people within an organisation to take a direction that will not benefit the business. Poor decisions can be disastrous for a business. A leader who listens to and is willing to accept the views of others is less likely to make decisions that are harmful to the business.

Who are classed as leaders in a business?

Within any business there will be leaders who play a smaller role than someone who drives the whole business; people such as the directors, departmental managers, supervisors and employee representatives are all leading or influencing others within a business. For example, managers and supervisors will "lead" their teams towards the targets that they have been set. A leader might be leading a department of 50 employees or a small team of five. The overall success of a business can depend on each leader, no matter how large or small their role or the number of people looking to them for guidance.

Leadership styles

The style of leadership can have a profound impact on the people working within that organisation and can determine their attitude to work, which in turn can influence the level of efficiency within the business.

It is accepted that different styles are appropriate for different circumstances and that a manager or leader might actually choose to use more than one leadership style depending on the situation at that time. For example, a democratic leader might adopt characteristics of an autocratic leader if a situation required immediate action such as an emergency.

There are four main styles of leadership, autocratic, democratic, paternalistic and laissez-faire. However, because paternalistic leadership is not in the specification it is not covered in this chapter.

Autocratic

Characteristics of autocratic leadership are:

- One-way communication and very limited information given to employees

Key terms

Director: a senior manager elected to represent shareholders.
Supervisor: an employee overseeing the work of others.
Employee representative: an employee who presents the views of the workforce to senior managers.
Autocratic leadership: a form of leadership used in a hierarchical business in which all decisions are taken by those at the top of the organisation. Such leaders often do not trust their employees to make decisions about their own work or to contribute to business decisions.
Democratic leadership: when business leaders take into account the views of those working at various levels within the organisation. The majority view is often accepted although the senior managers will make the final decision.
Laissez-faire leadership: individuals are given a lot of control over their own work while management will have a reduced input into decisions that have a direct effect on the way in which work is done. This is usually used with highly skilled and self-motivated employees.

- Close supervision of employees
- Lack of feedback
- All decisions made by the leader; employees are not involved in decision-making.

Table 2.1.4 Advantages and disadvantages of the autocratic leadership style ▼

Advantages	Disadvantages
• Quick decision-making; there is not always time to consult employees and an opportunity might be lost. • Can be very successful in emergency situations where quick decisions are needed. • Employees are closely supervised and know what is expected of them.	• Employees feel as though they are not trusted because they are not being consulted. • Better decisions might be made if employees are consulted as they might have some good ideas for improving products or ways of working. • Some employees would enjoy being involved and they might feel a lack of job satisfaction due to non-participation.

In this style of leadership employees are told what to do and are expected to follow, without question, any orders given. Employees who, by their nature, would enjoy knowing more about the business and who would like to take some responsibility are likely to feel less motivated than they would if they were allowed to participate more. Some employees are interested in the direction that the business is taking and might work even better if they knew what ultimate goal they were working towards. However, an autocratic leader would not involve employees in the business other than requiring them to perform their duties without questioning them.

Democratic

Characteristics of democratic leadership are:

- Two-way communication
- Employees allowed/encouraged to participate in decision-making
- Views of employees are taken into account by the managers
- Employees are usually given more information about the business and the direction it is taking.

Table 2.1.5 Advantages and disadvantages of democratic leadership ▼

Advantages	Disadvantages
• Employees are likely to be more motivated due to being allowed to participate in decision-making. • Employees can feel more involved in a business when they know and understand more about what the business is trying to achieve. • Two-way communication means that employees get feedback and managers get the benefit of input from employees. Employees might have very useful ideas to contribute that would be lost without two-way communication.	• There is not always time to allow for consultation with employees. Sometimes a quick decision is essential. • Some issues are too sensitive to be discussed with the whole workforce, e.g. proposed redundancies. • Giving employees more information about the business's goals and objectives might lead to dissatisfaction if the employees do not agree with the direction being taken.

Democratic leaders tend to interact with their workforce and are willing to allow employee participation in the decision-making process. They acknowledge that their employees could have a valuable contribution to make. It could be that their employees might know best how to solve a production problem if they are the ones doing that work every day. This is likely to make employees feel trusted and valued by management and as a result this could increase their commitment and loyalty to the business.

Laissez-faire

Characteristics of laissez-faire leadership are:

- Laid back, hands off approach
- Broad parameters given to employees
- Leaves employees to make decisions about their work patterns and methods
- Employees are highly trusted
- Often used when employees are highly skilled and self-motivated
- Can also been used by managers who are too lazy to take an active role in managing their employees.

Table 2.1.6 Advantages and disadvantages of laissez-faire leadership style ▼

Advantages	Disadvantages
• It can help employees to develop self-discipline. • It shows that employees are trusted, and can therefore be motivating. • This gives employees freedom and flexibility about how they organise their work.	• It can lead to too much control being in the hands of the employees. • Managers might lose touch with the way in which work is being done. • It can be used by lazy managers to avoid making decisions about work matters.

Laissez-faire leadership is frequently found in businesses where highly skilled and/or very creative people are working. For example, a business that designs and develops new apps for mobile phones would be likely to have a highly skilled workforce that does not need constant instruction and supervision. Such a workforce is likely to be working in project teams that will motivate and monitor each other to strive towards a successful outcome. Research and development businesses often use this style of leadership because their employees tend to be self-motivated.

Laissez-faire leadership does not mean that employees can do just what they want. They will have limitations (parameters) within which they must work. For example a team of employees might have been given a project to complete by a stated deadline. The actual means by which the project objectives are achieved will, however, be left up to the team of employees involved.

It is accepted that a very lazy manager might also adopt a laissez-faire leadership style: not because the nature of the work or the skill level of their employees justifies it, but because they are too lazy to manage the activities of their department themselves.

Activities

In small groups discuss how the following situations might be approached using each of the three leadership styles above.

1. A production manager needs to talk to production workers about reducing the rising level of faulty products that are being produced.
2. A sales manager estimates that sales targets need to be increased by 20 per cent in the following year if the business is to maintain its market share.
3. The human resource manager has noticed a significant increase in the rate of absenteeism and of late arrivals at work. The HR manager must reduce these if acceptable levels of production are to be maintained.

There are other theorists who have developed ideas about what can influence a manager's approach to their workforce; notable among these are Douglas McGregor and Daniel Goleman.

Douglas McGregor: Theory X and Y

Douglas McGregor's theory outlines how leaders and managers might view their employees. His theory is explained in terms of Theory X and Theory Y. He believed that the way in which managers viewed their employees must, ultimately, influence how they treat their employees. A manager's perception of their employees is also likely to influence them in terms of which style of leadership they feel is the most appropriate to adopt.

A leader or manager who believes that his employees fall into the Theory X category is likely to have a negative view of the workforce while those that see their employees as being Theory Y employees are likely to think more positively.

In McGregor's theory, managers believe that Theory X and Theory Y employees have the characteristics shown in Figure 2.1.4.

Figure 2.1.4 Theory X and Theory Y characteristics – what managers believe ▲

Getting it right

When answering questions remember that McGregor's Theory X and Y is about managers' perceptions of their employees and not about the employees themselves.

Key terms

Theory X manager: a manager who has a negative view of their workforce and who believes that employees need to be supervised and controlled.

Theory Y manager: a manager who has a positive view of their workforce and who believes that employees can make a positive contribution to business activity.

Theory X managers believe that their employees show characteristics of a Theory X attitude and are more likely to adopt an autocratic style of leadership/management. On the other hand, a Theory Y manager believes that their employees are showing the characteristics of Theory Y, they are more likely to consider using a democratic leadership/management style.

Case Study

Ravi and Gwenaelle

Ravi and Gwenaelle formed a business partnership 15 years ago to produce and sell a range of hair products – mainly shampoos and conditioners. In the past five years they have increased their range of products to include hair dyes and the output of their factory has had to increase by 250 per cent over the same period. Ravi manages the production department

and Gwenaelle manages the sales and marketing. Gwenaelle has told Ravi that too many orders are being delivered late and he says that his employees just do not work hard enough to meet the orders on time. Ravi adopts an autocratic leadership style while Gwenaelle adopts a democratic leadership style.

1 Discuss how Ravi, and the business, might benefit from him adopting a democratic leadership style with the production workers.

2 Gwenaelle is a Theory Y manager who views her employees as valuable assets to the business who can contribute useful ideas. Ravi believes that the production workers must be supervised and that they cannot have anything useful to contribute to the business other than their labour. Discuss the possible impact of these two approaches on a growing business.

Figure 2.1.5 Production workers ▲

Getting it right

Take note of whether a question requires you to discuss advantages or disadvantages. It is not unusual for students to write about advantages of a particular leadership/management style when the question actually requires a focus on the disadvantages.

Key term

Emotional intelligence: knowing and understanding your own feelings and those of others.

Progress questions

4 Identify two advantages of using a democratic leadership style.
5 Identify two disadvantages of using an autocratic leadership style.
6 Identify two possible characteristics of employees whose manager uses a laissez-faire leadership style.

Daniel Goleman: Emotional intelligence (EQ)

A recent approach to management has been outlined by Daniel Goleman who views the management of employees by using an analysis of emotional intelligence (EQ – Emotional Quotient). His theory is based on the need for managers to be aware of and understand their own emotions and feelings as well as those of their employees.

The underlying concept here is that managers need to be able to understand how they feel about work, what drives or motivates them and what their aspirations are. They also need to understand how their behaviour can impact on those around them. If managers are able to do this, they are more likely to be able to understand what drives and motivates their employees and also to appreciate how employees might be feeling towards work and towards decisions being made within the workplace. In other words managers need to be able to empathise with their employees.

His theory is based around four key competencies. He recognises the need for a manager to have:

1 Self-awareness. Knowing and understanding their own emotions.

   a Managers need to appreciate what feelings they experience and why. They must also be aware of how they act when feeling a particular emotion and just how this might influence their performance and also how they treat people.

2 Self-management. This requires managers to be able to understand and apply:

   a Self-regulation, which includes being able to manage their own emotions. They need to be able to control their emotions, particularly if they feel angry or distressed because these feelings are more likely to create a negative environment if they are noticeable to their workforce. It is important that during stressful times a manager is able to keep their emotions under control and can appear positive and in control of the situation. This type of control is more likely to make employees feel confident that their manager can handle the situation.

   b Self-motivation, which includes being able to motivate themselves. Managers need to be able to set goals and then be able to work with determination towards the achievement of those objectives. They need to be able to assess risk and work out how to minimise it. They will constantly strive to improve their performance and can also recognise and understand that need in their employees.

   c A manager who is seen to be striving to achieve goals that are beyond those that would normally be expected of them, is likely to inspire others to work harder to support them. This is a case of leading by example.

3 Social awareness. Being able to recognise and understand the emotions of others.

   a An emotionally intelligent manager is sensitive to the needs of others, whether employees or customers, and is prepared to give feedback and support to enable their workforce to develop their skills and role within the business.

   b They are also able to recognise that people do not all have the same needs and therefore that it might not be appropriate to manage all their employees in the same way. People will have had different experiences in life as well as at work that will have affected how they feel about themselves and the job that they do. It can also influence their aims and ambitions both at work and in their personal life.

   c A manager who can become aware of such needs is more likely to meet the specific needs of individual employees or customers and therefore to improve their relationship with them.

4 Social skills. Being able to manage relationships in terms of managing the emotions of other people.

a A manager cannot hope to manage the emotions of others if they are not aware of those emotions. Hence the importance of point 3 above.

b Employees and customers might feel anger or disappointment at some point and it is at this time when an emotionally intelligent manager will recognise and appreciate the cause of such emotion and will then actively seek to calm and resolve the situation. If the anger is not recognised then there will not be any action taken to deal with it and the situation might become even worse.

c An emotionally intelligent manager will aim to build relationships that encompass co-operation, mutual support and an environment that can prevent conflict by creating an atmosphere for open discussion.

Progress questions

7 State two characteristics of a successful leader.
8 Explain three functions of management.
9 Explain why there is no such thing as "a theory X employee".

Exam-style questions

1 Explain three main functions of management. [5 marks]
2 **a** Explain the possible disadvantages to the employees in a business with an autocratic leader. [8 marks]
b Discuss the qualities that are likely to be essential in order for a business leader to be effective. [12 marks]

Key concepts

AS **Change** can be developed through the theme of management of change.

AS **Management** can be developed through the consideration of management roles and leadership styles.

Progress check

You should now be able to:

AS identify the various functions, roles and styles of management and explain them in a given situation

AS explain the difference between a manager and a leader

AS explain the qualities of a good leader

AS analyse and evaluate the usefulness of different leadership styles in different business situations

AS recognise and discuss the importance of how managers view their workforce through the use of McGregor's and Goleman's approaches to leadership and management.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **AS** the need to motivate employees to achieve the objectives of a business
- **AS** what is meant by human need and how human needs may or may not be satisfied at work
- **AS** the ideas of various motivational theorists and how businesses apply them in practical situations
- **AS** the different payment methods that can be used
- **AS** different types of non-financial motivators
- **AS** how and why the different methods can be used to motivate employees
- **AS** ways in which employees can participate in the management and control of business activity

Key term

Motivation: a desire to do something; to develop a drive to reach a goal.

Link

Business objectives are covered in AS Level Chapter 1.4 Business objectives.

Key term

Human needs: the wants or desires of people that they hope will be met either at work or in their activities outside the work environment.

2.2 Motivation

The need for motivation

Motivation is a tool used by leaders and managers to encourage their employees to work willingly as hard as they can.

What are the benefits of a motivated workforce?

- Higher levels of productivity – motivated employees will work harder and be more productive.
- Better-quality products or services provided to customers – more attention will be paid to the way in which work is carried out, whether that is the production of goods or the provision of services.
- High levels of customer service – motivated employees will be trying to do the best job possible, and when this includes customer service this is likely to be of the highest standard possible. A motivated employee will recognise that a happy customer is likely to be a repeat customer and also that the reputation of the business rests not only on the goods produced but on the quality of aftercare that their customers receive.
- More loyalty from employees – this will manifest itself in lower absenteeism and lower labour turnover as employees feel that they want to give their best to the business.
- Lower absenteeism rate – employees are less likely to be absent unless they are genuinely unfit for work. Employees who are not motivated are likely to take time off when it is not absolutely necessary.
- Lower staff turnover – happy employees are less likely to look for work elsewhere. If they feel valued and trusted in their current job they might feel that their efforts will be rewarded and therefore they do not have any need to look for work elsewhere.
- Increased likelihood of achieving business objectives – when employees are working as hard as they can the business will have the best chance of achieving any stated objectives. For example, if a business objective is profit maximisation, this is most likely to be achieved when employees are working at their most efficient thus minimising waste and keeping costs to a minimum. This could also give a business the chance to reduce its prices thus increasing its competitiveness in the market, which could also help it to achieve a goal of market growth.

Successful motivation aims to meet the human needs of employees at their place of work. Most of us spend a large part of our life in one workplace or another and we are likely to produce our best work if we are happy to go to work and we enjoy the work we do.

What are human needs?

These are the wants or desires of people. Some of these can be met in their place of work and others will be met by their activities outside

Activity

Make a list of your "human needs" and then identify which are likely to be met by attending school or college. Identify how these needs are being satisfied.
Consider how you expect your human needs might change over the next five to ten years. It is useful to think about your future and how you might best work towards achieving your wants and/or desires!

Link

Quality circles are discussed in A Level Chapter 4.5 Lean production and quality management.

Key terms

Content theorists: motivation theorists whose work focuses on the nature of the work itself and/or the terms and conditions of employment.
Process theorists: motivation theorists whose work focuses on the psychological drivers that can encourage employees to work harder.
Piece rate: a payment made per unit produced.

Getting it right

Some similarities can be seen in the ideas of some of the theorists and, in some questions, these can provide the basis for an analysis of motivation theory in a given situation.

the work environment. In your studies of this subject it is primarily the needs that can be met in the workplace that should be examined and understood.

All people need to have the means to be able to feed and clothe themselves and also to provide themselves with shelter. This is the most basic of all human needs. Most people have a need to feel part of a social group and to be accepted by it. It is also a recognised need that many of us seek the respect of those around us and that many people want to feel as though they are making a positive contribution both in their work life and in their life outside of work. A proportion of any population will also desire improvement in their life; sometimes in terms of their standard of living but also frequently in terms of the work that they do. Ambition is often a driving force for people.

You need to be aware of the extent to which human needs can be met in the workplace. You also need to appreciate which needs are most likely to be satisfied and how. For example, the need for social interaction might not be easily met in the workplace if the work involves spending the working day at one particular point in a production line. Such work often makes interaction between employees very difficult if not impossible apart from when rest breaks are taken. However, if people are working in a team, such as a research team or a quality circle, it is possible that their social needs will be met at work because they need to interact in order to complete their job.

Motivation theories

Several people have put forward theories about what they believe motivates people at work. You need to be familiar with the motivation theories of the content theorists Taylor, Maslow, Mayo, Herzberg, and process theorists McClelland and Vroom.

Frederick Taylor – Economic man

Taylor believed that people were motivated by money and that they should be paid according to the output that they produced. His idea was that employees should be observed in order to identify the most efficient way of working. Once the best method had been decided, all employees should carry out the required task in the same way. A piece rate could then be determined by timing the employees after which all employees would be given the same payment per item produced. This theory assumes that people will work in order to receive the highest pay possible, i.e. that they are driven by the desire to earn money.

It is acknowledged that this approach to motivation is more likely to be successful in a manufacturing situation and when employees are still striving to satisfy their most basic needs such as the need for food and shelter. An employee who is struggling to feed and clothe their family is more likely to be driven by the need for money than to worry about whether they actually enjoy the work they are doing. This belief has some similarities to the basic needs level of Maslow's hierarchy of needs.

Possible weaknesses of Taylor's theory

Taylor's theory does not address the problem of how to motivate employees once their desire for money has been satisfied. There is one train of thought that believes that a person's desire for money can never be truly satisfied because the more they earn then the more money they will enjoy spending. Once the basic needs have been met, people will perhaps begin to desire status symbols such as a bigger house and a car. In this sense money might still be a motivator as more money will have to be earned if more expensive products are to be purchased. However, money cannot be the only motivator because if it was, why do people who have amassed more money than they can spend in their lifetime continue to work and acquire even more money? Perhaps they are meeting other needs at the same time; perhaps the fact that they have become even richer gives them status.

In 2013 for example, Bill Gates was estimated to be worth $80 billion, Richard Branson was estimated to be worth $4.6 billion and Mark Zuckerberg the founder of Facebook was estimated to be worth $30.2 billion. Such people must be inspired to work by something other than money – perhaps they just enjoy the challenge of what they do!

Abraham Maslow – Hierarchy of needs

Abraham Maslow based his theory on a series of human needs which he believed could be placed in order of importance. He stated that the most basic needs of food, clothing and shelter must be met before a person would wish for anything else such as social interaction or the respect of those around him. For this reason he placed the motivational needs in a pyramid structure, indicating the order in which he believed people would wish their needs to be met.

One crucial aspect of Maslow's theory is that once a need has been met, that need will no longer motivate and so managers need to be prepared to change the way in which they try to motivate employees.

Figure 2.2.1 Maslow's hierarchy of needs ▲

Basic (physical) needs

These are the desire to be able to access food, clothes and shelter; the most basic of human needs. Maslow believed that these needs would

be the driving force behind the actions of any person who feared that they might not be able to secure these for themselves. Such needs can be met by having the money to buy what is needed, i.e. being paid for work done enables the purchase of essential food and other products. Employees might not only be aiming to satisfy their own basic needs but they might also need to provide for a family.

Maslow believed that the other needs in the pyramid were irrelevant to a person who was struggling to satisfy these essential physical requirements. Only when they have ensured that they will not go hungry or lack suitable clothing or shelter will they look to the next level.

Safety needs

Once a person has made sure that their basic needs have been satisfied they will look for some security that they will be able to meet those needs in the future. This can be satisfied by having a contract to work; this provides job security at least in the short term. A person will be unlikely to be motivated by anything other than meeting their basic physical needs if they fear that they will not be able to continue to meet them in the future. If an employee feels that their job is threatened they will not be concerned with anything higher on Maslow's pyramid of needs until they feel confident that they will continue to receive the means to provide for themselves and/or their family.

Social needs

While not true of all people, it is accepted that most people enjoy contact with others whether at work or in their social lives. A large part of our lives is spent at work and so it is not unreasonable to feel that people benefit from some level of social interaction in their workplace. Social groups can be formed due to people being required to work in teams, such as in cell production, or as a result of social activities undertaken by their employers. Many businesses arrange social activities outside of normal working hours which can enable people to have contact with employees from different parts of the business. Alternatively it allows those who work together to get to know each other better beyond their working relationship. It is hoped that meeting the social needs of employees will lead to them performing better when at work.

Esteem needs

Esteem needs recognise that people need the approval and respect of others. These can be met in the workplace by employees being given positive feedback from their managers. Esteem needs can also be satisfied by co-workers showing their appreciation for the work of their colleagues. The respect of our colleagues can be just as important to us as any respect shown to us by our managers. Some businesses work with an award scheme that recognises the achievement of individuals or teams of employees; this is an obvious form of recognition for work done. However, less obviously, sometimes it might just be a simple "thank you" or "that is excellent work" from someone that is sufficient to make us feel that our contribution has been recognised and appreciated.

Key terms

Cell production: groups of employees performing the various tasks required to complete a process or product. Deemed to be motivational because the group get the satisfaction of completing a product or a substantial part of one.

Esteem needs: the desire of an individual to be respected by others and to gain their approval.

Key term

Self-actualisation: the ability and opportunity for an individual to achieve their full potential.

Link

See the section on recruitment and selection in AS Level Chapter 2.3a Human resource management.

Self-actualisation

Self-actualisation means the opportunity for an individual to be able to fulfill their own potential. Within a workplace this means that people need to be able to develop their skills and therefore will need to be able to progress beyond their current level of skill and responsibility. This can be achieved by having training and staff development opportunities available and also by internal promotion.

Progress question

1 Explain one similarity between the theories of Frederick Taylor and Abraham Maslow.
2 Explain why social needs might be important in the workplace.
3 Give one weakness of Taylor's theory.

How can a business meet these needs?

Table 2.2.1 Maslow's needs and how business can respond ▼

Need	Business action
Basic (physical) needs	• The payment of a wage or salary that allows employees to buy the essentials for life.
Safety needs	• Job security through a contract of employment; follow health and safety guideline for a safe work environment.
Social needs	• Encourage team work, social activities and communication between all levels of employees.
Esteem needs	• Give recognition for good work. Show appreciation, e.g. "employee of the month". Job titles give some employees status and meet this need. Promote people or give added responsibility.
Self-actualisation	• Meet the need for a feeling of achievement perhaps through assigning more difficult and challenging tasks. Allow for further training and progression within the business.

Possible weaknesses of Maslow's theory

- It is very difficult for a manager to know for sure which level on the hierarchy each employee is on
- Each employee is likely to be at a different level of the pyramid, which makes motivating them as a group very difficult, if not impossible, as each person will have different needs
- It is also possible for a person not to desire the approval of others and therefore, once their "safety needs" have been met, self-actualisation might be their next goal.

How can a manager know which level an employee is currently on? Perhaps at regular appraisal meetings the needs and wants of a member of staff could be discussed.

Activities

1 Design a short questionnaire that aims to discover what motivates people. This can be completed by your family and perhaps with some teachers in your school or college.
2 Once the information has been collected analyse your findings and allocate each respondent to a particular level of Maslow's hierarchy. Justify your placement.

The design of the questionnaire and the placing of responses on the hierarchy could be done in small groups.

Progress questions

4 Outline one method that the manager of a supermarket might use to meet the social needs of the employees.
5 Jerome runs a small business employing 25 people making pre-prepared meals that he supplies to supermarkets. Explain how he might try to satisfy the esteem needs of his employees.

Elton Mayo – Hawthorne experiment

Elton Mayo based his theory of motivation on the behaviour of a group of assembly workers observed at the Hawthorne Plant at the General Electric Company in Chicago. He anticipated that the work rate of employees would be affected by the physical conditions in which they were placed. He believed that the productivity of employees would be influenced by their work conditions as well as the skills that they possessed. He also linked productivity to financial incentives. His study involved employees being subjected to changes in light, heat, incentives, rest times and hours of work. His findings were that no matter what changes were made, a group of employees increased output. This was even the case when their original working conditions were restored. His conclusion was that these employees had increased their productivity due to being part of a team and that the very act of observing them had led to them feeling that someone was taking an interest in them. This was sufficient to raise their output levels.

At the outset of the original research Mayo was probably expecting to support the theory of Taylor to some extent, as he believed that financial incentives would increase productivity levels. However, the outcome revealed that employees work better if their social needs are being met. Some similarities with the ideas of Maslow can be seen.

Case Study

Bags By Design

Helene and Lara had been designing and making fashion bags as a hobby for many years before starting their business Bags By Design. Over the last five years they have opened their own factory and now employ 30 people who make the bags that Helene and Lara still design. The bags are made using outer layers of cotton which are sewn together with a fibrous wadding inbetween the two outer layers. The fibrous wadding leads to lots of small particles in the air in the workshop and for this reason an air filtration system was installed to extract the wadding particles from the air in the workroom. The extractor also cooled the sewing rooms which could be extremely hot due to all of the machines and the strong lights that were essential for the detailed work being done.

Helene and Lara know each of their employees by name and talk to each of them regularly in order to get feedback on the bag designs and on the fabrics that are being used. The employees feel as though they are part of the business and that their views matter to Helene and Lara. Recently the air filtering system broke down and it was ten days before the necessary parts to repair it could be delivered. The situation was made worse due to the breakdown occurring in August when the sewing rooms are usually at their hottest. During those ten days Bags By Design had a very big order to complete that needed everyone to produce maximum output to meet the delivery date. The order was completed on time despite the fact that the working conditions were worsened by the lack of the air filtration system.

1 Explain how the research and theory of Elton Mayo might have affected the employees of Bags By Design when completing the large order.

Key term

Hygiene factors: aspects of work that do not motivate but, if not present, cause dissatisfaction, e.g. a comfortable working temperature.

Frederick Herzberg – Two factor theory

Herzberg analysed motivational factors by grouping them into two broad categories: hygiene factors and motivators. He believed that the hygiene factors did not motivate employees, but if they were not present they would be a cause of dissatisfaction. However, the motivators would drive people to achieve more in their work as these are what lead to employees gaining job satisfaction.

For example, if the temperature was too low or too high an employee might comment that it was not possible to work well in such conditions (dissatisfaction), but if the temperature was just right, employees would be unlikely to make any comment. It is very unlikely that they would say that they would be able to work better due to the appropriate temperature (therefore not a motivator)!

Hygiene factors	Motivators
• Pay • Work conditions • Company policy • Relationship with others (co-workers, supervisors/managers) • The amount of supervision	• The nature of the work • The opportunity for promotion • Being recognised or appreciated • Having a sense of achievement • Being given responsibility

Figure 2.2.2 Herzberg's motivational factors ▲

How can a business satisfy the hygiene factors and the motivators?

Table 2.2.2 How businesses can satisfy hygiene factors and motivators ▼

Hygiene factors	• Pay an appropriate wage/salary; what is an "appropriate" amount will vary from one person to another. • Make sure that working conditions are as good as possible; clean and at a suitable temperature. This might include providing canteen facilities or rest rooms. • Company rules should be reasonable and not too rigid. • Team work can be used to improve relationships between employees; two-way communication can improve the relationship between employees and their managers. • Employees who are less closely supervised are likely to feel less threatened and perhaps feel more relaxed at work.
Motivators	• Give positive feedback to employees. • Involve employees in decision-making. • Use delegation, which allows employees to enjoy more responsibility and to feel valued and trusted. • Ensure that the work is stimulating and rewarding. This can be achieved by allowing employees to work on complete units of work giving them a sense of achievement. • This might also mean varying the work (job rotation) or broadening the scope of the work (job enlargement and job enrichment). • Rewarding good performance. Perhaps by using internal rather than external promotion.

Key terms

Job rotation: to vary the tasks undertaken, i.e. a group of employees have their tasks changed by managers on a regular basis to prevent boredom.

Job enlargement: to give additional tasks to employees thus broadening their skills and experience.

Case Study

Alhambra Ltd

Alhambra Ltd produces components for cars. The employees work in teams in quality circles. Recently there has been a higher than normal rate of defective components and also Ramone, the production manager, has noticed that the level of absenteeism is higher than normal. When he has questioned the employees they have said that their workplace has been too hot since the old air-conditioning unit was replaced. Ramone also recently introduced shift working for the first time in the history of Alhambra Ltd.

Ramone is puzzled by these changes because, after the introduction of quality circles, he believed that they would be more highly motivated due to having met their social needs.

1 Use the theory of Herzberg to explain why the level of defects and absenteeism might have increased.

Douglas McClelland – Motivational needs theory

McClelland believed that there are three key motivational forces that drive managers and employees. They are the need for:

- Achievement – the need to meet given goals and objectives
- Authority – the need to have power or influence over the actions of others
- Affiliation – the need to be liked and to work in a supportive environment.

The motivational driver of a manager is likely to determine how they treat their workforce.

Achievement

A manager who is driven by a need for achievement is likely to thrive from working towards stated targets, i.e. they need to meet, if not exceed, any targets set. Such people enjoy the challenge of difficult tasks with their achievement needs being met when they succeed. They are further motivated if they can produce results that are better than expected or required. It is possible that managers might set challenges and targets for themselves that are extremely difficult to achieve. This can introduce an element of risk into the organisation or department. A manager with this attitude to work might cause their employees to be under a lot of pressure as they, in turn, are set very challenging goals. Employees might feel that there is too much pressure and this can prove to be demotivating for some people.

Authority

Some people need to feel that they are having an impact on their work environment and that they can influence what happens there. These people are likely to seek to lead some aspect of business activity. This can be at all levels of a business. For example, this could apply to a team member who wants to try to get their ideas used by the whole team, perhaps because they believe that their ideas are better than those of their colleagues. This need for power or influence can be a strong driving force within a business as the individual may be hoping for a positive outcome for the business rather than just for themselves. Their fulfillment would also come from the self-esteem and respect that would be acquired if there was a successful outcome as a result of their influence.

Affiliation

Some people just need to be liked by others. This need is likely to drive a person to want to work as part of a team where they feel respected and also supported. This could make some decisions difficult for managers if they feel that the decision might be unpopular with their employees. Their need to be liked might stop them from making necessary but unpopular decisions and this might not produce the best outcome for the business.

How can a business meet these needs?

The need for achievement can be met by setting realistic targets that will meet the needs of the business but, at the same time, allow the employees to feel satisfied that they have met, or perhaps exceeded, the target set. Recognition of achievements by managers can also give employees the opportunity to feel that sense of achievement.

The need for authority can be met by including employees in discussions about their work. This might be in the form of departmental meetings where any proposed changes might be discussed and feedback taken from those present. This gives employees a feeling of having some input into the business and some influence over what takes place there.

Employees could be given small areas of responsibility within their normal sphere of work. For example, an employee might be made responsible for making sure that all the required materials are delivered from stores to the team of employees in time for production to take place.

The need for affiliation is more difficult for the business to meet. However, the use of team work gives employees the opportunity to work as part of a small group and to earn the respect of the other members of the group.

Activities

1. Jot down how your needs for achievement, authority and affiliation are met in school or college and in life outside education.
2. Compare these ideas in pairs and also discuss any other ways in which these needs might be met.

Victor Vroom and expectancy theory

Vroom's theory of motivation is based on a belief that employees are prepared to work hard if they feel that their efforts will be suitably rewarded.

The success of this is related to the strength of the employee's desire or need for the reward. This is known as "valence".

Employees need to believe that increased effort on their part can actually lead to a better performance. This is known as "expectancy".

Finally employees need to feel confident that if they deliver an increased level of performance they will receive their expected reward. This is known as "instrumentality".

In order for this theory to be effective in any workplace it is essential that:

- Employees have the skills and equipment required to do the work in question
- Appropriate performance appraisal takes place

- The rewards are attractive to the employees
- The expected rewards are received.

In order for people to be motivated in this way it essential that the link between effort and reward is a strong one and that employees believe that their desired reward will follow if they exert the right amount of effort. If their efforts are not appropriately rewarded or if the reward system is seen as unfair in any way then employees will cease to be motivated due to a loss of confidence that making an effort is worthwhile for them. Therefore, if Vroom's theory is to work then there must be a recognised system of appraisal and also a commitment to give suitable reward if targets and achievement levels are met.

How can a business meet these needs?

The type of reward might depend on the position of the employee in the business. For example, an assembly line worker might be incentivised by receiving a financial bonus or one or two extra days holiday. They might also be motivated by a promotion to team leader or supervisor. An employee at a higher level in the organisation, such as a supervisor or a manager, might be motivated by further promotion or by receiving extra fringe benefits such as private health insurance.

Getting it right

Make sure that you relate your answer to the precise wording of the question. If you are required to refer to the ideas of specific theorists ensure that you respond by making those theorists the focus of your answer. If a question merely asks about "motivational theories" then you can write about any theories. However, do not just recount the details of the theory; make sure that you relate the theory content to the situation given in the question. You should be able to recommend and justify the most suitable method in given situations

Key term

Fringe benefit: a benefit received by an employee in addition to their regular pay.

Progress questions

6 Explain the difference between Herzberg's "motivators" and "hygiene factors".

7 Ombre Ltd makes a range of wooden buildings. Teams of employees specialise in the making of one specific building type with each employee having responsibility for one or more aspects of the work. The teams compete for a monthly award which is given to the team that has the highest level of productivity.
Explain how McClelland's "needs" might be met by this type of working.

8 Briefly outline what is meant by "valance", "expectancy" and "instrumentality" in Vroom's expectancy theory.

Key terms

Financial rewards: monetary incentives given to employees, e.g. bonus payments.
Non-financial rewards: incentives given to employees other than those with a monetary value, e.g. extra holidays, employee of the month recognition.
Salary: an agreed amount paid monthly in return for work undertaken.

Motivation in practice

There are many actions or incentives that the managers of a business might use in order to motivate their employees. These fall under the general headings of financial rewards and non-financial rewards.

Financial rewards

Piece rate payments

These are payments made per unit or batch of units produced. This should ensure that employees produce as much output as possible but it does not necessarily mean that quality standards will be maintained. The focus will be on quantity rather than quality.

Salary

A salary is an agreed amount paid monthly. This form of payment gives employees some level of security regarding the amount they will earn each month.

Key terms

Time-based payments: payment made based on the number of hours worked.
Performance-related pay: payment made based on targets being met or exceeded.
Bonus: a payment to employees in addition to their normal pay.

Time-based payments

Employees receive payment that is related to the number of hours worked. This is an incentive to attend the workplace but does not guarantee the amount of work that will be completed during that time.

Performance-related pay

This type of financial reward is a bonus paid for meeting or exceeding targets. However, targets that are set too high are unlikely to motivate; indeed they might have the opposite effect. In order for bonus payments to be made, the targets need to be measurable and the bonus must be seen to be fair. If employees are not motivated by money this form of incentive is unlikely to be successful.

Profit-sharing agreements

If employees are to receive a share in the profits of the business then they should be working towards the same end goal as the managers and owners of the business. What happens if the employees are working as hard as they possibly can and circumstances outside the control of the business means that a profit is not possible? Economic circumstances, for example, could mean that the profit for a business falls despite the best efforts of all those involved in the business. Employees in such situations have been known to take a pay cut so that the business can reduce its prices and remain competitive in a difficult market. This is not a popular option! A pay cut might be acceptable in the short term but might be less acceptable if the difficult conditions were to continue for a long period of time. Also if employees are expecting to take a share of any profit made, would they be equally willing to share the burden of any loss made? This is not normally expected in any profit-sharing agreement.

Commission

Key terms

Profit sharing: employees are rewarded by receiving a share of the profit made by a business.
Commission: payment made according to the number of sales achieved.

A commission is money paid according to the level of sales achieved. This method will inspire employees to achieve the highest possible level of sales. The danger with this is that the pursuit of sales might lead to the priority being to make sure that the sale takes place rather than to ensure that the product or service is the most appropriate one for the customer. While in the short term sales might increase, in the longer term customers might feel that their needs had not been properly considered. The salesperson might have wanted to make the sale so much that they did not fully consider whether the product was the best option for the customer. In such circumstances the customer is less likely to buy from that business in the future.

Key term

Financial fringe benefits: benefits or perks given to an employee which have a financial benefit to them, e.g. payment of private medical insurance.

Financial fringe benefits

Money-related fringe benefits are things such as payment of private medical insurance or children's school fees, or the provision of a company car. Employees might be willing to work hard so that they will be rewarded by such fringe benefits. However, once they have been given, they often become part of the expected remuneration package. These are not usually the sort of benefits that can be given as a one-off

Key terms

Team working: groups of employees working together towards a shared goal.
Cell production: groups of employees performing the various tasks required to complete a process or product. Deemed to be motivational because the group gets the satisfaction of completing a product or a substantial part of one.

reward. Once employees have been awarded private medical insurance, for example, does its receipt continue to motivate the employee?

Non-financial rewards

Team working

The use of team working as a reward can include the use of cell production, where groups of employees will be given the responsibility to produce a certain product. It is hoped that this will draw the employees together to pursue a common goal: the production of more products of a high quality. When cell production is used it is not unusual for an element of competition to exist between different groups. Each group then tries to outperform the others and to produce the highest number of products and of the highest quality. This group cohesion also meets some of the social needs as identified by Maslow because there will be constant interaction between the members of each cell. Other motivational needs are also frequently met by the use of team work including the desire to be trusted and to be given responsibility as such teams are also often expected to suggest ways in which their work pattern or method could be improved. This shows that their knowledge and abilities are being recognised.

Status rewards or recognition of achievement or effort

Some businesses achieve this by naming an "employee of the month" although the means by which such an employee is selected should be seen to be fair and unbiased. If any element of unfairness is suspected then this can demotivate the employees who are not selected. Giving an employee a recognised status in a business can be a strong motivator. This can be achieved by giving extra responsibility to an employee that to some extent raises their status in the eyes of other employees.

Promotion opportunities

Achievement can also be rewarded by giving a promotion to those who meet, and perhaps exceed, expectations in their performance. Sometimes only a small promotion is needed to give an employee the feeling that their efforts have been recognised and appreciated. One drawback to promotion is that there are a limited number of promoted posts available in any business. The belief that promotion is a possibility for those who perform well can be a strong motivator for some employees.

Job design or redesign

Job redesign involves changing the tasks involved in a particular role within a business to make the job more challenging and interesting for the employee. There are times when the job itself is the cause of dissatisfaction. It might be that the work is not challenging enough to motivate people or that the actual tasks are very monotonous and therefore the employee becomes bored. This can be costly to a business because a bored employee is more likely to lose concentration and to make mistakes. Jobs can be redesigned by using job rotation, job enlargement or job enrichment. Quality circles can also be used to make employees feel as though their efforts are appreciated and valued. Quality circles can consist of employees from all level within the organisation

Key term

Empowerment: the giving of power to employees so that they can make some of the decisions relating to their area of business activity.

Link

See also AS Level Chapter 2.1 Management and leadership where leadership styles are discussed.

Key term

Employee participation: the involvement of employees in some business decisions.

Getting it right

When a question asks for "non-financial" means of motivation, make sure that you do not include financial fringe benefits such as company cars or the payment of school fees. If you choose to include fringe benefits, make sure you include those with no direct financial implications.

who will meet to discuss problems and to suggest ways in which the problems can be resolved.

Empowerment

Many businesses now use empowerment as a means of motivating employees. This gives employees a feeling of importance and of being valued and trusted by their managers. This is a form of delegation, and as such it helps to relieve managers of the burden of some day-to-day decisions thereby giving them time to devote to more important matters.

Employee participation

Employees often want to be recognised as having a good understanding of the business that they work in and also of the tasks that they are required to perform. Employee participation recognises that employees are likely to have some worthwhile ideas to contribute to the business and that, in some instances, they might have a better solution to a problem than their managers. For example, the employees actually doing a job might be the ones who are most able to suggest how improvements could be made to how the work is done. They might be able to suggest a different way of working that could improve efficiency and possibly reduce costs for the business. By involving employees in this way they feel valued and appreciated and are likely to work harder for the business.

Non-financial fringe benefits

Some fringe benefits do not offer a financial benefit to employees. For example, good performance can be rewarded with extra days holiday entitlement. For higher levels in the business, perhaps they can be given a designated parking space at work. These are not financial rewards, but they can be motivational perhaps by making the employees feel valued. There is no direct financial cost to the business.

How can employee participation be achieved?

- This might be through the use of staff meetings when employees are given information about future plans of the business or when they might be asked for their opinions about any proposed changes. Employees will only have confidence that their opinions matter if the points that they raise are actually acted on. If employees' views are constantly ignored they will eventually stop offering their ideas.
- Employee participation can also be achieved by appointing employees to the board of directors. The belief is that if employees are involved in decision-making at the highest level then they are more likely to be committed to any decision made. One drawback might be that some sensitive information may become available to the employees that might not be in the best interests of the business.
- Training. Training can take place for many reasons. Induction training is given when a person first joins a business and it introduces them to the structure of the business as well as to the job that they will be expected to undertake. This can make a new employee immediately feel part of the business that they have just joined. When an employee receives training this can also lead to

them feeling that their managers believe they are worth spending money on and therefore they feel valued by the business. Training can meet many of their workplace needs. For example, they might feel that their efforts have been appreciated and so their esteem needs might be satisfied. The training might make them more likely to be promoted and, once again, their esteem needs are being met. The training might also make them feel more able to reach their full potential thus meeting their need for self-actualisation.

- Fringe benefits. These are benefits/perks given to employees in addition to their wage or salary. They can include health care, extra holiday, a company car, sports facilities for employees or discounts on the products of the company. Giving fringe benefits to employees causes additional costs to the business, but if the benefits result in a more motivated and loyal workforce then the cost might be more than offset by an increase in efficiency and profitability.

Getting it right

When answering a question on motivation remember that you must use the relevant motivation theories to explain "how" or "why" something might have happened or could be resolved. It is not sufficient to just *describe* the theories.

Link

See also AS Level Chapter 2.3a Human resource management for further information on training.

Getting it right

If there is a context given in a question, e.g. manufacturing or retail, make sure that you give examples in your answer that are relevant to that particular situation. Also take note if the question asks you to discuss "how" or "why" as each word requires a different approach.

Case Study

P & A Textiles

Patrice and Adriana have run their T-shirt manufacturing business successfully for many years. However, over the past few months they have noticed an increase in absenteeism and also a rise in the number of employees leaving to take up work elsewhere. They are worried that this might be because of the growth that the business has experienced in the past three years. Three years ago they employed ten people and today they employ 45 people. Each employee makes complete T-shirts and they are all paid the same hourly rate. As the business has grown, Patrice and Adriana have relied on the more experienced employees to make sure that the newer members of staff are working to the required standard. They are becoming very worried because in the past three weeks four of their most experienced employees have said that they wish to leave as they have been offered work as supervisors in another local clothes manufacturing business. Over the last three or four months they have also noticed an increase in the number of faulty products being produced which is costing them a lot of money due to the wasted time and materials.They have also noticed that productivity levels have begun to fall.

1 Explain two possible causes for the increase in absenteeism and labour turnover.
2 Explain two ways in which Patrice and Adriana might motivate their workforce.
3 To what extent might Patrice and Adriana benefit from treating their long-serving employees differently from those who have recently joined the business?

Progress questions

9 Identify two financial rewards that might be given to employees.
10 Identify two non-financial rewards that might be given to employees.
11 Explain one situation in which financial rewards might not be appropriate.
12 Give two benefits of team working.

Exam-style questions

1 Explain two benefits of using non-financial methods of motivation. [3 marks]
2 Outline two disadvantages of using financial methods of motivation. [3 marks]
3 Briefly explain two ways in which a manufacturing business might meet the motivational needs of its employees. [5 marks]
4 Discuss how the owner of a retail clothes business might motivate their employees. Your answer should refer to motivation theories that you have studied. [20 marks]
5 Discuss the importance of motivation in a manufacturing business. You should relate your answer to the work of motivational theorists that you have studied. [20 marks]

Key concepts

AS **Change** can be explored through the impact of changes in employee behaviour over time and factors influencing it.

AS **Management** can be seen through the ideas of using motivation theories and practices to achieve objectives.

AS **Customer focus** can be considered through the links between motivation and customer perceptions.

AS **Creating value** can be developed through a link between motivation and quality.

AS **Strategy** can be developed in the context of strategic decisions for improving motivation.

Progress check

You should now be able to:

AS analyse and evaluate different motivational techniques and their appropriateness in a variety of situations

AS recognise and explain the theories put forward by different theorists

AS analyse and comment on the relevance of the theories in a given situation

AS make a distinction between financial and non-financial motivation methods and discuss how they can influence the motivation levels of different types of employees

AS appreciate the role of employee participation in the management and control of business activity.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **AS** the role of HRM in helping an organisation to be able to meet its objectives
- **AS** the involvement of HRM in recruitment, selection, training, advice and guidance, and workforce planning
- **AS** the meaning and significance to a business of labour turnover
- **AS** the various methods of recruitment and selection and the usefulness of such methods
- **AS** the purpose and content of job descriptions, person specifications and job advertisements and the difference between them
- **AS** the significance of employment contracts
- **AS** the role of HRM in redundancy and dismissal procedures
- **AS** how HRM contributes to staff morale and welfare and to staff training and development

Key term

Human resource management (HRM): this is the function of ensuring that the employees of a business can be and are being used in the most effective way possible.

2.3a Human resource management (HRM)

What is the purpose of human resource management?

The purpose of human resource management (HRM) is to make sure that the business has the appropriate human resources to enable it to meet its stated objectives. Many large businesses readily accept that if they are going to be in a position to achieve ambitious goals, then their workforce must be fully committed to achieving those goals too. The workforce must be committed and physically capable of doing the work required. It is for such reasons that large companies regard the human resource department as essential. This department will help employees to understand the philosophy behind the business's stated objectives. The human resource management department will help to equip the workforce with the skills and knowledge to allow them to contribute to the company. They will recognise that employees must be physically and psychologically healthy if they are to work to their maximum capabilities. For this reason the welfare of employees is considered to be of paramount importance. Many businesses state one of their objectives as being that they want their products to "exceed customers' expectations". The achievement of that objective requires a healthy and motivated workforce, and the human resources department can help with that by undertaking the following roles:

- Recruiting new staff when additional personnel are required.
- Selecting the appropriate recruits from the applicants.
- Arranging for any necessary training to take place; this can be for new recruits or for existing personnel who need to acquire new skills or upgrade their existing ones in order for the business objectives to be satisfied.
- Being involved in the appraisal of staff and the recording of performance indicators.
- Giving guidance and advice to the management and to the employees on matters such as employment contracts, staff training and development and redundancy issues.
- Dealing with disciplinary and grievance procedures and advising management and employees on the issues in question.
- Maintaining high levels of staff morale and welfare.
- Giving advice to employees who want to know what training and skills they need to acquire if they are to progress to a higher level within the business.
- Negotiating with different parties involved in the business, e.g. employees, management and trade unions.

- Workforce planning. This involves finding out what the future labour requirements will be and then comparing those needs with the current workforce in order to ensure that the business will have the correct number of employees with the appropriate skills.
- Dismissing staff when appropriate.
- Carrying out the process of a redundancy procedure when necessary.
- Ensuring that all relevant employment legislation is followed and dealing with issues arising from this if the legislation is breached.

Progress questions

1 Explain three functions of the human resource management department.

Recruitment

The amount of time that any business needs to spend on recruitment can depend on its rate of labour turnover. A business with a high rate of labour turnover will have to devote more time and resources to the recruitment and selection process.

Key terms

Recruitment: identifying the need for an employee, devising a job description and finding a person suitable to fulfill the needs of the job.
Labour turnover: the number of employees leaving a business in a given time period, expressed as a percentage of the total number of employees. It is calculated as follows:

$$\frac{\text{Number of employees leaving in a year}}{\text{Total number of employees}} \times 100$$

Possible causes of a high rate of labour turnover include:

- Better opportunities arise with another business
- Some employees reach retirement age
- An employee might be dismissed
- Employees might be made redundant if the need for their job no longer exists
- Low pay and poor working conditions
- Low morale in the workforce.

There are many circumstances that can lead to a business wanting to recruit new employees:

- The business has grown and simply requires more employees
- Some employees are leaving to take up employment elsewhere and replacement employees are needed

- The business might be planning to introduce a new product or service and therefore needs employees with skills and experience that the current employees do not have
- The business might have relocated and therefore needs to recruit employees in the new locality.

Workforce planning

Before a business begins the process of recruitment the future needs of the business should be compared with the workforce that is currently employed. This must be in terms of the numbers employed and also the skills available within the business. This is known as workforce planning. Workforce planning ensures that a business has the right number of employees with the right skills in the right place at the right time. This can involve making some employees redundant or recruiting additional employees depending on the needs of the business.

Key term

Workforce planning: to assess the number of employees and the skills required to meet the future needs of the business. To compare that with the number of employees currently employed and the skills and experience of those employees.

When a business has several branches, sometimes fewer employees are needed in one branch and more in another. This would require employees to be transferred from one branch to another. Such transfers of staff need to be planned carefully in order for the employees to be where they are needed at the right time. Some employees might not be willing to transfer to another branch if it is some distance from their current place of employment and requires them to relocate themselves and their family. This can be disruptive to the family, for example if the employee has children who go to school they would need to change to a school in the new location.

If workforce planning reveals that fewer employees will be required in the future then redundancies will need to be made. This can be costly to businesses due to the redundancy payments that are often incurred.

There are times when some jobs are no longer required but new jobs will be created perhaps due to a change in the range of products being produced. In this case, redeployment to one of the new jobs may be a solution rather than making an employee redundant. This might require some training to be undertaken in order to make sure that the employee has the correct skills to do the new job.

Key terms

Redeployment: to move an employee to a new task or role within the business.
Skills audit: finding out what skills and experience employees have whether or not they are currently relevant to the work they do within the business.

If some employees have left the business then the first step is to decide if those employees need to be replaced. Sometimes it is possible and preferable to redesign the jobs of those remaining in the business rather than to recruit replacement employees. It is also useful for a business to conduct a skills audit of its staff because employees often have skills and experience that their employer is unaware of but which might prove useful to the business. Some employees' skills and experience might not have been disclosed to employers because they were not relevant at the time of being appointed to their current job or because they have been acquired since starting work with their present employer.

Internal and external recruitment

Once it has been decided that a position in the business needs to be filled, the decision needs to be taken about whether or not the post can be filled by someone already working within the business (internal recruitment) or whether the post should be filled by someone from outside the business (external recruitment).

There are some advantages and disadvantages to each of these approaches, particularly when the post is a promotion.

Table 2.3.1 Advantages and disadvantages of internal recruitment ▼

Advantages	Disadvantages
• The candidate is known to the business. • Can be motivating to others if they feel that they might be rewarded with promotion in the future. • Can be less expensive as the recruitment and selection process will be shorter and also less training might be required.	• Can cause dissatisfaction for those not promoted. • Can cause line management problems for the promoted person if they now supervise former colleagues. • There might be a better applicant externally.

Key term

Selection: the process of choosing an appropriate person to fill a post within a business.

Table. 2.3.2 Advantages and disadvantages of external recruitment ▼

Advantages	Disadvantages
• Brings in "new blood" and new ideas. • Possibly fewer line management issues.	• The new employee does not know the internal structure of the business as well as someone who already works there. • Internal applicants might be unhappy that a "stranger" has got the job. They might feel undervalued by the business.

Progress questions

2 Explain the difference between internal and external recruitment.

3 Discuss possible reasons why external recruitment might be more beneficial to a business than internal recruitment.

Recruitment process

The first step is to decide exactly what is required, i.e. what tasks will the person be expected to undertake (job description). The next step is to outline the qualifications, skills and experience that the applicant will be expected to have (person specification). When a post becomes vacant it is not always necessary or desirable to keep the job exactly as it is. A job analysis is often undertaken which involves looking at what tasks and responsibilities are involved in the job in question. This is an opportunity to change the content of the job by changing the tasks that are included in that particular job before any steps are taken to recruit someone to fill the post.

Key terms

Job description: outlines the details of the job such as the job title, tasks and responsibilities, pay scale and holidays.

Person specification: outlines the essential and/or desirable personal qualities and qualifications that applicants should possess.

Job analysis: identifying the tasks and responsibilities included in a specific job.

Job description

This gives information such as the title of the job, e.g. production line supervisor, and the tasks and responsibilities involved in the job. For example, a production line supervisor would be expected to supervise

and monitor the work of a team of assembly line workers. They could also be responsible for maintaining a certain level of productivity within their team and also for reporting any production issues to the production manager.

The job description would also set out what the pay scale is likely to be (this is often experience-dependent) and how many days' holiday the employee would be entitled to (this is often linked to length of service).

The job description also usually states who the successful applicant would report to whether directly or indirectly. In the case of a business with more than one branch or department, the job description would also tell applicants where they would be working if successful.

Marketing Assistant

Clearsky Holidays is an exclusive collection of exceptional holiday accommodation based in West Malaysia with its office in Kuala Lumpur.

This is a newly created role within the small team at Clearsky. The business was established in December 2009. We are now looking to expand our team to support our growing business with a dedicated marketing assistant.

We pride ourselves on attention to detail and on giving our guests a very personal service. This will only be possible with a team that is as passionate and enthusiastic about our business as we are.

Outline of the work

The successful applicant will be required to:

- Work with the director to develop and implement our marketing strategy.
- Support day-to-day tasks required to deliver our tailor-made service to our ever-expanding client base.

An increase in revenue will be the key performance indicator for this role, which we expect the successful candidate to generate by working "hands on" with our close-knit team to maintain our excellent media coverage and high level of guest satisfaction.

Pay
Rm14 400–Rm17 000 depending on experience
37 hours per week
28 days paid holiday per year

Person specification

This outlines the personal qualities, skills and qualifications that the successful applicant would be expected to have in order to fulfill the role effectively.

For example, in the case of a production line supervisor, they might need to be a good team member and also have the ability to lead a team of employees towards stated goals. They might also need to be highly literate and numerate in order to be able to give accurate reports to their line manager. Due to the nature of the work, the person specification

might also state that applicants must be competent in the use of CAD/CAM and all related issues. They would probably be expected to have well-developed IT skills.

It is possible that the person specification will distinguish between the qualities, skills and qualifications that are essential and those that are desirable but not essential. This indicates to potential applicants that they should not apply if they do not possess the attributes that have been identified as essential.

Person specification for the Marketing Assisant at Clearsky Holidays

Requirements

Applicant must have:

- Relevant degree in marketing or related subject
- Excellent communication, negotiation and interpersonal skills
- Full driving licence

Ideally with experience of creative writing for media coverage, and developing and delivering marketing strategies and campaigns.

Key skills: High standard of written and spoken English to enable excellent customer communication. Good working IT skills such as Excel, Word, email and Photoshop. A good working knowledge of digital and social media is also required.

Applicants should have a genuine passion for our business, flexibility, attention to detail, and a willingness to learn and adapt to change as the company grows and changes.

Advertising the job

Once the job specification and the person specification have been completed the job must be advertised. It is essential that the advertisement is designed to attract the appropriate type of applicant. It is necessary to include in the advertisement all the relevant information that can allow prospective applicants to decide whether or not they might be suitable to fill the post. If an advertisement attracts several unsuitable applicants then time will be wasted filtering these out from the suitable applicants. It might also lead to fewer suitable people applying for the post. It is not only the content of the advertisement that must be appropriate but also the media that is used. If it is a higher management post that is being advertised then an advertisement in a local newspaper might not reach a large enough pool of suitable applicants. Perhaps a management journal would be more appropriate in the case of a more senior position.

It can be difficult to achieve a balance between including sufficient information to attract applicants and putting in too much information which might make the advertisement lose its visual impact.

The following need to be included in a job advertisement:

- Job title
- Job location

Activities

Draw up advertisements for the following vacancies:

- A waiter or waitress to work at a local fast-food restaurant
- An office assistant to work in the office of a local accountant
- A manager for a new branch of a large international hotel.

- Essential skills, qualifications and personal qualities
- Brief outline of the job responsibilities
- Pay scale
- How to apply (curriculum vitae (CV), letter or telephone call, or online)
- Who to apply to (this can be the business itself or a specific person in the organisation, or it might be through an agency).

The content of an advertisement must comply with all national and local legislation. For example, in the European Union legislation regarding equality must be followed. It is not legal to advertise specifically for a male or a female or for someone from a particular religion or ethnic group to fill a particular post except in very specific and limited circumstances.

Other recruitment sources

There are other ways in which a business can reach potential employees other than by directly advertising posts. Some of the methods frequently used are outlined below. The job details would be circulated to appropriate people in the search for a new employee.

Recruitment agency

The details might be passed to a recruitment agency and therefore the responsibility for finding suitable applicants is delegated to the agency. This saves time for the business although it can be expensive because agencies usually charge the business a percentage of the annual salary paid to the successful applicant. The business itself would not need to become directly involved until applicants have been shortlisted by the agency, thereby saving time and some internal costs.

Headhunting

A recruitment agency might also be involved in "head hunting" a suitable applicant or it might be done by someone within the business that is seeking personnel. This involves making a direct approach to a specific person who is perhaps very well known and highly regarded in a particular industry. One danger of recruiting someone in this way is that if they have been prepared to be enticed away from a job to take up a position in another business then they might be prepared to do it again and therefore might leave the business after a short time if they get a better offer.

This might be seen as unethical by some businesses although others see it as a legitimate way of recruiting.

Government careers/job centres

In some countries, governments provide a network of offices through which job vacancies can be advertised. Such offices can often also provide links to training schemes that might be producing potential employees. Often these offices are mainly dealing with local jobs for local people although sometimes job opportunities in other parts of a country might be notified to each branch.

Websites

There are now many websites where people looking for work can post their CVs. This is done so that any business wishing to recruit staff can search for people who meet their requirements and can then contact the individuals concerned. This will depend on the business involved. It is unlikely that a local electrician will use the Internet to find a new employee, but a large business with branches in many countries may look online.

Many websites are dedicated to advertising job vacancies. This provides another way in which businesses can make their vacancies known to potential applicants.

Personal contacts

Some businesses might be able to find new employees by using the friends or family of their current employees. Many businesses that recruit within their own locality might simply ask all of the current employees if they know of anyone who would want a job with the business.

Progress question

4 Analyse the possible methods of recruitment that might be used by a major retail company that is seeking to employ a new senior manager.

Selection

Once a business has attracted applicants for an advertised vacancy, the task is then to select the most suitable applicant to fill the post.

This is done as follows.

- The first step is to check that applicants have the "essential" skills and qualities required. Any applications from candidates who do not possess the necessary skills and/or qualities will be rejected. This is achieved by matching the qualities, skills, experience and qualifications of the applicants to those in the job specification that are stated as being essential.
- Once the applicants who meet the "essential" requirements have been selected, further details from their application will be considered.
- At this stage the "desirable" qualifications and qualities will be considered. Some applicants might have more experience or more varied experience than others, which could make them more suitable for the post on offer. It is often the extent to which the "desirable" elements have been met that can distinguish between applicants.
- Most application forms have a space for the applicant to add "other information". It is here that applicants can make themselves stand out from other applicants by outlining what additional experience they have or what ambitions they have. Sometimes non-work-related experience can be useful. For example, if a person is applying for

their first supervisory role, they will not have had any supervisory experience. However, they might have captained a school football team or a debating group. This can show that they have some experience of leading and supervising people and such experience can be relevant because it can be transferred to the workplace.

At this stage the business will have selected a shortlist of applicants that might be suitable to fill the advertised post. A shortlist is a small list of applicants who are judged to be the most suitable for the vacant post.

Selection methods

A range of methods can be used to select the right person for the job from the shortlist:

- Interviews
- Aptitude tests
- Psychometric tests
- Demonstrations or presentations.

Interviews

These can be informal or formal. The shortlisted applicants do not always need to visit the business as they might be interviewed by telephone. An informal interview might involve a telephone call or a relaxed discussion over coffee or lunch. A formal interview might involve the applicant being questioned by one or more people. The interviewer or interview panel will usually decide, before the interview, the questions that will be asked of each applicant. The questions will be designed to gain information from the applicants that the interviewers feel is necessary to allow them to choose the best person for the job. An interview also allows the people doing the recruiting to assess the appearance of the applicants as well as their body language when they respond to questions.

How effective are interviews?

Interviews allow the interviewer to ask follow-up questions if they feel that they are not getting the information or response that they expected or require from the applicant. However, interviewers need to be aware that applicants can practise their interview technique and, if appointed, their actual performance and ability to do the job might not be as good as the impression given at interview. Some people can become very good at saying what they know people want to hear and therefore might not be absolutely truthful in their answers to questions at interview. The successful outcome of an interview can often depend of the skill and experience of the interviewer and how good they are at asking the right questions and judging the responses given.

Aptitude tests

These are usually related to the skills required by the job in question. The tests can include practical tests requiring the applicant to perform some part of the work that they are applying for. For example, if a

Getting it right

Be careful not to confuse recruitment and selection methods. Take note of what questions are asking you for and remember to be aware of the difference between recruitment and selection.

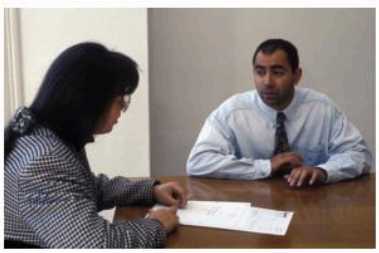


Figure 2.3.1 A job interview in progress ▲

person was applying for an administrative post, they might be asked to produce a document using a computer because they would need to demonstrate this ability in order to be considered for the post. If the work was on an assembly line, the applicant might be asked to assemble one or two components so that their ability to handle the items could be assessed.

How effective are aptitude tests?

A person who has done similar work before might perform very well, while someone who is attempting a task for the first time is likely to perform less well. However, with some training the employee without experience might prove to be the better choice.

A person capable of carrying out the given task might not perform well during the test due to nervousness but might be capable of a high level of performance in a daily employment situation.

However, aptitude tests can identify those potential employees who already possess appropriate skills and who would require little or no training if appointed.

Psychometric tests

These are designed to give more information about the applicant's personality. For example, a role play might reveal whether or not the applicant works well as part of a team. Psychometric tests often take a written form that asks a series of questions designed to assess an applicant's attitudes and decision-making ability. If teamwork is a requirement of the job then this test would give important additional information to the interviewer(s). Such tests can also be designed to give an indication of how a person might react to a highly pressurised situation. This might be useful if the job in question is likely to put the successful applicant in a stressful situation, for example if urgent changes need to be made to a product and the timescale available to make the required changes is very short. Not all people are able to work effectively under pressure.

Demonstrations or presentations

Applicants might be asked to prepare a short presentation. For example, they could be asked to talk about why the job is so important to them. If they are applying for a supervisory post, they might be asked to explain how they would handle a difficult situation within their team. Candidates are usually given warning that they will be asked to make a brief presentation so that they can prepare. A person applying for a teaching position is often asked to prepare a short lesson on one of the topics that they will be teaching if they are successful.

How effective are demonstrations or presentations?

Such exercises allow an employer to see the person's ability to present themselves and material and can help to judge the applicant's organisational skills and their creativity in producing materials for a presentation.

However, the applicant might have practised and prepared for a long time in order to produce a short demonstration or presentation and might not be able to produce the same quality of work in a more time-constrained work environment.

Problems with selection methods

All of these methods are designed to give the business more information about each candidate and to assess who is the most suitable person for them to employ. However, none of these methods are perfect and it is still possible that when a new employee joins a business the appointment proves to have been a mistake. This can happen for a variety of reasons:

- The person performed well on the day of interview or test but has not been able to sustain a high level of performance once actually employed.
- The person appointed might find that the job is not as interesting or fulfilling as they thought it would be.
- Any tests administered might have failed to reveal other shortcomings in the person. For example, they might be good team members and physically capable of doing the job but they might be consistently late for work or frequently absent from work.

If an unsuitable appointment is made this can prove very costly to the business. It will have to dismiss the employee and it must make sure that the way in which they are dismissed complies with the laws regarding employment.

Progress questions

5 Explain two methods of selection that might be used to select a new sales manager for a car retailer business.
6 Outline two advantages of using interviews as a method of selecting a new employee.
7 Analyse the usefulness of using any two methods of selection when recruiting a new manager for a clothing retail store.
8 Assess the importance to businesses of having an effective recruitment and selection process.

Employment contracts

Key term

Employment contract: a legal agreement between the employer and employee setting out terms and conditions that apply to an employee.

Once a new employee has been appointed they should be given an employment contract. In some countries this is required by law and must be in place within a specified time from the date of the employment starting. The time by which a contract must be issued varies from one country to another. For example, in Mauritius, any business employing more than ten people must issue a written statement within two weeks to anyone who will be employed by the business for more than one month.

Employment contracts can be written or verbal and contain some implied terms as well as those stated explicitly in the contract document. In an employment contract an implied term might be that the employee expects the employer to provide a safe and healthy working environment. The employer can reasonably expect that the employee performs their designated duties to the best of their ability and with all reasonable care. Some countries insist that employment contracts must always be written because a verbal contract term can be difficult to prove in the case of a dispute.

Activity

Find out what the law is regarding the issuing of employment contracts in your country. Investigate what they must they contain and how soon must they be issued after the start of employment.

What is contained in an employment contract?

- An outline of what the job is, including the job title.
- A broad outline of the duties and responsibilities of the employee.
- The length of the contract if relevant; some contracts are for a specified period such as six or twelve months.
- The normal hours of work.
- The pay scale and how payment will be calculated, e.g. on a piece rate system, hourly or daily rates. The contract should also give details about when payments will be made, e.g. weekly or monthly.
- Any holiday entitlement. This will outline how many paid days holiday the employee will be entitled to and any changes to that entitlement that occurs as a result of longer service.
- A statement of how the contract can be ended, for example a statement that the employee and the employer would each need to give one month's notice in writing in order for the contract to be terminated.

The benefits of having an employment contract

- Both parties are clear about the terms and conditions that have been agreed
- The employer and the employee both know what a person has been employed to do because this would be clearly stated in the contract that would be signed by both parties
- Any dispute about the terms and conditions of employment could be resolved by referring to the employment contract.

How can an employment contract be terminated?

- If the employer and employee agree to changes in the contract of employment, the new contract and the terms in it would negate any earlier employment contract.
- The employee can resign in order to take up employment elsewhere.
- The employee might reach retirement age and therefore not wish to continue in employment. The contract would then end by mutual agreement.
- The employee might be in breach of contract and therefore the employer might be able to dismiss them.

- The employee might have broken the terms of the contract causing the employee to wish to leave their employment.
- The term of the contract might have come to an end. For example, at the end of a 12-month contract the employment contract between the employer and employee is automatically terminated if not renewed.
- The employee might be promoted, in which case their role and responsibilities would probably change. They might also be entitled to more holidays or a change in the way that they will be paid; for example they might be paid monthly rather than weekly. A promotion or substantial change in the job being done should be confirmed by issuing a new contract of employment.

Case Study

Helenex expansion

Helenex Ltd is planning to expand the workforce at its Bangalore site by 200 employees due to a large contract to supply its products, taking the size of the workforce there to 1350. The contract is for one year after which time it will have to be renegotiated. Mr Patel, the production manager, has told the human resource management department that the workers are possibly only going to be needed for 9–12 months and therefore they should not be issued with a contract of employment. The HR manager, Afia Shah, has told him that he is required by law to give each new employee a contract of employment.

Mr Patel has also said that while they are going to be getting applicants from many highly skilled people this could be a good opportunity to make some of the less-efficient employees redundant. He has said that there are approximately 15 of these employees.

1 Explain, giving your reasons, who you believe to be correct regarding the issuing of contracts of employment.
2 Discuss possible reasons why Mr Patel may be able to make some employees redundant without being in breach of their employment contracts.

Key term

Redundancy: when an employee loses their job when the business no longer requires that work to be done.

Redundancy and dismissal

What is the difference between redundancy and dismissal?

Redundancy is when the business no longer requires a particular job to be done. It is important to remember that it is the job that is no longer needed, not the person doing the job. It is often inevitable that when the requirement for a job no longer exists, the person doing that job will no longer be employed. However, many businesses will try to find alternative work for employees whose jobs have become redundant. Moving employees to another job might involve the business in some extra costs as the employee might need additional training in order to transfer to the new tasks.

Link

If you are doing the full A Level, there is more on trade unions in A Level Chapter 2.3b Human resource management: further functions of HRM.

In many countries, businesses are required to discuss possible redundancies with the appropriate trade union before making their plans known publicly.

When employees are to be made redundant the process is usually handled by the human resource management department. It must always ensure that the redundancies are lawful and that all correct procedures are followed.

Key term

Dismissal: terminating a contract of employment because the employee has not fulfilled the conditions of the contract in some way.

Getting it right

Remember: redundancy is when the job no longer exists; dismissal is when the contract of an employee is terminated earlier than expected. A question might be specific to one or the other, so read carefully!

Dismissal is when the employment contract of an employee is terminated. Other than in exceptional circumstances, this should be a last resort when all other options such as disciplinary procedures and possibly training programmes have been exhausted.

Why would an employee be dismissed?

- For failing to perform their duties to a standard required by the employer. Dismissal for this reason should be after attempts have been made to train the employee. Alternatively, it could be because the employee had claimed to be capable of doing a job but, once appointed, was judged not to be able to complete the required work. In the latter example, the employee had made false claims about their ability and therefore the contract of employment could be ended.
- For persistent absenteeism if a valid reason for the absence was not given.
- For being persistently late for work. In some businesses this can cause a delay in the output of other employees if the work process involves passing work from one employee to another. The absent employee would be a missing link in the chain of production. Dismissal would not be appropriate for one or two instances of lateness but rather a warning should be given. If the lack of punctuality is repeated then perhaps some disciplinary action needs to be taken before dismissal is considered.
- For using violent or threatening behaviour in the workplace. If the incident was not too severe, the employee might first be given warnings about their behaviour. If the behaviour did not improve then dismissal would be appropriate. However, some incidents would justify instant dismissal. For example, if an employee violently attacked another employee causing them some injury, the incident would be serious enough to justify immediate dismissal.
- For failing to disclose relevant details when being offered employment. For example if a person was employed in a cashier position but did not reveal that they have a criminal conviction for the theft of money from a previous employer. However, dismissal would not be justified if the criminal offence was for a non-related incident. For example, if an employee was found to have been convicted of driving dangerously but was employed as a cashier, the conviction would not be relevant to the employment and therefore would not justify dismissal.
- For causing damage to products or to the property of the business.
- For the theft of products or property from the business.

The last four reasons in this list would justify instant dismissal without any payment being made in lieu of notice being given.

Activities

1 Investigate the current legislation regarding redundancies in your country.
2 Find out what would justify instant dismissal from employment according to the current legislation in your country.

Case Study

Jobs to go at Brevia plc

Brevia plc has announced that 10 per cent of its workforce will be made redundant when the current government contract for waste disposal comes to an end in April next year.

The company currently employs 750 workers and is advertising 50 new posts in its new waste processing department. The new department will concentrate on recycling waste materials rather than disposing of waste into landfill sites as previously. The employees will need to have technical experience of recycling processes whereas the employees who will be made redundant are unskilled.

Some of the employees who face the possibility of redundancy are claiming that this is unlawful because there are jobs available in the business.

1 Explain whether or not the redundancies are lawful.
2 Briefly explain if there are any actions, other than redundancy, that Brevia plc can take.

Maintaining staff morale and welfare

Key terms

Morale: the confidence and enthusiasm people feel about their work and the business.
Welfare: the health and happiness of the people employed by a business.

The human resource management department will often deal with issues that can directly affect the morale of the employees. It is important that employees feel positive about the business that they work in. Any negative feelings can result in lower-quality work and an increase in absenteeism and labour turnover and a lack of punctuality, all of which can prove costly to a business. The welfare of employees is also important because any employee who is experiencing problems will not be able to fully apply themselves to their work. For example, an employee who has been told that they must move from their rented house at the end of the month will be very worried if they cannot easily find somewhere else to live. A fall in the level of production can sometimes be caused by factors outside of the business environment. It is in the business's interests to help the employee to resolve such issues and thus help them to be able to concentrate when at work rather than worrying about issues such as housing.

How can the HRM department maintain or improve staff morale and welfare?

- Ensure that health and safety guidelines/legislation is met. Staff welfare can be affected both physically and psychologically. The physical welfare of employees can partly be assured by the following of strict health and safety measures. Most countries have health and safety legislation that dictates some basic rules that all businesses must follow. The economy of some countries is largely dependent on a key industry and legislation is sometimes passed that is specific to that industry such as the sugar industry in Mauritius. The HR department would have to make sure that such legislation is followed. It would also have to deal with issues resulting from incidents that are caused by a breach of health and safety regulations.

- Offer help and guidance to employees who might be experiencing problems in their life outside work. Some problems can affect the ability of employees to work effectively. For example, if they have recently experienced a death in the family or the serious illness of a child, they may need financial help or guidance on what benefits can be available to them in order to help them financially. The HR department would usually have information that could be helpful to the individual involved. Although the problem is one that is external to the business, it is in the business's interests to help their employee because they are less likely to be working effectively while they have such serious worries.
- Provide medical facilities within the business in order for the employees to get treatment for any injuries or ailments. This can benefit the business by making sure that their employees get treatment and therefore can be fit for work quicker than they would if no treatment was available to them. In some countries medical treatment is very expensive and for this reason people might avoid getting treatment, which could allow a medical condition to worsen and therefore make the person unfit for work.
- Be aware of the psychological welfare of employees. In order for staff to be most effective at work they need to feel motivated to work hard for the business. The HRM department would be expected to deal with issues that are demotivating employees and to try to find some way of removing or improving the demotivating factor. There are also many motivation techniques that require the involvement of the HRM team such as managing a system that rewards good performance. This would probably involve an appraisal system the results of which would be recorded in the personnel files of employees and kept by the HRM department.
- Follow equality and diversity guidelines. Employees need to feel that they will receive fair treatment and will have the same opportunities within their organisation regardless of their gender, race, religion or any other aspect of their background. Businesses will sometimes actively recruit or promote people from a certain background in order to ensure that their workforce is representative of the diversity of the population in a particular locality or country. A business that functions in a multicultural society will aim to recruit employees from as many of the different nationalities as possible. This will also include recruiting people who follow various religions. However, there have been occasions when a business has appointed a person because of their race or religion rather than for their ability. If this kind of positive discrimination takes place it can sometimes be demotivating to members of staff who do not match the profile of the person being employed or promoted.

  The equality and diversity should develop naturally from a desire to recruit openly and honestly the best people as employees regardless of their background.

Activities

1. Find out if your school has diversity and equality guidelines.
2. Use the Internet or other methods to find out if a large business in your country has such policies.

Key terms

Equality: to treat each employee in the same way regardless of race, colour, religion etc.

Diversity: to ensure that the workforce reflects the differences between people found within the country, e.g. in terms of ethnic origin or religious beliefs.

Key term

Work–life balance: prioritising of the amount of time and effort spent at work and the time committed to life outside of the workplace. The aim is to maintain a sensible balance that allows career and ambition needs to be met as well as family and friendship needs and commitments.

Link

Motivation is covered more fully in AS Level Chapter 2.2 Motivation.

Key terms

Training: teaching work-related skills.

Induction training: training given to new employees to familiarise them with the business and their role in it.

Figure 2.3.2 An unbalanced work–life balance can cause stress ▲

Key terms

On-the-job training: training that occurs at the place of employment and is directly relevant to the job being done.

Off-the-job training: training that occurs away from the workplace and which is not always directly relevant to the tasks being performed in a business.

- Encourage an appropriate work–life balance. Employees, particularly those who are especially ambitious, can work so hard that they leave little time and/or energy for their life outside of work. It is recognised that employees are able to be more productive when they have a suitable amount of leisure time. This allows them to return to work refreshed and rested and ready to work to the best of their ability. This is likely to maintain or improve the physical and mental health of employees, therefore enabling them to be more effective in their work. Most employees will benefit from spending sufficient time with their families or from being able to pursue their hobbies. Some businesses also recognise the need for time "away from work" while actually at work. For example, Google encourages employees to take breaks and gives them the opportunity to take part in exercise, such as playing table tennis, in order to give them a change of activity and a mental and physical break from their day-to-day work. This has proved to be a productive approach because the employees feel that the business cares about their overall well-being and therefore can create a loyal and motivated workforce.

Staff training and development

Once a training need has been identified, it is the HRM department that will usually organise the training sessions. It may be that the employee is new to the business or that a line manager has identified that an employee would benefit from some training.

Training needs can arise for a variety of reasons:

- When a person is appointed to work for a business they are often given induction training.
- Employees might also need specific task-related training if their work changes in some way such as a new product being introduced. The production of the new product might require some new skills to be acquired due to new production processes being involved.
- An employee could be underperforming and therefore may be judged to be in need of some additional training in order to be faster or more accurate in their work or perhaps both.
- When an employee is promoted, training is often needed to enable the promoted employees to make the change to a more responsible post. There may be aspects of the new post that they have not had to undertake in their previous work. For example, they might need some training in how to supervise people effectively if supervising employees had not been part of their work before the promotion.

Types of training

Training can be broadly categorized into three types:

- Induction training
- On-the-job training
- Off-the-job training.

Induction training

This takes place when a new employee begins working for a business. It can vary in length depending on the type of work involved. For example, a new employee who has been recruited to work on a checkout in a supermarket may be given a half-day induction course, but a nurse appointed to work in an operating theatre is likely to be given a longer period of induction training. The nurse would need to be made familiar with the complex equipment and procedures that they would be required to work with. The nature of the work in an operating theatre is more complex than working on the checkout in a supermarket and therefore more detailed induction is likely to be necessary.

What would be included in induction training?

- Induction training usually gives a brief outline of the structure of the organisation including the chain of command and the channels of communication. This would include an explanation of who the new employee should report to and who they are accountable to.
- They would be given an employee handbook, if one exists, which would outline any rules that they are expected to follow whilst working for the business. The handbook should also provide the employee with information about the business's disciplinary and grievance procedures. If details are not included in the handbook or if the business does not produce such a handbook, the employee should be told where they can get access to details of such procedures.
- New employees might be given some task-specific training. For example, if they have been employed to assemble mobile phones they may be shown how to assemble components before they actually join the production team.

All of this input at the start of new employment can help the new employee to settle into their job more quickly. This also has the benefit of giving the new recruit the opportunity to ask questions about the business that they did not get the chance to ask when they were interviewed.

Link

If you are doing the full A Level, see also A Level Chapter 2.4 on Organisation structure.

On-the-job training

This is when training takes place as the employee does the job they have been recruited to. It can involve simply being told how to do the job and then being expected to go and do it. Alternatively, it can involve

Table 2.3.3 Advantages and disadvantages of on-the-job training ▼

Advantages	Disadvantages
• The employee is learning skills that are directly relevant to their work. The new recruit will only be taught what is specifically relevant to that business and to the work that they have been recruited to do. • They can actually be contributing to production while they are learning. • They are becoming familiar with their work environment and with the people that they will be working with. • It can be less expensive than paying for training away from the business.	• The new recruit will be using production equipment but will be working slowly while they are learning how to do the job. • The person who is training them will be losing production time. As it is usually a very experienced employee who would be asked to train new employees, it is likely that there could be a significant reduction in output from them. • The recruit might make many mistakes whilst learning and this can be costly for the business due to a high rate of scrap or unusable output being generated.

watching an experienced member of the workforce doing the work for a while before attempting the work themselves.

Off-the-job training

This is when training takes place away from the place of work. This can be at a local college or training facility. Some large businesses have developed their own training centres which are able to meet most of the training needs of the organisation. However, there are occasions when training away from the place of work can be beneficial. For example, if changes in legislation are about to occur, government departments might hold training sessions for business owners and/or managers so that they can become familiar with the changes and how it will affect the way in which their business operates. Such training meetings are likely to be held at regional centres around the country which interested parties will travel to in order to gain the updated information.

Sometimes a business might be considering introducing new equipment into the business. The introduction of new equipment often requires employees to be trained in its use. Therefore some personnel may be sent for training on the new equipment before it is actually installed in the business.

Key term

Staff development: encouraging staff to progress in their personal development perhaps by giving them additional roles and/or responsibilities

Off-the-job training may be used as part of staff development. Many businesses encourage employees to acquire additional qualifications. This might be in order to equip them for promotions or a more diversified role in the future. In some developing countries, if literacy rates are low a business might encourage its employees to attend classes to improve their ability to read and write. Some businesses are also willing to pay for such classes even though they are not of direct relevance to the work of that employee. The business could benefit in the longer term if its employees are better educated and therefore more able to understand some of the more complex aspects of business activity.

Table 2.3.4 Advantages and disadvantages of off-the-job training ▼

Advantages	Disadvantages
• The production time of experienced employees is not lost by training new recruits. • The cost of any materials wasted or damaged during training would be borne by the training centre not by the business. • A wider range of skills can be acquired than those directly required by the business. • New ideas may be brought back to the business by meeting people from outside the organisation. • The skills gained could enhance the business environment. For example, training on health and safety issues could reduce the number of accidents and injuries that occur within the business. • Training might also enable additional facilities to be offered such as a first-aid room that could treat minor injuries and ailments once some employees have received appropriate training.	• Some training courses can be very expensive. • Some of the skills acquired through the training may not be relevant to the employee and the work that they have been recruited to do.

A disadvantage of any type of training is that once an employee has gained more skills they may decide to leave the business and take up employment elsewhere. Employees can become more attractive to other employers once they have acquired a higher level of skills and there is a possibility that another business will entice them away from their current employer. Another general disadvantage is that if an employee becomes more skilled they might demand higher pay from their employer.

Progress questions

9 Briefly explain three ways in which an HR department can improve staff morale and welfare.
10 Give two advantages of on-the-job training.
11 Explain two advantages of off-the-job training.
12 What is meant by the term "induction training"?

Exam-style questions

1 Explain what is meant by the term "redundancy". [3 marks]
2 Discuss the reasons why staff training and development is believed to be essential in modern businesses. [20 marks]
3 Assess the potential problems that a business might experience if it did not use appropriate methods of selection when recruiting new members of staff. [20 marks]
4 Read the following text and then answer the questions below.

Alijandro has been making rope and twine in his family-run business for 20 years. Up until six months ago all of the employees were very experienced and could produce rope and twine of the highest standard. Very few complaints were ever received from Alijandro's customers. However, six months ago Alijandro received an unusually high number of orders for his products resulting in him having to recruit several new employees very quickly. Eight of the 15 new employees were recommended to him by some of his current employees. These people were employed without any interview or aptitude tests being carried out. The remaining seven new employees were recruited after responding to an advertisement in a local newspaper. These seven applicants were each interviewed and all of them were asked to complete an aptitude test that tested their ability to carry out the work for which they were being recruited.

Since taking on the new employees, the business has noticed a 20 per cent increase in the number of complaints about its products.

a Discuss possible weaknesses in the selection procedures used to recruit the new employees. [8 marks]
b Discuss what steps Alijandro might take to improve the quality of rope and twine being produced and reduce the number of complaints being received. [8 marks]

Key concepts

AS **Change** can be explored through changes in employee needs and workforce planning.

AS **Management** can be developed through the roles of workforce planning and managing changing needs.

AS **Customer focus** can be explored through the relationships between customers and employees and HRM factors affecting quality.

AS **Innovation** can be explored through training for innovation.

AS **Creating value** can be explored through the link between quality and value.

AS **Strategy** can be developed through corporate responses to changing HRM needs.

Progress check

You should now be able to:

AS understand many of the functions of human resource management and of the involvement of that department in recruitment and selection

AS understand the different content and the purpose of a job specification, a person specification and a job advertisement

AS analyse the usefulness of various methods of recruitment and selection in a given business situation

AS analyse and evaluate the importance of effective recruitment and selection

AS analyse and evaluate the importance of employment contracts to effective human resource management

AS understand the difference between redundancy and dismissal and the implications for a business of both

AS discuss the importance of staff morale and welfare, their contribution to a successful business and their relationship to HRM

AS discuss the importance of staff training and development and its role in improving business performance.

3 Marketing

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **AS** the role of marketing objectives in relation to other business objectives
- **AS** how price, supply and demand interact
- **AS** the key features of different types of markets
- **AS** industrial and consumer markets
- **AS** niche marketing, mass marketing and segmentation
- **AS** how businesses adapt these marketing tactics for different markets

Key terms

Marketing: the process of identifying, anticipating and satisfying customer requirements profitably.

Link

See AS Level Chapter 1.1 Enterprise for more on the difference between wants and needs.

Link

See AS Level Chapters 3.3a The marketing mix: elements and product and 3.3b The marketing mix: price, promotion and place for more on marketing mix. See also AS Level Chapter 3.2 Market research.

3.1 What is marketing?

What is the role of marketing?

Marketing is the process of identifying, anticipating and satisfying customer requirements profitably by getting the right product to the right place and time at the right price. Doing this will meet customer wants and needs and enable the organisation to at least cover all of its costs. So marketing involves finding out what customers want or might want, and what price they are prepared to pay for a product. Market research can identify opportunities. Marketing will then involve making sure that the design and production teams produce what customers want at a cost that will enable a price to be set so the business can make a profit. Customers and potential customers have to be told about the product through a range of methods including advertising, promotion and sales brochures. They must then be convinced enough to make a decision to buy, perhaps by sales staff or an attractive offer. Finally the product must be distributed to the customer in some way.

The marketing mix

These activities may be summarised by the concept of the marketing mix – the 4 Ps. This is the combination of product (design and characteristics), price (what customers are asked to pay), promotion (methods of communicating with customers including advertising) and place (the way the product reaches the customer). Each of these activities needs decisions to be taken so that the whole process is integrated.

For instance, an expensive coat uses high-quality materials and is often advertised in glossy magazines and sold in specialist clothing shops or department stores.

The common theme in marketing is communication – between areas in a business, between an organisation and the general public and between the organisation and its own customers and potential customers.

When a business is small the owners or managers are often in direct contact with the buying public and can speak to customers directly. A market stallholder does this all the time and varies the stock and how it is presented in response to people's reaction to the stall. If a lot of customers ask for bananas they will know it is worth stocking more, or to cut the price of pomegranates if hardly anyone is buying them. As a business gets larger this direct contact is less possible and a marketing department is often created. This functional area must then work together with other areas including production, human resource management, accounts, finance and operations planning to try and achieve agreed objectives without harmful conflict.

Marketing objectives and corporate objectives

Effective marketing needs to have a clear sense of direction. This comes from the overall purpose of the business as expressed in business objectives. Organisations exist in order to try and achieve certain goals

Link

AS Level Chapter 1.4 Business objectives considered the way organisations set out their reasons for what they do and we saw how important it is for every area in a business to be clear about what they are trying to achieve.

Key term

Marketing objectives: the goals or targets a business has that are concerned with marketing methods or issues.

and objectives. These may vary from one time to another or in response to changing market situations. The objectives should have a timescale attached and may be numerical, e.g. to improve profits by 8 per cent in the next year. They may be qualitative, e.g. to become the world leader in innovative products within three years.

Corporate objectives are the goals or targets a business sets out to achieve. They provide a real focus for devising activities and strategies to take place so as to achieve them. They should be definable and specific so that it is possible to measure the extent to which they have been achieved. Nestlé's corporate objective, for example, is to be the world's largest food manufacturer, whilst ensuring that the Nestlé name is synonymous with products of the highest quality. This means that its marketing objectives must be related to achieving high sales revenue rather than high sales volume. It also means that it must use good quality ingredients in its food products meaning that it will find it difficult to sell at a lower price than some of its competitors. In turn this will determine how it advertises and presents its products as giving customers qualities that other food manufacturers do not while still appealing to a mass market, not just relatively few wealthy customers.

These implications for marketing must be set out in the form of marketing objectives relating to the function of the marketing department in meeting customers' wants and needs through the elements of the marketing mix. Achieving the marketing objectives must contribute to achieving the overall corporate objective(s).

Examples of marketing objectives include reference to sales revenue, sales volume, customer satisfaction, customer awareness, customer retention rates, extending customer profiles, product ranges, product innovation, market share targets, new markets, market leadership and brand loyalty.

In Nestlé's case marketing objectives support the corporate objectives and all of them work together.

Figure 3.1.1 Hierarchy of objectives – Nestlé ▲

Activities

1 Research the corporate and marketing objectives of a business in your country.
2 Discuss how effectively they relate to each other.

Progress questions

1 Explain three marketing objectives a small business might have in its first year – make sure they are SMART (see page 51 Chapter 1.4).
2 Explain the need for marketing objectives.
3 State the 4 Ps.

Case Study

IKEA objectives

IKEA is the world's largest manufacturer and retailer of home furnishing products. It sells from its own stores in 31 countries and has suppliers in 50 countries. Its main corporate objective is to create a better life each day for people. It supports this by having a wide range of products that are extremely well designed, look good, and are easy to transport and assemble. Prices are deliberately set to try and maximise the number of people who can afford to buy IKEA products. Stores are located in low rent areas and have low-maintenance displays and a minimum number of staff.

Figure 3.1.2 ▲

1 What are the marketing objectives of IKEA?
2 The objectives in the paragraph are not measurable. For IKEA suggest measurable marketing objectives that will support the corporate objective in each of the following areas:
   a Sales volume and revenue
   b Product
   c Price
   d Promotion and advertising
   e Distribution networks and retail outlets.
3 Explain how each of these objectives supports the corporate objectives of IKEA.
4 In 2013 IKEA decided to open stores in India following a change in the law. How might IKEA's set of objectives assist IKEA in planning how to do this?

Supply and demand in a market

How a market works

Key term

Market: a place or system that enables producers of a product or service to meet potential buyers and exchange these for money.

Businesses produce products that are sold in a market setting. A market is a place or system that enables producers of a product or service to meet potential buyers and exchange these products for money. It may be a physical location like a market hall, a computer environment such as the Internet or a series of networks of suppliers and customers. The participants in a market are often thought to be producers of a product or a service and customers. The producers sell to the customers in the market. In reality many producers sell to distributors who then sell to customers. For instance, many food manufacturers sell to supermarkets who then sell to customers. The marketing activities of the producers must then be directed at both the distributor and the customer. It simplifies the process to regard producers as selling to customers.

Factors influencing supply

Key terms

Supply: the supply of a product is the quantity of products or services being made available for sale at a particular price and time.

Supply is the quantity of products or services being made available for sale at a particular price and time. The two main factors that influence supply are price and costs. If the price of a product rises, more business will be tempted to start producing that good. For instance, if woollen scarves were selling for a million dollars each, many of us would learn

to knit and start selling scarves. So if the price of a product goes up, its supply will usually rise too. The rising price of oil meant businesses invested in developing shale oil deposits (fracking), increasing the supply of oil from the deposits. It works the other way too; as prices fall there will be less incentive to produce, some businesses will not be able to stay profitable and they will leave the market – supply falls.

Costs are also an important factor in determining supply. If the costs of production go up, a business will make less profit, assuming price does not change. It therefore has less incentive to produce the product or service so less will be produced as some businesses cut back and some go out of business as they start to make losses.

Costs are influenced by four main factors.

- Costs of production – labour (wages), materials, fuel and rent. If any of these rise then profits will fall, there will be less incentive to produce, some businesses will start making losses and stop production and supply will fall. An example is the flooding in Thailand in 2011–12 that resulted in manufacturers of hard drives facing large price increases in component costs. These increases resulted in fewer hard drives being manufactured and supply fell.
- Advances in technology will often result in lower costs and so supply rises. Examples include the Green Revolution in crop growing, industries where mechanisation has occurred and the way computer/IT systems have reduced costs thus enabling supply to rise.
- Taxes and subsidies can affect supply due to their influence on the costs of production. A tax on a product increases its cost so there will be less supplied. A subsidy has the effect of making costs fall, so more will be supplied. Examples include the taxes that many countries place on tobacco products, with the effect that costs rise and affect supply or the subsidy offered to non-domestic businesses to encourage them to set up in a country.
- Government regulation can influence supply. Health and safety laws will often increase costs and reduce the incentive to produce, so supply will fall.

Key terms

Supply curve: a supply curve plots the quantity of a product supplied against its price.
Demand: the quantity of a product or service which customers are willing and able to buy at a particular price and time.

These effects may be shown on a supply curve that plots the quantity of a product supplied against its price. It is upward sloping left to right, showing that as price increases the quantity supplied will increase. Any changes in the four factors affecting supply will shift the supply curve to the right (an increase in supply due to a fall in costs) or to the left (a fall in supply due to a rise in costs). If any of the costs of production increase, the supply curve will shift to the right as shown by S to S1 (see Figure 3.1.3). If any of the costs of production decrease, the supply curve will shift to the left as shown by S to S2.

Factors influencing demand

Demand is the quantity of a product or service which customers are willing and able to buy at a particular price and time. The factors

Key terms

Demand curve: a demand curve plots the quantity of a product demanded against its price.

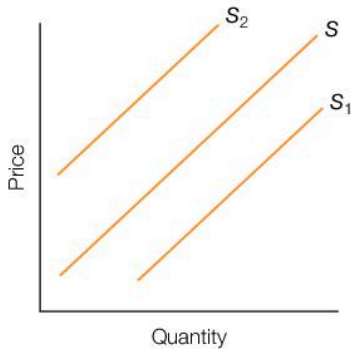


Figure 3.1.3 Shifts in the supply curve ▲

Getting it right

When assessing the impact of changes on a business, do so systematically so that you only consider one factor at a time that affects demand or supply.

Key terms

Normal product: a product the demand for which increases as income increases.
Inferior product: a product the demand for which falls as income increases.

that influence demand, and therefore affect the demand curve, are interconnected and so it is essential to consider changes in only one of them at a time, with the rest being assumed to remain the same.

The price of a product is a key factor in its demand. If price falls then demand will rise as the product becomes more affordable to customers so they buy more of it. Also it will become relatively cheaper than other products so more attractive to customers and they will buy more of it. When products increase in price people will buy less of them and demand falls.

This is seen when oil prices increase and people reduce their purchases of petrol. The opposite happens when prices fall. Many countries in the last twenty years have seen the prices of cars fall and the quantities of cars bought have increased significantly. As prices change the products become more or less affordable.

Other factors influencing demand are as follows.

Price of other products

The price of other products may affect demand. For instance, consider margarine. If the price of butter rises people will buy more vegetable fat or margarine. This is a positive relationship as the rise in price of butter causes a fall in demand for butter and a rise in demand for margarine. Sometimes this change in demand has a negative relationship with the change in price of another product, e.g. if the price of cars falls the demand for cars rises and so does the demand for petrol.

Income

As people gain higher incomes they will demand more of most products. Between 2004 and 2014 incomes of the population of China rose significantly and so did the demand for meat. So meat is a normal product, i.e. one that will increase in demand as income increases. There are some products that act in the opposite way; the demand for these inferior products falls as income increases because they are seen as inferior. Examples include concentrated fruit juices. As incomes rise people buy less of them and more of the freshly squeezed juices. These changes in demand operate at the level of the individual and that of the whole society.

Customers' attitudes and fashion

The media, government actions or fashion/taste may influence customers' attitudes. How competitors and businesses behave will influence demand for a business's product. This behaviour might involve changes to prices or marketing activities. A strong advertising campaign can increase the demand for the products of the business carrying it out but decrease demand for the competitors' products. This factor is relevant to films and music whose success often depends on the way the media determine trends. Holiday destinations that become fashionable will see an increase in demand. This is the reason that advertising and promotion are so important for businesses as they can shift the demand curve to the right and increase demand for a product.

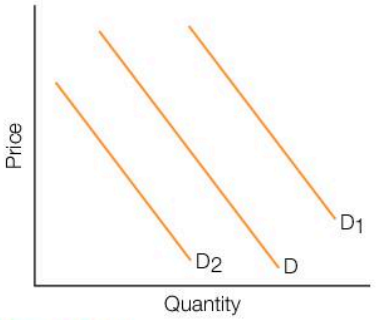


Figure 3.1.4 Shifts in the demand curve ▲

Seasonal factors

Seasonal factors are important for some products. Ice cream, hot and cold drinks are obvious examples and so are products that are sold at or during particular festivals such as Christmas, Diwali or Eid.

Demographic factors

The age and gender distribution of a population can affect demand. If there is a high percentage of older people the demand for products will be different from the demand if there is a high percentage of young people.

These effects may be shown on a demand curve that plots the quantity demanded against price. It is downward sloping left to right showing that as price increases the quantity demanded will fall. Any changes in the factors affecting demand will shift the demand curve to the right (an increase in demand) or to the left (a fall in demand).

Supply, demand and price: the impact of changes

Supply and demand curves come together to create a price in the market, shown where the two cross. Any changes in the factors influencing supply or demand will cause the corresponding curve to shift and the price in the market to change. Businesses must take care to understand these factors and be prepared to invest to lower costs, take action in response to competitors, be proactive in promoting their products or anticipating government actions or social trends which may influence demand or supply. They will then be in a position to act to achieve their objectives.

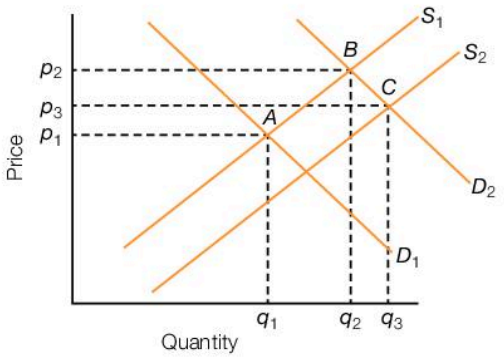


Figure 3.1.5 Shifts in supply and demand and effect on price ▲

At point A the initial supply and demand curves cross and the price will be p1. The demand curve now shifts to the right showing an increase in demand. The new demand curve (D2) now crosses the supply curve S1 at point B. This shows an increase in price to p2 and quantity sold to q2.

Now factors influencing supply change to cause an increase in supply and the supply curve shifts to S2. The demand curve D2 now crosses the new supply curve at point C. The price is now p3 and the quantity sold is q3.

Activity

Choose a product you know well. List three factors that will affect its supply and four factors that will affect its demand.

Progress questions

4 Using supply and demand curve diagrams, show how the price and quantity demanded of soap made by Lodor will change in the following circumstances. Make sure you identify whether it is supply or demand that is changing.
   - **a** The government carries out an extensive campaign to get people to wash their hands more often.
   - **b** A new process is invented which reduces the cost of producing soap.
   - **c** Lodor's main competitor reduces its price.
   - **d** The government puts a new tax on soap.
   - **e** Unemployment in the country rises significantly.

Case Study

De Beers Diamonds

De Beers is the largest company in the rough-diamond world, controlling 50 per cent of world supplies, selling diamonds at high prices. Diamonds are normal products, but several factors have changed in the last 20 years to affect the price of diamonds and lower De Beers' prices and sales.

In 1991 the Soviet Union collapsed resulting in the increased sale and supply of diamonds from that region.

During the 1990s diamonds became tainted by the term "blood diamonds", making many people suspicious of buying them.

At the same time large diamond deposits were discovered in Canada.

Other businesses became more aggressive in promoting their diamond products.

The major diamond buying areas of the world suffered relative economic decline and reduced income levels.

In response De Beers employed a number of strategies.

- It promoted itself as the "Supplier of Choice"
- It engaged with other businesses in joint mining ventures to reduce costs
- It began selling De Beers brand jewellery
- It engaged in large-scale promotion in emerging markets in lower-income countries
- It invested in new mining technology
- It increased its focus on social responsibility projects which gave it a halo effect and disentangled itself from the "blood diamond" taint.

How far De Beers is successful depends on how well it can compete with the eight large diamond businesses in getting diamonds from the mine to the jewellery store.

Figure 3.1.6 ▲

1 Draw supply and demand curves for De Beers' diamonds. Show an equilibrium price and quantity. (There is no need to give specific price and quantity.)
2 Consider the five reasons why De Beers has faced reduced prices and sales. Decide which two of these are factors influencing supply and which three are factors influencing demand. Draw a supply and demand diagram for each to illustrate your explanation of how these changes have reduced diamond prices for De Beers.
3 Consider the six responses from De Beers to falling diamond prices and sales. Decide which two factors affect supply with the objective of increasing De Beers' diamond sales and which four factors affect demand with the objective of increasing prices. Draw a supply and demand diagram for each to illustrate your explanations of what De Beers hopes to achieve.

Features of markets

How markets may be categorized

A particular market for a product or service may be difficult to define. How this is done will help determine how businesses try and sell their products. For instance, are walking boots in the shoe market, the boot market or the leisure market? If in the shoe or boot market they might

be sold in shoe or boot shops, if in the leisure market they might be sold in specialist leisure/activity shops.

Markets can be so broadly defined that businesses will find it difficult to find out and meet customer needs. For example, the "market for cars" is a very broad concept. In reality the car market is made up of a number of different sub-markets – including sports cars, family cars, sports utility vehicles (SUVs), and these may have smaller divisions within them. Family cars may be small or large. Producers need to define their marketplace in order to find customers, and customers need to know where to find suppliers for their needs.

Markets may be physical locations, like a shopping mall or a marketplace. They may be electronic, like online ticketing agencies or eBay auctions, even if the products being traded are physical ones.

Another feature of markets is the presence of a number of competitors selling products and services that customers may buy. It is this competition which drives most marketing decisions. The number of competitors, their aims and objectives and their short-term tactics and long-term strategy will help determine how a market operates.

Progress questions

5 Are electric light fittings in the lighting market or the home furnishings market? Explain how your answer might influence:
   a Where light fittings are sold
   b How they are presented to the buying public.

6 A market may operate through price competition – i.e. customers are interested in low prices. Apart from price, give some examples of factors that a business uses to compete.

Location – local, national, regional and international markets

Customers in all of these geographical areas – local, national, regional and international – may have different needs and wants depending on cultural, economic or historical factors. An area of high unemployment may be unlikely to have a large market for luxury products, or one country's eating habits may be very different from those of another. On the other hand coffee drinking is a worldwide habit and customer needs may be very similar in every country.

Local markets

Local markets are ones that are operating within a small geographical area. Typically services like car maintenance, restaurants, grocery shops and house painters are provided by businesses that are located close to their customers and they are in a position to easily find out what their customers need. However, the influence of the Internet means local businesses may now be more able to use online selling to deal with customers further away.

Activity

Here are three businesses which market internationally:

- Levi's
- Coca-Cola
- Nissan.

Discuss how they get their message across to customers in your country.

Link

See A Level Chapter 3.5 Globalisation and international marketing.

Key term

Globalisation: the growing integration and interdependence of economies and cultures involving increased trade, movement of capital and people.

National markets

National markets are larger and will require more research. Businesses have to be of a certain size to offer products and services to national markets. They must be able to get what they offer known to potential buyers across a country so mass media is often used for advertising. Today it may be possible for a business to do this by having sales outlets across a country or by using online selling.

Regional markets

Regional markets are larger again. They may cover a wider political grouping like the European Union or a geographical area like South East Asia. Each region will have its own identifiable characteristics and customer needs. Businesses will have to make sure that they offer a similar product proposition to all customers in the area but they may have to cater for variations in customer needs between areas of the region.

International markets

International markets are increasingly important as globalisation continues. These markets are often for products that appeal to particular needs, and often involve an element of fashion and taste, e.g. coffee, cola, wheat, jeans and luxury cars. Businesses selling internationally must be able to communicate a common message in a variety of different cultures and regions but still make adjustments for local differences. Marketing decisions must be made centrally but applied across the world.

Case Study

New Belgium Brewing

New Belgium Brewing sells beers in the USA. It started in 1989 selling to a small local market, people who the founding partners knew. It always wanted to get larger and today it has grown into the USA national market as a significant smaller producer of specialist beers. It now uses 182 distributors across 26 states and is still expanding. It has attempted to keep the image of a small craft producer, appealing to people who want a product that is not mass produced. It does this by using carefully designed packaging and a network of dedicated sales staff who sell to selected outlets (pubs, bars and specialist shops) using a personal direct approach. Interest is maintained by producing a few standard products plus new recipes that are each brewed for a short time.

1 Outline the challenges faced by New Belgium Brewing as it expands from one city to a whole country.
2 Explain three possible reasons for its success.
3 Assess the possibility that it might sell internationally.

Product or customer (market) orientation

Some businesses supply products to the market and have designed them to meet certain design or technical criteria. Internally focused product-orientated businesses believe that the design of the products will be attractive to customers and meet their needs. A good example is the iPhone, which was designed by Apple and then sold worldwide on the strength of its design and technical features. This product-orientated approach saves market research costs and means businesses use their strengths, but it runs the risk that consumers will not buy the product and the resources invested in the product are wasted.

This is a different approach from finding out the needs of customers and then designing a product to meet them, which is what customer-orientated businesses do. Virgin Blue, a low price Australian airline,

Key terms

Product-orientated business: a business that supplies products it thinks will be attractive to customers.
Customer-orientated business: a business that researches what customers want and designs and supplies these to the market.

determined that its short-flight customers would prefer ticketless flights and fun while in the air and would be prepared to not have food served if it meant a cheaper price for a flight. It then designed its service to provide these things. This customer-orientated approach generates products that customers want but involves research costs and may stretch the resources of the supplying business.

Progress questions

7 Explain the difference between a business that has a product orientation and one that is customer orientated.

8 A small business making shirts is thinking of expanding to sell to a national market. Outline two possible implications for each of the following:
- **a** Marketing
- **b** Product range
- **c** Quality control.

Getting it right

Always think carefully about what type of market a product or service is selling in before you answer a marketing question.

Key terms

Market size: the total sales revenue or volume in the market.
Market growth: the absolute or percentage increase in the size of a market.

Market size, market growth and market share

Before these indicators can be considered the market concerned must first be defined.

Market size

Market size is the measurement of all the sales by all of businesses that are supplying to that market. This may be expressed in terms of size by value – the total amount spent by customers on products in that market. This will be equal to the total sales revenue received by all of the supplying businesses. It may also be expressed in terms of size by volume – the total quantity of products or services sold in terms of tonnes, litres or numbers of units.

Market size indicates what is happening to the market as well as being a starting point for calculating the performance of businesses in the market.

Market growth

Market growth is the absolute or percentage increase in the size of a market. Calculating it will enable a market trend to be seen, helping businesses to plan ahead. A growing market indicates opportunities but may also mean more competition as businesses are attracted in. A declining market may indicate that a wise action would be to withdraw the product or stop advertising, but it may mean that competition will be falling as competitors leave. On the other hand competition may increase as businesses try to get their share of falling sales.

Market share

Market share is the percentage of the total market held by a business or a product. It may be expressed in value (the usual measure) or volume. It shows how successful the business is in relation to its competitors and offers a key variable that managers can use to assess their performance and what decisions they need to take.

A high market share indicates that the business can control certain aspects of the market, for example price, or that it has been particularly

successful in developing a product meeting needs. However, it may also indicate that competition may be about to be extremely strong as other businesses try and reduce this control. A low market share might indicate a new product in the marketplace, just growing, or an older product on its way out, or a business happy to maintain a low position relative to its competition.

Problems with measuring market share and market growth

It may be difficult to define accurately exactly what a market is and what products are being sold in it. Markets can change rapidly, especially in services or technology-based industries, making it difficult to track changes over time. Data on sales or profits can be hard to obtain. The size of a market share need not reflect profits as low prices and low margins may be responsible for the sales giving the high market share. Businesses have to be careful in interpreting these measures, but they must monitor market share in order to plan for the future.

$$\text{Market share} = \frac{\text{Sales value or volume of business}}{\text{Total industry sales value or volume}} \times 100\%$$

Progress questions

Study this table and then answer the questions that follow.

Company	Net sales 2013 ($ million)	Mkt share %
Mars Inc. (USA)	17640	20.4
Mondelez Int. Inc. (USA)	14862	
Nestlé SA (Switzerland)	11760	13.6
Meiji Holdings	11742	
Ferrero Group (Italy)	10900	
Hershey Foods Corp. (USA)	7043	8.2
Arcor (Argentina)	3700	
Other 3 companies	8667	10.0

Candy Industry January 2014. Source: Adapted from www.icco.org/about/chocolate.aspx

9 Calculate the market share for Mondelez and for Ferrero.

10 Explain why these figures might overstate the actual market share of these companies.

Case Study

Cloud-based data/ information storage systems

One calculation for cloud storage systems estimates the USA market size in 2013 to be sales of $80 bn and by 2020 this will be $120 bn. If this trend is accurate it represents a huge opportunity for IT businesses to plan products that they will be able to bring to this market.

Market sales in this industry are extremely difficult to measure. Some customers are private individuals, others are businesses, some use dedicated data servers, some use software technology available to all systems and providers are reluctant to issue separate figures for these services. Although businesses are increasingly interested in cloud storage the main use in 2013 was by individuals for music and media.

Estimated sales in 2013: USA	
ICloud	$21.6 bn
Dropbox	$13.6 bn
Amazon	$12.0 bn
Google	$8.0 bn

1 From the information in the table and the text:
   a Calculate the market shares of the four named services.
   b Calculate the total sales for each service in 2020 assuming market conditions remain the same and sales increase as described.
2 Assess how likely it is that market conditions will remain the same.
3 Explain why these figures may not give an accurate view of the cloud-based storage market.

Industrial and consumer markets

Products can be classified in different ways. A key way is to consider which customers they are aimed at. Some products and services meet the needs of final consumers and some meet the needs of industry (producers). Final consumers buy chocolate bars, fashion clothes and restaurant meals, though they may be sold to them via a distributor such as a supermarket. Customers in industrial markets buy raw materials, components and services that the business uses in its own operations, for example elevators, business conference centres and machine tools. Consumer markets are for individuals who are interested in obtaining products and services that make them feel good or which they need in everyday life. Producers are often looking for technical performance, efficient working and low-cost operation of the things they buy. It is difficult to communicate effectively with a market of many consumers, and it is easier to access producers as there will be fewer in the market. However, it is important to remember that many consumer products are often actually sold by the producers through distributors and not directly to consumers.

Key terms

Industrial market: a market for which customers are other businesses and they buy products/services as inputs to their own processes.
Consumer market: a market whose customers are final consumers such as members of the public.

This difference in the type of market has a major influence on the way products are marketed. Car components such as clutches or brakes are sold in large quantities but customers rarely see any advertising or marketing related to them. This is because the buyers are industrial businesses that assemble cars. The brake and clutch manufacturers need to approach car builders directly and identify the key people in the car business who make decisions about clutches or brakes. These people will be interested in technical performance, price, delivery times, quality and speed of response to a desired change. Customers who buy shoes or biscuits may be concerned with fashion or attitudes and can be more influenced on an emotional level by advertising and promotional offers. This brings out the key point that marketing activities are different for different types of products.

Activity

Consider these products:
- Socks
- Computer on/off switches.

Imagine you are the marketing manager for businesses making these products.

1 Discuss the different ways you might try and sell these products in your country.

Niche versus mass marketing

In order to meet customers' wants and needs all businesses must provide products which appeal to potential buyers in a positive way. Decisions have to be made regarding the target market – that is the type of person the business is aiming the product at. The product and the way it is marketed must match the target market. For example, it is generally not effective to advertise expensive women's shoes in a football magazine or sell them in a

Key term

Target market: a group of customers that a business is focusing its marketing activities on. They will all share similar characteristics.

Key terms

Mass market: the whole of a market.

Niche market: a small segment of a larger market.

Link

See AS Level Chapter 4.2 Operations planning for a detailed explanation of economies of scale.

very poor part of a city. The first decision is whether to aim a product at a very wide and large market made up of different types of customers (mass market) or to focus on a narrow specific type of customer (niche market). All decisions about target markets and methods must be informed by the particular marketing objectives of the business.

Mass marketing

Mass marketing produces a product that appeals to the whole market, so that everyone becomes a customer, no matter what their age, job, income, wealth or gender. This means the product must appeal to all and be marketed to all. The product will be produced in high volume and often at a low price, affordable by everyone. Mass marketing usually involves creating a brand – a name, term, design, logo, price, or any other feature that means customers recognise that product and the particular values associated with it, e.g. quality, value for money, good taste. It requires products to be widely available and not limited to a small number of stores. Companies that use mass marketing include McDonald's, Mars and Levi's. They spend large amounts of money on advertising and promotion in order to build a brand identity and gain a large volume of sales.

Table 3.1.1 Benefits and limitations of mass marketing ▼

Benefits	Limitations
• Large volumes mean low per unit costs via economies of scale and low price is possible. • Large sales volumes, revenues and profits are possible for a successful product. • A strong brand image and customer loyalty is reinforced and these act as barriers to entry making it difficult for competitors. • Successful products can be a platform for the launch of other new products as consumers know and trust the brand. • Many mass marketed products are long lasting and some brands have even become the names for the product – e.g. Hoover, Coke and Biro.	• Mass marketing requires communicating with all of the market so it is likely there will be significant regular spending on advertising to maintain customer awareness. • This awareness may not lead to sales as competitors may be able to effectively focus on particular consumer groups. • Mass marketed products are often sold in markets that are very competitive, with a number of producers all trying for sales. • It is likely to require very high advertising, promotion and distribution costs and failure to succeed will be very expensive.

Niche marketing

A niche market is a small segment of a larger market. Because it is aimed at particular types of customer these must first be identified. Then the product or service must be designed to meet their particular needs. Such products are often specialised and sales volume will usually be low, meaning that the selling price will be high, partly because specialist products are often high quality and partly because there will be no economies of scale to reduce unit costs. The products are often significantly different from mass marketed products and services and promotion must be targeted at the customers in the niche market. Niche markets often have small numbers of producers operating in them and generate high profit margins as products are being supplied in small quantities at a high price to customers who do not have a wide choice of supplier.

Table 3.1.2 Benefits and limitations of niche marketing ▼

Benefits	Limitations
• The product can be designed specifically for the target consumer so they are likely to buy. • Promotion can be focused on the target market so money is not wasted on trying to reach consumers who will not be interested. • There will be less competition in the smaller market. • The ability to set a high price means high profits can be made. • A brand name can be established.	• Success requires accurate definition and targeting of consumers in the niche. • Market niches are small and offer little opportunity for expansion. • A business can be defined in terms of its niche product, making it difficult to expand into other markets. • If the product fails or the consumers in the niche change, sales revenue and profits fall and there might be no other market suitable for the business.

Case Study

Toyota Prius

An interesting example of a mass producer who entered a niche market is Toyota, the multinational car business selling cars in mass markets. Toyota was the first car manufacturer to realise that there was a small group of people interested in environmentally friendly vehicles. They researched these people and designed the Prius, a hybrid fuel car that can run on petrol or electricity. It then promoted the Prius only in publications and websites that were read by people who might be concerned about the environment. Sales met and then exceeded the targets and now the Prius is being sold to a wider market than just those with a big concern for the environment.

1 Explain why hybrid fuel cars are a niche market.
2 In what ways did Toyota's promotion of the Prius differ from their other models?
3 Explain some difficulties that Toyota might have as sales of Prius cars increase.

Progress questions

11 Explain the difference between mass and niche markets.
12 Here are some examples of mass markets. Suggest niche markets that may be contained within these. The first two are done for you.

Mass market	Niche market
Animal feed	Racehorse feed
Shoes	Footwear for tightrope walkers
Chocolates	
Coats	
Headphones	
Cups	
Movie films	

13 List three benefits associated with mass markets.
14 Give examples of products in an industrial market.

Market segmentation

Key term

Market segmentation: the process of identifying particular groups that have similar needs and wants in a market.

Segmenting a market has a broader application than just defining a niche. Market segmentation is the process of identifying particular groups that have similar needs and wants in a market. They will therefore exhibit similar characteristics such as age, attitudes, gender, income or geographic location. This means that the supplier can then aim products and marketing activities specifically at people in a particular segment; for instance, designing slightly different advertisements.

Segments may contain large numbers of customers. For example, the breakfast cereals market may contain health conscious people, people wanting a fast meal, children, or those who need gluten free cereal. Segmenting a market means that marketing activities are focused on people who are more likely to buy, meaning they are more cost effective and less likely to be a waste of time.

Link

See AS Level Chapter 4.3 Inventory management for inventories.

Different segments must be identifiable and large enough to provide appropriate sales levels and they must be reachable for the product and the marketing. Segmenting a market means that different products or marketing techniques must be used for each segment.

Table 3.1.3 Benefits and limitations of market segmentation ▼

Benefits	Limitations
• Segmentation is potentially a very valuable tool for increasing profits. • There may be less competition in an identified segment. • Meeting customer needs more exactly will enable greater sales, a higher market share and more brand loyalty. • Focusing on one segment can provide efficiency and competitiveness. • A business may be able to increase price as its targeted segment sees added value. • Marketing costs may be reduced because the relatively more effective targeting means less waste as specific segments are targeted. • Communications to consumers can be clear and relevant to the segment.	• There are costs in identifying the target market and developing suitably varied products as well as the cost of using different marketing techniques. • Segmentation makes it more difficult to develop a product into a wider market and there may be higher inventory holding costs. • There is an increased risk as the segment may be too small or not buy the product and there may be nowhere else to sell to. • If marketing communications are not exactly right for the segment sales may be low. • Market segments may change and leave a business with unsold inventory and an image that makes it difficult to sell elsewhere.

There are many ways to segment markets – here are some of the commonly accepted methods.

Table 3.1.4 Segmentation methods ▼

Method	Comment	Example
Geographic		
By location or area	• Nations, regions, cities or neighbourhoods. Often used by global or large businesses	• Coca-Cola, McDonald's vary recipes for different areas
Demographic		
Age	• Some products are purchased by particular age groups	• Walking frames • Skateboards

Method	Comment	Example
Gender	• The important factor is the person who makes the purchase, not necessarily the user. Any currently gender related product that can be sold to the other gender is potentially a real winner, e.g. the growing market for men's cosmetics	For females: • Barbie dolls, washing powder, jewellery • Diet Coke For males: • Footballs, men's magazines • Coke Zero

Household type	• Number and type of people:
	  • Single people
	  • Couples
	  • Couples with children
		• Households with children – comics, educational material, car seats, family holidays
		• Couples – holidays, romantic city breaks

Socio-economic characteristics		
Socio-economic group	• A mixture of income, education and occupation on a scale A–E, A and B are high earners in managerial work, C–E are manual workers or unskilled	• Higher income groups – quality clothing, designer watches, restaurant fine dining • Lower income groups – discount stores, small motorbikes, workwear
Product usage	• Customer classified according to frequency of purchase and type of purchase	• Usually needs detailed database from questionnaire surveys. Money-off vouchers can be targeted to individuals related to their past spending patterns
Pyschographic		
Personality, attitudes and reasons for buying	• Many variations, e.g. some people are early adopters, they buy innovative products as soon as they come out, some wait till the products are proven. Some people take risks, others will not	• Technically advanced products sold to early adopters • Luxury products sold to those who like a reward • Vegetarians and meat eaters
Lifestyle	• Busy employees in high-pressure jobs have different needs from those who have retired early	• Convenience ready-meals for working people with families • Health clubs – daytime sessions for mothers and older people, evening for people who work during the day
Location	• Where people live may reflect different needs	• Different areas have different food preferences – city districts like Chinatown and the French quarter will differ

Progress questions

15 Define market segmentation.
16 Outline three benefits of segmenting a market.
17 Describe three methods of segmentation.

Case Study

Quorn

Quorn is a high-protein alternative to meat. It is a mycoprotein derived from a fungus and is a bit like chicken in texture. Quorn currently markets this as a mince, as sausages and in a range of ready-meals. It has no fat, is low calorie and is suitable for vegetarians. It was introduced in 1995 with a target market of vegetarians but it did not sell very well despite focused marketing to vegetarian groups. After advice Quorn identified a different market segment – those people who wish to reduce or replace their consumption of meat in an attempt to eat a healthier diet. Since then Quorn has had increasing sales and has expanded from the UK to 11 countries, all of them in the developed world. It is sold at a price roughly the same as the meat products it is competing with, which makes it a more expensive product than most of its competitors, many of which use soya-based recipes.

1 Describe possible marketing objectives for Quorn:
  a when it was introduced in 1995
  b when it changed its target market segment
  c now.

2 What is Quorn's target market? Use Table 3.1.4 to identify which methods Quorn is using to identify this.
3 Explain why the change in the market segment targeted was so important for the success of Quorn.
4 Suggest how Quorn might use market segmentation if it wishes to expand into less-developed countries.
5 Explain how the different marketing objectives in question 1 relate to possible changes in the target market segments you discussed in questions 2–4.

Exam-style questions

1 a State two reasons why the market for a product might reduce in size. [2 marks]
b Distinguish between market size and market share. [3 marks]
2 a Analyse the difference between niche markets and industrial markets. [8 marks]
b Discuss how a soft-drinks manufacturer might segment the market for its products. [8 marks]

Learnwell Tutorial Services (LTS)

LTS operated in a country that had seen rapid growth in the number of children, but this was slowing quickly. It meant that the numbers of students in secondary schools was set to peak in two years and then there would be a rapid increase in university entrants, especially as the government was investing heavily in post school education and awarding grants to students. Incomes in the country were rising rapidly.

LTS had provided three main tutoring products: assistance to help children progress at primary school, specific exam coaching for secondary school students aimed at the School Leaving Qualification at 16, and the Pre-University Advanced Level examinations for 18-year-olds.

LTS realised that the market for primary school tutoring was becoming more competitive and not growing. The secondary school market was set to peak. In response the directors looked for other possibilities to use their expertise. They identified university students as a new area for their tutoring services and started offering tailored help in specific subjects, especially essays, report writing and logic. Learnwell marketed this service under the name Get Ahead.

This proved very successful so the directors introduced two new tutoring services. One was aimed at adult non- or poor readers and one at business people focusing on business communication and meeting skills. These were both marketed under the brand name Get Ahead.

3 Using supply and demand analysis analyse reasons why the market for tutorial services was increasing. [8 marks]
4 Evaluate the way in which LTS segmented the market for its products. [10 marks]

Key concepts

AS **Change** can be observed through implications of changes to market share and market growth.

AS **Management** can be explored through the role of managers in achieving marketing objectives.

AS **Customer focus** can be explored through factors influencing consumer demand. It can also be explored through ideas of mass and niche markets and the concept of segmentation. There is also the development of the ideas of market orientation and product orientation.

Progress check

You should now be able to:

AS explain the role of marketing

AS apply the ideas of supply and demand factors

AS discuss the different features of markets

AS discuss how marketing might differ between different types of markets

AS recommend methods of segmentation.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **AS** primary and secondary market research
- **AS** methods of information gathering
- **AS** sampling methods
- **AS** the value of market research results
- **AS** the cost-effectiveness of market research

3.2 Market research

What is market research?

Market research is finding out about the market that a business is in. In order to produce products and services that customers need, businesses must find out about the customers' characteristics and preferences. It might be very useful to engage in market segmentation to identify groups of customers with similar characteristics in order to target them in particular. A customer/consumer profile describes what a typical customer might be like in terms of characteristics such as age, income, geographic location, lifestyle, reading habits and buying patterns. Similarly, businesses need to find out what trends are occurring in their markets in terms of sales of their own and others' products and a business will need to know what its competitors are doing. Only then can planning and decision-making be based on a solid foundation.

Market research is the process of gathering information about markets, customers, competitors and the effectiveness of marketing methods. This may be quantitative information (in the form of numerical data) or qualitative information (non-numerical, e.g. attitudes, opinions, ideas). To be effective, market research must be carefully planned, starting with identifying the reasons for gathering the information. This will lead to determining what information will be useful. The methods of gathering the information can then be chosen after consideration of what they are and their advantages and disadvantages.

This model is similar to that used when a business draws up a planning document, i.e. objectives lead to a choice of a strategy which determines methods or tactics as part of a plan.

Key terms

Market research: the process of gathering information about markets, customers, competitors and the effectiveness of marketing methods.
Customer/consumer profile: a description of the type of person a business is selling to. It includes characteristics such as age, income, lifestyle and buying patterns.
Quantitative information: information that can be analysed numerically.
Qualitative information: information about attitudes, views or opinions.

Progress questions

1. Suggest five possible objectives for market research (what a business might wish to find out).
2. For each objective suggest a reason why a business might want to know that information.

Methods of information gathering: primary and secondary research

Primary research or field research consists of gathering information for the first time, directly from sources in the market. Secondary research or desk research consists of using information which has already been gathered, either by the business or other agencies, often for a different purpose. An example of primary research is asking people what is their favourite chocolate. An example of secondary research is using government statistics to find out the size of the car market.

Primary research information is obtained by contacting subjects such as customers, distributors or competitors. This method is under the

Key terms

Primary research: also known as field research, this consists of gathering information for the first time, directly from sources in the market.
Secondary research: also known as desk research, this consists of using information that has already been gathered, either by the business or other agencies.

Getting it right

It is usually best to start by carrying out secondary research. This is relatively cheap and will help identify the objectives and methods for primary research.

control of the person carrying it out – they decide what they wish to know, what method of gathering the information to use and how detailed the study will be. It may be a lengthy process and can be expensive, and the method of collecting must be appropriate in order for the information to be worthwhile and accurate. Primary information often takes a great deal of analysis and some judgment is usually involved. This makes the results capable of different interpretations and means the methods used must be appropriate. What it does generate is direct understanding of key aspects of a market. Because primary research is a specialist area of business activity many businesses pay a market research agency to carry it out and larger ones may have a dedicated market research department with specialist employees.

Primary research information-gathering methods

Observation

The researcher watches the behaviour of subjects. This may be done via a CCTV camera in a store, or by an observer standing in an appropriate place taking notes. It might be useful for a supermarket that wants to find out how customers behave when deciding what to buy. For instance, the importance of the shelf height that an item is displayed at or how long customers take to decide what to buy.

Surveys

Key term

Survey: gathering information by collecting the answers to questions in writing or verbally.

Survey is a general word that describes the process of collecting information by using questionnaires or interviews. A questionnaire may be given out to respondents and collected later or used as part of an interview. Questionnaires may use closed or open questions. Closed questions have a list of possible answers so the respondent only has to tick the one that applies to them. Whatever the format, questions must be easily understandable and must not lead the respondent in a particular direction.

Closed question

How often do you go to the cinema in a month?

☐ Never ☐ 1–3 times

☐ 4–6 times ☐ 7+ times

Figure 3.2.1 An example of a survey ▶

These collect factual information, are easy and quick to record, collate and analyse, but do not give much information about attitudes and opinions.

Open question

Open questions allow the respondent to reply as they feel, e.g., "What is it about a film that would make you recommend it to a friend?"

These collect information about reasons and attitudes, but are difficult to analyse as the responses are not channelled in a particular way.

Interviews

Interviews can be structured or unstructured. A structured interview is based on the respondent answering specific questions in a set sequence.

The questions may be closed or open and they are set beforehand by the interviewer. The results of these interviews are easy to analyse as they are all structured the same way, but they do not allow the respondent to give answers which consider things that are not in the questions.

An unstructured interview may have some suggested prompt questions but the interviewer has the freedom to ask other questions and allow each interview to take a different course. These will generate wide-ranging information about the respondents' views, particularly their feelings, but are difficult to compile and analyse. The interviewer needs to fully understand what information is required. They must be well trained in order to obtain this from the respondent.

Interviews may be carried out face to face, by telephone or by email. They are more expensive than a questionnaire filled out by the respondent on their own and involve the cost of training interviewers. Unless the subjects have agreed to the interview there may be a low response rate as many people do not wish to spend time on the phone or in the street talking to a researcher. Typical response rates for telephone surveys are 5–10 calls to get one interview.

Questionnaires and reviews

Questionnaires may also be posted to respondents, left in places where they might be picked up, or given out in the street. They may also be placed on websites, for visitors to complete when browsing or buying. These methods are cheap but will have a low response rate. There is no control over the respondents' answers. They may be giving joke responses.

Constructing an appropriate questionnaire that is not biased and generates the information wanted in a reliable way can take as long as three weeks.

In recent years there has been a growth in websites that offer reviews of products and these can be a valuable source of information, though account must be taken of the fact that generally comments are positive and may be placed by those supplying the product or service being reviewed.

Shopping for shoes

1 Do you ever buy shoes yourself?
Yes
No

2 If yes:
Where do you buy them?
- **a** High Street
- **b** Shopping mall
- **c** Market stall
- **d** Department store
- **e** Internet site
- **f** Other

3 How often do you buy shoes?
- **a** Once a week
- **b** Once a month
- **c** Once every three months
- **d** Once every six months
- **e** Once a year

4 How much do you usually spend on a pair of shoes?
- **a** less than $5
- **b** $6–$10
- **c** $11–$20
- **d** $21–$24
- **e** over $40

5 What is the most important thing you look for when buying a pair of shoes?

6 How important to you is the place you buy shoes in?

7 How much do you consider fashion when buying a pair of shoes?

Figure 3.2.2 An example of a questionnaire ▲

Activity

Jasmine, the marketing manager for Fashion Shirts, wants some information so that she can increase the number of shirts sold to 16–30-year-olds. She asks a marketing assistant to produce a questionnaire to obtain information that will help plan a new marketing campaign. Fashion Shirts operates in a competitive market which is frequently changing. Jasmine is unhappy with the questionnaire and takes it to a marketing agency who are very critical of the objective and every question.

Market research questionnaire

Objective
To find out what customers think about our shirts and why they would buy one.

Questions
1 Do you like our shirts?
2 How much would you pay for one of our shirts?
3 We think our shirts are better than anyone else's. How much better?
4 How many shirts a year do you buy?
5 Why would you buy a Fashion Shirt rather than one from another business?

In groups, produce an improved objective and five questions which will be useful to Jasmine as she tries to increase sales of shirts to 16–30-year-olds. Share your results and discuss the differences, commenting on the reasons for these.

Activities

1 In pairs, use the questionnaire in Figure 3.2.2 to conduct an interview with your partner.
2 Which of the questionnaire questions were closed questions and which were open questions?
3 Comment on how successful the questionnaire was in the interview and in obtaining useful information.

Case Study

Boots'n Shoes

Boots'n Shoes has produced a new pair of fashion shoes that can also be turned into boots. They are waterproof, light and available in a range of colours. The managers of Boots'n Shoes are confident their production systems will enable the boots to be made to order and delivered within 48 hours. The complexity of the design and the order system means that the boots will be significantly more expensive than the competition, though no one else has anything like their design. Boots'n Shoes wants to know if it can make a profit selling its new product.

1 Suggest two questions it would like market research to answer.
2 Giving reasons, suggest a method of secondary research it might use to help answer these questions.
3 Evaluate the primary research methods it could use in its research.

Key term

Focus group: a small number of selected people brought together to discuss questions or topics set by the researcher.

Focus groups or panels

These are selected people, typically 6–10 in number, who have agreed to take part in a discussion led by a researcher. The focus group is generally selected to be representative of a target group, maybe the target market for a new product or possible retailers. The researcher leads a discussion in order to obtain the views of the panel. This means the researcher has a structure to find out views on particular topics but also the freedom to encourage talk that is useful and might highlight things the researcher had not thought of. A potential problem with this method is that group members may not give their own views but might be influenced by others or say what they think the researcher wants to hear. It is also expensive as a number of groups will need to be set up and the information can be difficult to analyse.

Activities

1 Interviewing
In pairs design and carry out an interview using structured or unstructured questions to find out your partner's views about changes in your local town.
2 Focus groups
Form groups of six, one person to act as the chair. That person conducts a focus group exercise, getting the other group members to discuss what changes they would like to see in their town.
3 Compare the results of these two activities.
4 To what extent do they give the same results?

Test marketing or field trials

Test marketing occurs at the later stages of product development. A new product is actually put into the marketplace and sold, often in a small selected area. Another variant is that advertising or promotion of a product is carried out differently in different areas. This often precedes a full-scale launch. Sales data is then collected along with other forms of research to come to a decision about what is needed to achieve the marketing objectives set. Test marketing is expensive but it will give valuable information about the actual buying behaviour of customers rather than their opinions.

Loyalty, store cards and databases

These are becoming an important source of information as they tell a business exactly what customers are buying and when. A picture of customer trends can easily be built up from compiling the information generated from store cards. This kind of information is now available in a series of large databases linked to other information held in government databases such as driving licence information. Research agencies can cross-reference these to provide pinpointed information on individuals and groups, and this kind of market information is increasingly important. Stores use it for targeting offers and contacting

customers with information specially tailored for each individual, based on the patterns of buying the information shows.

Table 3.2.1 Primary research methods – advantages and disadvantages ▼

Method	Advantages	Disadvantages
Observation	• Subjects behave naturally	• No contact with subjects
Structured interviews	• High response rate • Specific focused responses • Easy to analyse	• Relatively expensive • Set answers mean no discussion
Unstructured interviews	• High response rate • Flexible – can adapt questions • Full explanations possible • Difficult to analyse	• Expensive • Interviewer bias • Subject's response biased by interview pressure
Postal surveys	• Relatively cheap • Easy to set up	• Low response rate • Impersonal • Response bias – not taken seriously
Telephone surveys	• Flexible compared to postal survey • Quick responses • Relatively cheap – especially automated versions	• Low response rate • Annoying to subject • Response bias as subject wants to finish quickly
Online surveys	• Quick • Cheap • Large audience	• Only computer users • Sample bias as self-selected • No way to check subjects/ responses
Focus groups	• Allow exploration of feelings and attitudes • Controlled by researcher	• Expensive • Difficult to analyse results • Subject bias due to peer pressure
Test marketing	• Actual market situation • Real data • Could save a lot of money spent on selling a product that will not sell well in actual market conditions despite favourable market research	• Expensive
Database use	• Readily available data • Allows personal targeting	• Expensive to set up • Might have limited relevance

Getting it right

When selecting a method of primary research make sure you start with the objectives. Then match the method to what you are trying to find out.

Getting it right

Information-gathering methods (interviews, questionnaires etc.) are not the same thing as the way a business chooses who to gather the information from (sampling methods). Write about each one separately in your answers.

Progress questions

3 Explain three methods of primary research.
4 Outline their advantages and disadvantages.

Secondary research information-gathering methods

Secondary research is gathering information from data that has already been collected. External sources include official government-produced data from various departments, trade journals, Internet sites, business libraries, university papers, market research agencies, company reports and books. The information may be available in printed form (journal articles, books, university papers, reports) or web based. The Internet has increased the availability of many of these sources and meant they can be accessed from all over the world. Secondary research, paper or web based,

may be free or it may have to be paid for, especially if it is in a book or published report or obtained by a research agency or another business. Internal sources within the business include customer records, sales records, production data, accounts and electronic point of sale.

Secondary information is relatively cheap to gather and gives clear indicators on total market changes, but it may be out of date. It is also very helpful in giving direction to the objectives for any subsequent primary research.

Figure 3.2.3 Computer-based research ▲

Case Study

Barclays Bank market research

Barclays Bank operates in 56 countries, offering financial and banking services. It has divided its market into segments, based on particular groups of characteristics. One segment is university students, who form a discrete group with their own needs. Many of them have not held a bank account before starting at college and Barclays wanted to make sure that more of them chose Barclays as their bank, especially because secondary research shows that most people stay for many years with the bank they first open an account with.

In its research in one country Barclays started with a question: What do students really want from a bank? It employed a market research agency who used an online questionnaire aimed at students and found that 81 per cent of students held a savings account. A follow-up focus group exercise provided detailed information about why students chose a particular bank. Barclays also found from its Banking Association that 5.4 million new accounts were opened each year, of which 0.4 million were from students. The next step was to hold focus groups with students as well as interviews in branches with student customers. These found that students relied heavily on credit, especially an overdraft. They also expected to buy electrical products, often quite expensive ones like laptops and phones. They wanted a dedicated student-type account that had built-in incentives for them to choose. From the results Barclays determined that students would appreciate an account that was free to operate, had an interest-free overdraft, mobile banking and a 25 per cent discount on the cost of an Orange mobile broadband package. This was then introduced. The result was that following a marketing campaign involving social networks, leaflets, online adverts and direct mail to students, Barclays' number of student accounts rose by 34 per cent, exceeding the target of 25 per cent.

1. What was the objective of the market research Barclays undertook?
2. Explain why it is so important to have a clear objective before starting market research.
3. What reasons might Barclays have had to choose an agency to carry out the research?
4. Identify three pieces of primary research and one piece of secondary research used by Barclays.
5. The agency constructed an online survey using a questionnaire, followed by a focus group exercise. Explain, giving detailed reasons, why they chose these two different methods.
6. Barclays spent hundreds of thousands of dollars on this research exercise. To what extent do you think this was a justified expense?

Sampling methods

When a business has chosen its information-gathering method it has to choose who to get the information from. The right group or segment must first be selected. When carrying out primary research it is usually impossible or too expensive to ask everyone in that group or segment, although the more people who are asked the more accurate the results will be. It is also not necessary to survey everyone as a number of people who represent the group will give statistically accurate results that apply to the whole segment. So observation, surveys and focus groups are carried out on a sample of the whole group. Statistical theory will determine how many people should be involved to give a meaningful result. Sampling theory determines who these people might be. They have to accurately represent the target group if the results are to be taken as valid and extended to cover the whole population. Cost and availability of funds will also help determine the sample size.

Key term

Sample: a selection taken from a larger group (population).

First, the characteristics of the target group must be clearly established. This is called the population. Then the sample size must be chosen from the population according to statistical rules. Lastly, the sampling method must be selected. The ideal method will achieve a random sample. This sample method means that every member of the population has an equal chance of being chosen so the sample will truly reflect that group. There are several ways to try and achieve a random sample, although none of them entirely succeed. Achieving a random sample can be very expensive in money and time and enough accuracy can be obtained with a less-than-random sample.

Key terms

Population: the target group of people for the research.
Random sample: one in which each member of the population has an equal chance of being chosen so the sample will truly reflect that group of people.
Stratified sample: one in which the population is divided into groups (strata) with defined characteristics so that the number of people chosen in each strata reflects the percentage for that group in the whole population.

Stratified sample

A stratified sample is often used when there are clearly identified separate subgroups within the population. These are called strata. A simple stratified sample might be a saucepan manufacturer being interested in the views of women aged 25–45. Their stratified sample would be all women, aged 25–45. A more complex sample might be a music promoter interested in researching a market for a particular musical ensemble. They could divide the sample into a number of strata, e.g. gender (male/female), age groups (16–23/24–35/36–49) and income per year ($12 000– $16 000/$17 000– $22 000/$23 000–$29 000/over $30 000). They would then divide the sample size up in such a way that the percentage of people in each stratum was the same as in the general population. So perhaps 55 per cent would be female, 16 per cent aged 16–23 and 8 per cent earning over $30 000.

The actual subjects will be chosen in the most random way possible thus maximising the chance that the sample would represent the population. This would then be a random stratified sample.

Quota sampling

This is a form of stratified sampling. It is used when the researcher wants to choose particular numbers of people in each subgroup or strata. Once the strata are determined and the number of people in each is decided these numbers then form the quota to be chosen.

Key term

Quota sample: one in which set numbers of people with different characteristics are chosen to be in the sample.

Getting it right

Make sure you select a sampling method that matches the objectives of the market research given in the question.

A quota sample sets up a number of subjects with a particular characteristic. For example, 25 men aged 16–24, 30 women aged 16–24, 25 men aged 25–35, and 20 women aged 25–35, giving a total sample of 100. How this is done can vary. For instance, allowing an interviewer to stand in the street and pick out people until they have reached the quota for each stratum is less random than giving interviewers particular addresses and names to contact. All methods of choosing a random sample involve a trade-off between the cost and ease of sampling and the degree of randomness.

Choosing randomly

There has to be some method of making a random choice for a sample or for strata within a sample. This is important because the sample should represent the whole population. This means that results from researching the sample can be taken to apply to the whole population. So the research costs are much smaller because the whole population does not have to be investigated. All of the methods below can be criticised as not being truly random.

Convenience sampling

The researchers choose their subjects in the way that is easiest and most convenient for them. This is unlikely to result in a random sample.

Snowball sampling

A small number of respondents are chosen and asked to suggest other subjects who are then contacted. This is unlikely to result in a random sample.

Systematic sampling

The sample is carefully chosen in a systematic way, e.g. every tenth name in the phone book, every tenth house in streets spread across an area.

Multi-stage sampling

An initial selection for a sample is made. If not all of the individuals respond substitutes are found. This method may be random if systematic methods are used.

Limitations of sampling methods

Market research using sampling methods is not always reliable. This may be because:

- The sample size is too small. The smaller the sample size the more the opinions sought are limited. However, the larger the sample size the greater the cost. A small sample can also introduce bias – see below. So, for example, the results of a survey into food tastes limited to your friends would not be representative of the population as a whole, and your friends are likely to have similar food tastes.
- The sampling method is inappropriate. Some products are limited to particular groups of people. So, for example, textbooks are usually bought by students or their parents. So the sampling method chosen needs to be one that excludes the rest of the population otherwise time and effort is wasted asking people who will have no useful opinion to express.

Key term

Bias: in primary market research this means that the findings of the research do not truly represent the whole population. This may be due to a small sample size or an inappropriate method.

Activities

1 Design primary market research to investigate where the most popular destination for holidays is for students in your school or college. Make sure you choose an appropriate method of gathering information and an appropriate sampling method.
2 Explain why you chose to carry out the research in the way you did.

- There is bias in the method. Methods that are truly random, provided the sample size is sufficient, should produce unbiased results. In contrast, other methods that may involve sampler choice, such as quota sampling where the sampler designs the quotas, may have bias introduced by the sampler.

Progress questions

5 Explain the difference between random sampling and stratified sampling.
6 Give two benefits of quota sampling.
7 Explain why a textbook publisher would not want to sample the whole population.
8 Why might a shoe manufacturer want to have separate quotas for men and women?

Market research results

The reliability of data collection

The results from market research will depend on the methods chosen to collect the information. Surveys that generate numerical quantitative data will be analysed using a range of statistical tools. Experts will be able to decide which tools to use and will then apply them to the data to produce some conclusions. Other methods, e.g. observations or focus groups, will require other analytical approaches. The information must be collated in some way. Set criteria will be applied in order that responses can be grouped into similar sets. This will enable patterns of response to be detected.

The conclusions drawn from the analysis must not be merely accepted. They are based on methods that may contain a degree of error.

Sources of unreliability

- Questionnaires used may have had misleading or leading questions
- Interviews or focus group leaders may guide respondents or may not fully understood the questions they are asking
- Interviewers or focus group leaders may lack sufficient training or may complete the forms themselves
- Respondents to questionnaires, interviews and discussions may deliberately not give their real views in order to get the process finished quickly or just for fun
- People in focus groups may say what they think other people in the group would like to hear
- The sample size may be too small and so not represent the whole population
- The sampling method chosen may not have resulted in a representative group of interviewees

- Different statistical methods of treating data will often result in different conclusions.

All of these possible sources of error need to be considered and the final results given some kind of reliability index or confidence measure.

Case Study

Campbell's Soup

Campbell's Soup set up focus groups made up of regular buyers of its products to test if a low-sodium recipe would be a good seller. The focus groups' response convincingly showed that customers did not like the new product. However, Campbell's was concerned that this result conflicted with trends in other products as more and more doctors recommended low-sodium products. It retested groups of customers who did not buy its soups and found a positive reaction to the low-sodium product.

The focus groups made up of loyal Campbell's customers gave unreliable results.

1 Analyse why Campbell's was right not to act on its loyal users' views.
2 What does Campbell's experience tell us about using market research methods?

Analysis and interpretation of the results of market research

Market research is usually ordered with a clear objective. The results have to show information relating to a particular set of questions. Either a business will ask its marketing team to carry out research or will order it from a research agency. The information therefore must answer the questions set by those who ordered the research.

Most market research reports will be presented in writing, though there may be meetings where the findings are orally presented. The writing may be supported by graphs, charts, tables and diagrams. Part of the presentation will contain estimates of the reliability of the information gathered. There will normally be some summary of the results with conclusions drawn regarding possible actions. The information must be presented clearly and in an organised way. There may be recommendations, though these may be left to those who the report was produced for.

Methods of presenting market research results

Tables

Using tables to present data is an effective way of organising large quantities of data. The data is organised and summarises information so that the reader can see connections between variables clearly. Tables show categories and the rows and columns show any relationships between them.

However, tables do take time to interpret and are often not very visually interesting. It is important to choose appropriate headings for the rows and columns and not use too many significant figures.

Table 3.2.2 An example of data presented in a table ▼

Supermarket sales, market share and marketing budget			
Supermarket	**Sales revenue $000**	**Market share**	**Marketing budget $m**
Kwickbuy	4200	60	43.8
Spendezy	1020	15	30.4
Easibuy	740	11	10.2
Lorca	550	8	24.5
Ready4U	400	6	17.8
ADL sales	30	0.5	9.0
BuyCheap	3	0	10.7

Charts and graphs

Other methods of presenting data are charts and graphs. These are visually attractive and present data in an easy-to-see way. However, they usually only present two variables and cannot deal with complex interrelationships.

Pie chart

A pie chart shows data broken up into categories. The area of the circle occupied by each category is in proportion to the percentage that category is of the total. Pie charts are visually attractive and show these percentages in a simple way. The actual values may be entered onto the pie chart. However, one pie chart can only show one variable. The information in Table 3.2.2 would need two pie charts to present it all.

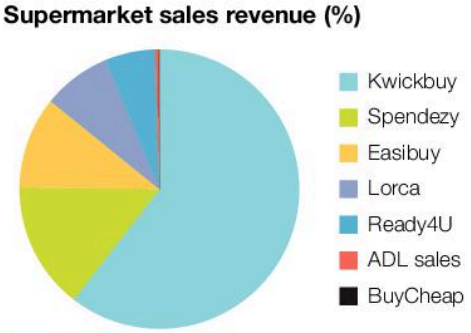


Figure 3.2.4 An example of data presented in a pie chart ▲

Bar chart

A bar chart shows information in the form of vertical or horizontal bars. They may show absolute values or percentages. These represent the values of the chosen categories. Bar charts are visually attractive and allow quick comparisons, including over time by using a bar chart showing two different times.

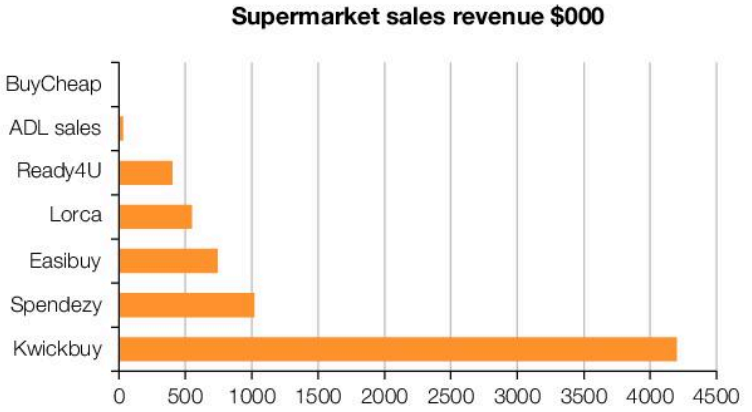


Figure 3.2.5 An example of data presented in a bar chart ▶

Pictograph

A pictograph uses icons or pictures to represent the information. It is visually appealing and it is easy to see the variables. However, care must be taken in interpreting the pictograph. It cannot show exact values for

data and the eye may mistake what is actually shown. For example, the pictograph in Figure 3.2.6 shows sales revenue by number of dots. The eye may perceive instead that it is the overall quantity that is important and so come to the wrong conclusion. In addition it may be that the drawing representing a partial value is misleading, e.g. half a glass to stand for half a million. It is difficult to see what number the half actually represents.

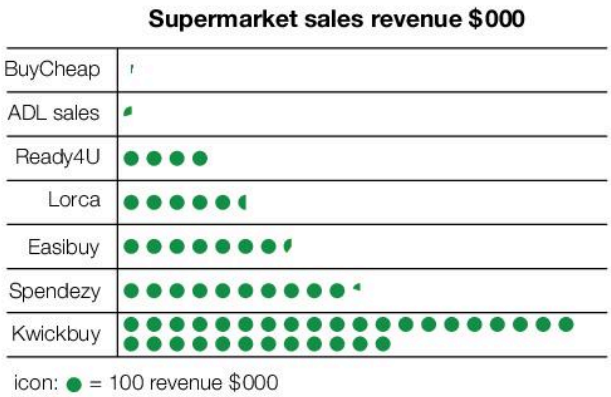


Figure 3.2.6 An example of data presented as a pictogram ▲

Scattergraph or scattergram

A scattergraph shows the relationship between two variables by placing dots or crosses to show where the two variables coincide. It provides a clear visual display and enables any trend or positive relationship to be detected. However, this requires the use of complex statistical techniques. The scattergraph shows a positive relationship between sales revenue and marketing budgets, but without applying a complex statistical technique we cannot determine the exact nature of this relationship.

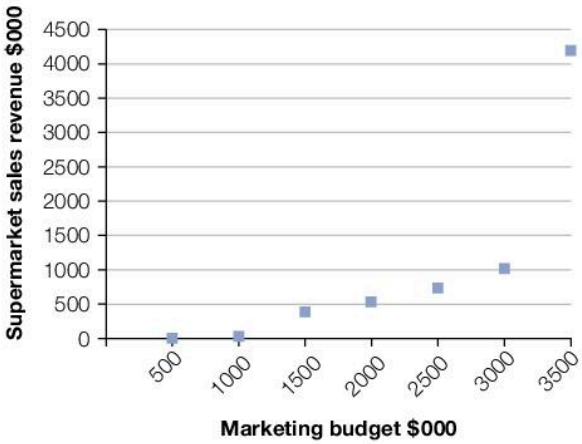


Figure 3.2.7 An example of data presented as a scattergraph ▲

Line graph

A line graph is useful for showing the way a variable changes over time. It is simple and clear and more than one line can be shown on the same axis to enable a comparison. It does require the values to be within a given range. If the data covers a very wide range it will be difficult to see how the variable changes over time. Care must be taken to check exactly what the axes are showing.

The line graph in Figure 3.2.8 clearly shows that the sales revenue of Spendezy is larger than that of Easibuy and has been growing at a much faster rate in the last 50 years. It is possible to forecast that these rates of growth is likely to continue in the future unless there is a change in the factors which determine sales revenue growth rate.

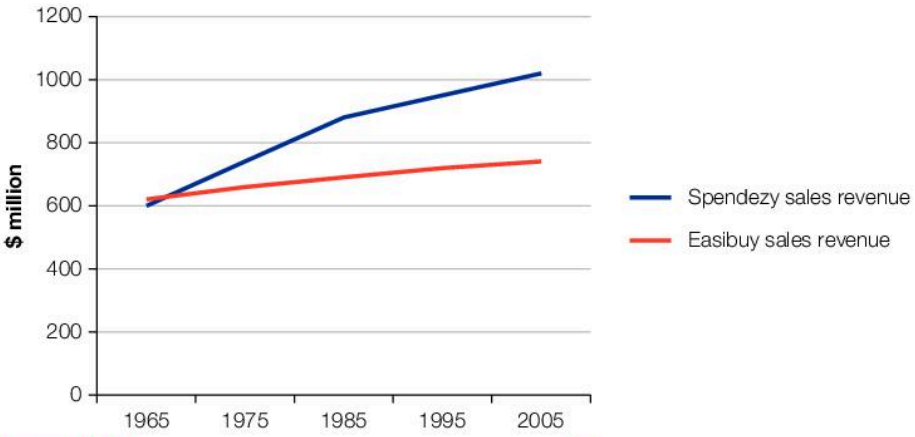


Figure 3.2.8 An example of data presented as a line graph ▲

Table 3.2.3 Comparison of methods of presenting information ▼

Pie chart	A pie chart displays data as a percentage of the whole. Each pie section should have a label and percentage. A total data number should be included.
Bar graph	A bar graph displays data in separate columns. A double bar graph can be used to compare two data sets.
Scattergraph	A scattergraph displays the relationship between two variables. A trend line can show relationship between them.
Pictograph	A pictograph uses a drawing to represent a quantity. A key must be used to explain the icons.
Line graph	A line graph plots data as points and joins the points with a line. More than one data set can be plotted and a key used to distinguish between them.

Activity

Use printed or online media to find different examples of the way market research data is presented. This may be from market research agencies, marketing departments or academic organisations. Consider the possible reasons for different types of presentation. These may include the context of the presentation, the role of the presenter and the target audience.

Getting it right

You should be able to use data presented in a range of formats to inform decisions and help you illustrate or support your answers to problems. You should be able to analyse market research results presented in a range of formats. The tools and formats shown here will help you do this. This course does not demand any detailed ability to use statistical techniques to analyse data.

Progress questions

9 Give one advantage and one disadvantage of a table.
10 Outline the main features of pie charts.
11 Give one limitation of a pie chart.
12 Explain why you would not use a line graph to show information about students' favourite colours.

Methods of analysing information

Statistics is the science of analysing numerical data. To understand data we need to know the average and how wide the distribution is from lowest to highest. There are three ways to measure the middle or average number in a group of numbers. The range deals with how spread out the data is from the lowest to the highest number and how it is spread out within those two numbers. Table 3.2.4 will be used to illustrate the construction and use of these measures.

Measures of the middle or average

A business selling cosmetics carries out some market research. It investigates the amount that customers spend per year on its main perfume brand and Table 3.2.4 sets out the results. The marketing director wishes to know what the average income of customers is. The three ways to calculate this average are set out below and use the data in the table.

Table 3.2.4 Customer spending on main perfume brand ▼

Spending $ per year	Number of customers	Total spending $ (1)
5	2	10
15	12	180
25	20	500
35	26	910
45	21	945
55	13	715
65	6	390
Total spending		$3650

Customers were asked which number most closely represented their annual spending on the main perfume brand.

Key terms

Mean: an average calculated by adding up all the numbers in the data and dividing by the total number of variable in the data.
Median: the middle number when the numbers in a set of data are arranged in ascending or descending order.
Mode: the most commonly occurring number in a set of data.
Range: the difference between the lowest and highest values in a set of data.

The mean or arithmetic mean

The mean is an average calculated by adding up all the numbers in the data and dividing by the total number of variables in the data.

Calculate total spending by multiplying the amount spent by the number of customers spending that much to give total spending (1) at each level of spending. These are added to give total spending by customers per year. This is $3650. There are 100 customers in the sample so the mean is $3650 divided by 100 = $36.50.

The median

The median is the middle number when the numbers in a set of data are arranged in ascending or descending order. In this case there are 100 numbers so the middle number will be between the 50th and the 51st number when they are arranged in ascending order. This middle number falls in the $35 spending. This will therefore be the median spending.

The mode

The mode is the most commonly occurring value in a set of data. In Table 3.2.4 this is the $35 spending group with 26 members.

So the mean of this data set is $36.50, the median is $35 and the mode is $35. Notice that these are not all the same.

Measures of spread

The range

The range is the difference between the lowest and highest values in a set of data. In Table 3.2.4 this will be 65 – 5 = $60.

The range gives an idea of the spread of the data.

Key term

Interquartile range: the difference between the largest and smallest values in the middle 50 per cent of a set of data.

Progress questions

13 Why is the mean not a good measure for shoe size?

14 Why is the mode a better measure of shoe size?

15 Why is it important to know the spread of data?

Interquartile range

In Table 3.2.4 the middle 50 per cent of the data falls between \$25 and \$45 so the interquartile range is \$20. This is because the lowest quarter of the total data (25 variables) falls at or below \$25 and the highest quarter falls at or above \$45. The bigger the interquartile range the more spread out the data is.

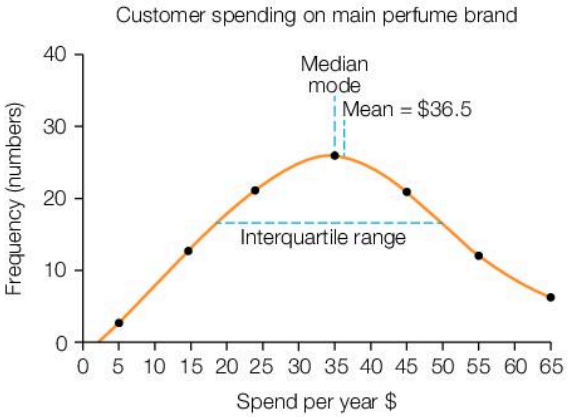


Figure 3.2.9 Measures of central tendency ▲

Case Study

Johnson – manufacturer of soda ash and other alkaline products

Johnson manufacturers soda ash and other alkaline products selling worldwide to other manufacturers. It has five manufacturing plants in different countries. Its products are used in a range of applications and its clients are all manufacturing businesses that produce various chemicals and materials which they then sell on to other businesses.

Johnson is always looking for new markets and in the last year it has developed a new product which is being used by clients to produce a different type of mixed metal/ceramic material for use in vehicles and aircraft. Johnsons has to decide whether to build a new factory to meet increasing demand. Before it does this it needs to be sure that it will be able to sell the additional output. It needs to investigate its competition and the market. The information it is interested in firstly concerns who the competition is and what they offer, and which distribution/wholesaler businesses can be used to get the material to clients. Secondly it needs to know what the potential market size is, what makes clients buy from a particular business, what price to set and the likely potential value of sales revenue if it expands production.

1 Recommend appropriate methods of market research Johnsons can use as it considers building a new factory to expand production.

Tip: Start by recommending whether Johnson should carry out the research itself or employ an agency. Make sure that you relate the methods to the objectives of the research businesses.

Cost-effectiveness of market research

Market research is worth it if it gives the right answers that enable cost savings, designs that meet customers' desires, marketing campaigns which meet objectives or generate information which results in higher sales. The additional revenue or cost savings should be more than the cost of the research. The problem is that the outcome is not known before the research takes place.

Market research is expensive – an agency will typically charge around \$1000 for a focus group, a phone interview costs around \$50, an in-depth interview \$2000 and an online survey around \$1000. These

costs do not include writing and producing the questions, piloting questionnaires, training interviewers, printing, the cost of meetings with the agency and the analysis. There are also the costs of writing up and presenting the information. These costs are only guides as every research project is individually tailored to the client. The American Marketing Association, for example, recommends setting a budget of 0.02 per cent to 1 per cent of gross sales for an existing business, and in launching a new product or business the cost can be as high as 10 per cent of expected gross sales.

A key way to maximise the likelihood of cost-effectiveness is to plan thoroughly. This involves deciding the objectives and how market research will meet these, deciding on appropriate methods given the constraints of finance and the time available. Remember that competitors may see your research and gain vital information about your plans. Many businesses spend 25–50 per cent of their marketing budget on market research, though in the UK the average is around 10 per cent. These businesses must believe research is cost-effective, generating more savings or revenue than the cost of the research.

Case Study

MRSI market research studies

MRSI is a market research agency. Both of the following MRSI research studies were cost-effective, leading to increases in revenue much larger than the cost of the research.

New packaging design

A food manufacturer was faced with falling sales and thought that a redesign of a canned food product would update its brand image. The new can would still have to be easy to find on the shelf. MRSI carried out web-based research in which volunteer respondents saw two new designs and competitors designs flashed on the screen.
They then commented on what they remembered.

Results

One of the new designs was preferred 3:1 over the current label and was seen as modern and exciting. It was introduced and sales rose steadily.

Targeted marketing campaign

A company in the USA selling packaged goods wanted to increase sales of its cleaning product brands to Hispanics, a defined population group. It ran an advert but this failed to increase sales and brand awareness in the target group.
MRSI ran an expensive research programme involving firstly in-home detailed unstructured interviews, followed up with informants keeping product usage diaries and finally a range of focus groups that looked at the product and how it was seen.

Results

The research provided key points about how Hispanics saw the products. It discovered that the original advert was irrelevant to Hispanics and provided no emotional responses.
A new marketing campaign based on emotional connections led to a significant increase in sales to the target group.

1 Suggest two reasons why MRSI was employed to carry out research.
2 Explain two reasons why the research was cost-effective.
3 Explain the difference between an unstructured interview and a focus group.
4 Suggest reasons for the choice of research methods used by MRSI.

Case Study

Kellogg's

Kellogg's is a food manufacturer that produces a wide range of products. Its best-known brands are breakfast cereals. It makes a number of different types of cereal and aims these to segmented markets in 180 countries. This involves different marketing strategies and methods.

In 2003 it considered developing its very successful Crunchy Nut cereal by adding Crunchy Nut Clusters, a much sweeter cereal than the original. These proved successful and Kellogg's thought that it might be able to achieve a bigger market share by further extending the product range to include a new cereal variant – Crunchy Nut Bites. This would involve considerable expense so it wanted to be sure that the new product would be successful.

It was particularly interested in what customers felt. It employed a market research agency to carry out the research.

1 Explain why Kellogg's might have employed an agency rather than carrying out the research itself.
2 Recommend methods of market research that the agency can use as it considers the design and marketing of the new cereal.

Exam-style questions

1 a Briefly explain the difference between primary and secondary research. [3 marks]
b Define market research. [2 marks]

Desta Department Store (DDS)

DDS is located in a large city. It is a large department store and sells a wide range of household items, clothes, furniture, jewellery and electrical items. The costs of staff, lighting, display and inventory mean that prices are relatively high. Increasingly consumers are turning to other ways of buying products and DDS is now the only department store still open. Sales are falling and DDS will close in a year unless costs can be reduced or sales revenue increased. DDS stocks only quality products from reputable reliable suppliers and this policy is supported by employing well-trained staff who can give tailored advice to individual shoppers. The idea of opening in the evenings for two nights a week with discount prices in some departments has been put forward as a possible way for DDS to continue in business.

2 Recommend a method of market research that DDS could use before making a decision about the extra opening hours. [10 marks]

Key concepts

AS **Change** can be linked to the need for market information to find out what changes are taking place.

AS **Management** can be developed through the ideas of decisions based on cost-effectiveness of market research and the choice of methods to be used.

AS **Customer focus** can be related to the ideas of sampling methods and questionnaire design.

AS **Creating value** can be developed by the right application of information.

Progress check

You should now be able to:

AS explain the purpose of gathering market research to meet objectives

AS understand the difference between primary and secondary research in order to recommend an information-gathering method

AS analyse different sampling methods so you can choose an appropriate method for a given business situation

AS interpret the information from market research

AS assess the reliability of market research results

AS evaluate the cost-effectiveness of market research which has been carried out.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **AS** the elements of the marketing mix: Product, Price, Promotion, Place (4 Ps)
- **AS** the role of the customer (4 Cs) in relation to the marketing mix
- **AS** ways in which customer relations can be improved
- **AS** the product element of the marketing mix including:
  - **AS** products and services
  - **AS** tangible and intangible attributes
  - **AS** product development
  - **AS** product differentiation and unique selling point
  - **AS** product life cycle and marketing activities
  - **AS** portfolio analysis

Key terms

Marketing mix: the combination of product, price, promotion and place (4 Ps) that is used to achieve marketing objectives.
Direct marketing: selling directly to the possible buyers, not via an intermediary such as a shop.

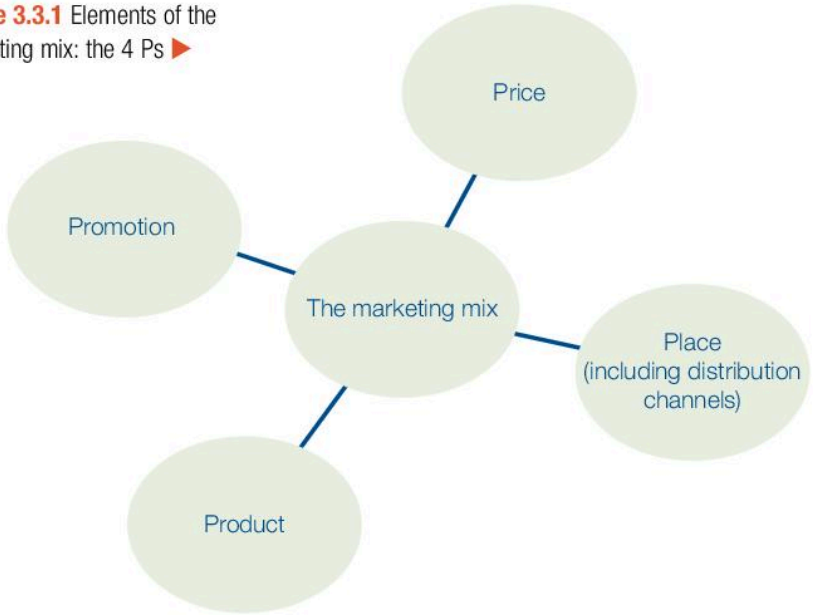
3.3a The marketing mix: elements and product

This chapter deals with the first component of the marketing mix: the first P of the 4 Ps – product. AS Level Chapter 3.3b then goes on to cover price, promotion and place, and all four Ps should be integrated to form a marketing strategy.

What is the marketing mix?

The marketing mix is the combination of product, price, promotion and place (the 4 Ps) that is used to make sure that customer's requirements are met. The constraints in place mean that these elements in the mix must be put together in an effective coherent and integrated way. This must be related to the target market and the budget available, e.g. a product such as a machine tool aimed at a producer market is likely to be efficiently designed with a focus on function. Direct marketing to the producers without a mass advertising campaign is likely to be used and the price is likely to be near or below competitors' products. A product such as a dress aimed at a consumer market is likely to focus on the needs of a segment, using promotional methods and prices appropriate to that segment.

Figure 3.3.1 Elements of the marketing mix: the 4 Ps ▶



Elements of the marketing mix: the 4 Ps

This chapter deals with the marketing mix as a whole and then focuses on one of its elements: product. Price, promotion and place are dealt with in AS Level Chapter 3.3b.

Key term

Product: the product or service being produced and sold.

Product

This includes the design, functionality, colour, level of service and lifespan of a product. It includes the features of a service including times, level of quality and exactly what is being offered. It also includes the brand chosen for the product.

Key terms

Price: what the business is charging customers in money terms.
Promotion: the methods used to inform customers and persuade them to buy. It includes advertising and a range of promotional methods.
Place: the methods used by a business to get products or services to customers. It includes physical means of transport and where and how customers can obtain the product.
Packaging: the technology of enclosing or protecting products for distribution, storage, sale and use.

Price

This is what a business is asking consumers to pay for the product or service. It may be high or low in relation to the business's costs or to the prices charged by competitors in the market.

Promotion

These are the methods used by a business to inform consumers about the product and to persuade them to buy. Promotion includes advertising and special offers, sponsorship and public relations activities.

Place or distribution

This relates to the methods used by a business to physically get products to a customer or to the place where a customer may purchase a product or service. Place refers to points of sale such as stores or websites as well as lorries that distribute products. It also includes the idea of which supply chain a business will use, e.g. selling direct to the consumer or via a wholesaler.

In recent years the 4 Ps have been expanded, firstly by separating packaging from promotion, then adding physical evidence, people and process. There can be even more Ps, up to 27. You need to focus on the basic 4 Ps as these cover all the additional Ps.

Integrating the elements of the marketing mix

It is important that these elements are integrated. This means that they must reflect and support each other in a coherent way. For example, a high-quality product will be expensive and is likely to be promoted in media that high-income groups read. It will have high-quality packaging and is likely to be sold in exclusive stores.

Progress questions

1 Comment on the likely success of the following marketing mixes and suggest changes to improve them by making them more integrated.
   - **a** A perfume for women which is very expensive, is sold on market stalls and written about in articles in expensive women's magazines and quality newspapers.
   - **b** An ice cream made from quality ingredients. The price is low but it is not the cheapest on the market. It is sold in several supermarket chains and advertised in a range of newspapers and magazines and some billboard adverts.
   - **c** A family-sized car, all models with the same features, sold at a medium price with no advertising or reviews in the media, available from selected garages and dealers.

The role of the customer – the 4 Cs

It is very important that the customer is not forgotten. The 4 Ps tend to be internally directed – they refer to what businesses are deciding. Of course the 4 Ps must take account of the target market and the needs of the customer, but it is easy to forget these. The 4 Cs try to address this by taking the 4 Ps and looking at them from the customers' point of view. The point of this is to try and think like consumers.

This will highlight the need to give consumers a real reason to buy a particular product from a specific business.

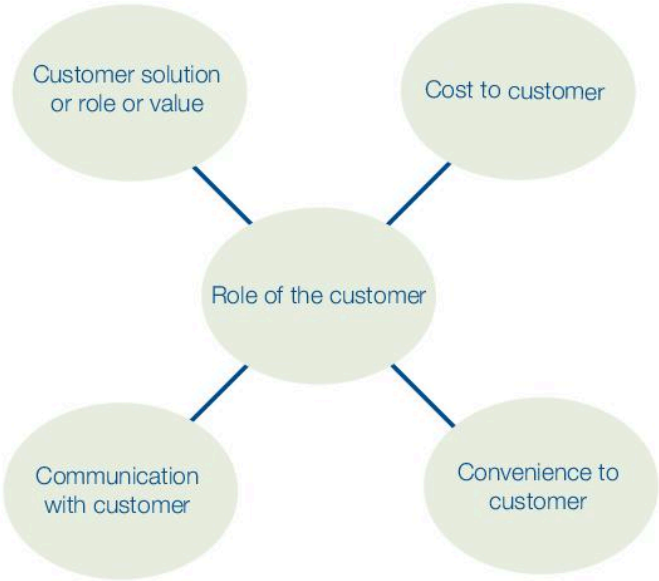


Figure 3.3.2 The role of the customer: the 4 Cs ▲

Customer solution

Customer solution is about looking at the product from the customer's viewpoint. Producing what consumers want is what will give a product value in their eyes. It is not good enough to only focus on what is produced. A business needs to concentrate on the perceptions of the customer about a product and what value they place on a product. If a business produces a technically wonderful, well-designed product it will not sell unless it does what consumers want at a price that consumers value it at. It is this sense of value that marketing should be promoting.

Key terms

Customer solution: looking at the product from the point of view of the customer.
Cost to customer: what the customer thinks the product will cost them, not just in money but what it is worth to them.
Communication with customer: the building of a two-way relationship, not just giving information or persuading.

Cost to customer

Cost to customer is not the same as price. Price is what a business charges, cost is the cost that the consumer has to pay. Looking from this point of view highlights that customers have to decide how to spend their limited income on their unlimited desires. The product must offer something that will entice a consumer to part with their money. This links to the idea of providing value for the cost customers are paying rather than thinking of the profit to be gained. This means that a business should focus on how they can provide more than competitors' products for the same cost.

Communication with customer

Communication with customers is very important. Rather than promoting products to customers a business should engage in an exchange of ideas with customers who have been faced with advertising claims and a barrage of promotional methods. They may no longer believe what producers tell them. They will be much more likely to trust a business that is prepared to listen to them and interact with them. This is especially true because the days of mass marketing are declining. Market segmentation using technology is now much more a feature of consumer markets and it is important that businesses build a

relationship with their customers rather than merely provide products for sale. This will also provide a sense of value.

Convenience to customers

Key term

Convenience to customers: how easy it is for the customer to access and obtain the product.

Convenience to customers is a much wider idea than how easy it is for customers to obtain the product. Consumers are increasingly interested in the when, where and how of getting products and services in the most convenient way for them. Customers are busy and have a great deal of choice so a business must make it as easy as possible for them to choose their product or service.

Activity

An ice cream store sells a range of ice creams: different flavours, cones and bars. Discuss how the 4 Ps and the 4 Cs might be used to increase sales.

Improving customer relations

The way businesses interact with their customers is becoming increasingly crucial for success in a world where choice is everywhere and consumers have access to so many sources of information. Customers have always wanted more for less, they have always wanted value for money and will shop around to get these things. Businesses must learn to have close relationships with customers rather than just sell to them. This means integrating all the functional areas of a business to satisfy customer needs and this must include production and accounts. For instance, reminders and invoices should use friendly, non-aggressive language. A business must focus on customer-friendly processes, employees' commitment to customer service and creating a dialogue with customers.

Here are some positive ways to improve relations with customers. They will maximise the chance of orders, repeat orders and recommendations to others.

Table 3.3.1 Methods of improving customer relations ▼

Business to customer (B2C) relations
The business should: • Tell customers how much it appreciates them visiting its website or buying its product. • Solve complaints by being quick and friendly. The faster the response, the more the customers will feel the business cares about them. Money should be refunded or a discount or free gift given. The customer is always right. • Constantly find new ways to better its product and service. • Give clear ordering instructions. • Email each visitor a satisfaction questionnaire after they purchase. This will allow the business to improve its order system, customer service and website. • Provide a "Contact Page" on the website and give visitors as many options to contact the business as possible. • Create a customer focus group that meets regularly. This will provide ideas about how to improve customer service. • Train employees to be polite to all customers at all times.
Product to customer relations
The business should: • Keep its product available to customers at all times. • Offer a free trial of the product for a set period of time and charge or bill customers only after they have decided to buy the product. This will remove any risk. • Create new products or services only if there is a strong need for them. There will be nobody to sell products to if there is no market.
Customers incentives
The business should: • Give prospective customers extra incentives. It could be free or faster shipping, or free gift wrapping. • Offer visitors a free gift for filling out an online survey. • Give new customers surprise free gifts to increase their loyalty • Keep loyal customers happy. Give them discounts and free gifts. • Give customers a surprise bonus for buying. When customers are given more than they expect, there is a good chance they will buy from the business again.

- Use incentives to gain referrals; tell people that they will be rewarded with free products when they refer customers.
- Let customers have a discount, e.g. for ordering over a set product amount.
- Give prospective customers confidence; use endorsements, testimonials, a strong guarantee or warranty.

How the 4 Cs relate to the 4 Ps

The 4 Cs consider the point of view of the customer. The 4 Ps refer to decisions businesses take about marketing. They both deal with the same topics from different points of view. The 4 Ps are what businesses have to decide on, and by considering the 4 Cs businesses will make sure that the customer's point of view is not ignored. This will ensure that the marketing mix (the 4 Ps) will give customers real reasons to buy.

Table 3.3.2 The 4 Ps and 4 Cs compared ▼

4 Ps	Meaning	4 Cs	Meaning
Product	• What the business produces	**Customer solution/value**	• How the customer values the product
Price	• What the business charges	**Cost to customer**	• What the customer sees they have to pay
Promotion	• What the business tells customers	**Communication with customer**	• How businesses and customers interact
Place	• Where the business sells its products	**Convenience to customer**	• How the customer obtains products in the easiest way for them

Getting it right

The 4 Ps must be integrated. Analysis is shown by commenting on how the elements of the marketing mix relate to each other in a way that supports each of them in giving the same message.

Link

Price, promotion and place are just as important as product and they are discussed in AS Level Chapter 3.3b The marketing mix: price, promotion and place.

Key terms

Attributes: the characteristics of a product or service that make it what it is.
Tangible attributes: those that are physical, i.e. can be touched.
Intangible attributes: those that have no physical existence and cannot be touched.

Progress questions

2 Explain three reasons why it is so important today to have good customer relations.
3 Consider the 4 Ps and the 4 Cs. Use Table 3.3.1 to suggest appropriate ways a business might deliver each of the 4 Ps and 4 Cs.
4 Select three methods of improving customer relations from each of the sections in Table 3.3.1. Explain how they might improve customer relations and what the results of this might be.
5 Explain how improving customer relations relates to achieving marketing objectives.

The 4 Ps: Product

Products, services and product attributes

The product is the good or service that is offered for sale to the customer. Examples of a product are cars, drinks and computers. Examples of services are music concerts, house cleaning, haircuts and banking. Products have a number of attributes – things that make the product what it is. These can be tangible attributes (physical characteristics like the type of wood used or the shape) or intangible attributes (things that cannot be touched, concepts like quality, durability and fashion appeal).

A product will have a variety of tangible attributes, meaning the product has a physical existence. A service consists of intangible attributes. In reality, products have a combination of tangible and intangible attributes and businesses must make sure that customers obtain satisfaction from the whole product. A well-cooked meal badly served is not a good product and the customer is unlikely to be pleased. It is important that all products are appropriate for the target market and meet customer expectations. This includes the way that staff behave as they give information, provide the product or service and deal with enquiries and complaints. If all these are positive, customer relations will be good, repeat purchases and recommendations are likely and marketing objectives will be met.

There are various different ways to achieve good customer relations depending on the target market. Some supermarkets have well-lit, wide aisles, carefully stocked shelves, tidy ordered trolley areas, trolleys with children's seats, and accessible staff. Shopping there may give consumers some kind of status. Others have few staff in the store, piles of products still in boxes, untidy trolley areas and cramped space. Shopping in them may show the consumer is not interested in status. Both types of store offer a different experience (product and service) but both may be successful. The other elements of the marketing mix may also be different to reflect a different target market. The well-lit, well-staffed store will usually have higher prices and perhaps better-quality stock than the less well-staffed store.

Table 3.3.3 Attributes of an expensive perfume ▼

Tangible attributes	Intangible attributes
• Chemical composition • Shape of bottle • Packaging	• Gives sense of confidence • Shows wearer is rich • Gives appeal to opposite sex

All these attributes have to be designed to take account of the target market and businesses must be careful to get all aspects of the product appropriate.

Progress questions

Consider the two types of supermarket described above.

6 List the possible tangible and intangible attributes each type of supermarket has.

7 Discuss how integrated the marketing mixes of the two supermarkets are.

Key term

New product development: the creation of products with new or different characteristics that offer new or additional benefits to the customer.

Product development

New product development is the creation of products with new or different characteristics that offer new or additional benefits to the customer. Product development may involve modification of an existing product or its presentation, or formulation of an entirely new product that satisfies a newly defined customer want or market niche.

Products do not just arrive from nowhere. Businesses with good customer relations and a market focus will be looking to develop new products all the time. The aim is to ensure that competitors do not enter new markets first and gain market dominance, but also to maintain a competitive edge in existing markets, as Kellog's did when adding Crunchy Nut Bites to their range (see page 156).

Case Study

Developing washing powders

In Europe Procter and Gamble and Unilever hold the majority of the domestic cleaning chemical market and a high percentage of global markets. They have each developed a number of brands of washing powders. These are all essentially the same but each brand is marketed as a different product. Ariel, Bold and Daz (Procter and Gamble) and Persil, Radiant and Surf (Unilever) are constantly being refined and changed. Some of the changes are tangible, e.g. different chemicals and colourings and some are intangible, e.g. brand value appealing to different emotions in consumers. Persil introduced tablets and capsules instead of powder in 2000, then liquigels in 2003 and a double concentrated version in 2007. This kind of competitive development had the objective of maintaining market share in the face of stiff competition.

1 Explain why the washing powder market has seen a lot of product development.
2 Suggest reasons why it is important to develop both tangible and intangible attributes for washing powders and chemicals.

Some markets have product development as an obvious key component. Technology-based products like computers, cars and music technology see new models and innovations nearly every year. More stable markets, like jam, see less obvious changes.

Reasons for product development

Asset-led development (product orientation)

Businesses engage in research and development, using the assets they have, sometimes with little reference to markets. They may have scientists and management experts interested in making new things for their own sake, without directly thinking about selling. These businesses then detect a market opportunity and start selling their new ideas. A famous example from the 1970s was the original Sony Walkman, a device that played music from cassettes but which could not record. No market research was done before the new product was sold successfully. Some Apple products have evolved in a similar fashion. Success from this route depends on how quickly commercial potential can be realised.

Market-led development (customer orientation)

Businesses engage in market research and a dialogue with consumers. They find out what consumers would like in a new or refined product and they then set about deliberately designing a product to meet the identified consumers' needs. The majority of new products today are

based on this market-led approach. It relies on accurately knowing what consumers think and how the market is likely to behave in the future. There are three main factors that influence product development.

1 Technology

Technological advancement means that businesses have the capacity to meet the needs of consumers in ways that would not have been possible in the past. It also means consumers' needs develop as new possibilities appear. The developments in smartphones and mobile computers including tablets are examples of this. E-book readers have been available for specialist material since the early 1970s but it was only when improved wireless technology and data communication became available from 2007 that dedicated e-readers were able to be developed to meet a growing market in the developed world. By 2011 the market indicated that consumers wanted an e-reader that would also double as a mobile computer, and first the iPad then Amazon's Kindle Fire and Barnes and Noble's Nook were developed to meet this need.

2 Competition

Businesses in competitive markets face a constant struggle to offer products that consumers will prefer to buy. New products have to be developed to stop market share being taken by the other businesses. The first business to develop a new product will often sell at a relatively high price before competitors' versions appear at a lower price. The Amazon Kindle Fire is an e-reader which will access the Internet, download a full range of apps and deal with emails. These were exactly the facilities offered by Apple's iPad, but the Kindle Fire uses a different system to do so and it is sold at a much lower price. Car businesses developed sports utility vehicles in response to market research, but the car manufacturers did so in the knowledge that other car manufacturers were also developing these vehicles and they could not afford to miss out on this area of the market.

3 Managers' abilities and skills

Some managers are better than others at interpreting market information. Some have an uncanny way of picking areas for new products and motivating their research teams to produce the desired product. This entrepreneurial ability to see gaps in the market for a new product or a change to an existing one is difficult to teach. Jeff Bezos founded Amazon in 1995 as an online bookstore after he saw an opportunity to stock more books than a hard-copy store could. His belief in the opportunity that online selling offered enabled him to persist with his business plan despite the opposition and uncertainty of many shareholders. Being the first major online retailer eventually paid off. Despite his belief in online and the opposition of shareholders to his development plan Amazon did not make a profit until 2001. Since then it has diversified to be the largest online retailer in the world.

Figure 3.3.3 Jeff Bezos, the founder of Amazon ▲

Product development is a vital part of marketing. Consumers' needs are always changing and businesses have to respond to this. If they do

Activitiy

Think of three products which are new or have been recently introduced to the market in your country.
Discuss the main reasons for their development.

not, they will fail as their products are no longer wanted. Cigarette and tobacco businesses are facing this prospect in developed countries as are manufacturers of small motorcycles in other areas of the world.

If new products are not produced by existing businesses the new ideas of their competition will eventually force them out of the market. The new products enable gaps in the market to be filled as consumers' needs, whether existing and unmet or new, are addressed. Market change is inevitable.

Product differentiation and unique selling points (USPs)

Key term

Product differentiation: the degree to which customers perceive a product or brand to be different.

Product differentiation is the degree to which customers perceive a product or brand to be different. This may be achieved through various routes and the aim is to make customers see that the brand or product is the only one that meets their wants and needs. The differentiation may be through an actual advantage in design, performance or price, or an imaginary but real process in which the customer is convinced that the product or brand has something over and above its physical characteristics. Customers then consume the product and also the brand, as happens in many fashion accessories. Ways to achieve product differentiation include:

- Advertising or marketing campaigns to make a product stand out – Nike
- Superior or particular design or performance characteristics – Dyson or IKEA
- Aftersales service and guarantees – Prime in Mumbai follow up any complaints until they are dealt with
- Branding and packaging – Coca-Cola
- Particular distribution methods – Amazon.

Link

Branding is covered in AS Level Chapter 3.3b The marketing mix: price, promotion and place.

Product differentiation enables businesses to build value into their products and convince customers to buy, knowing that their particular wants and needs are being met better than by an alternative product.

Key term

Unique selling point (USP): the one particular factor that makes a product different.

Building on this idea many businesses attempt to differentiate their products or service by providing a unique selling point (USP). This is differentiation applied so that customers feel that the product has something no competitors are able to supply. This will attract customers to buy as they may not even consider any other options. The USP may be something unique to the product, the distribution arrangements or the marketing methods. The USP needs to be constantly reviewed as competitors may be able to alter their products to erode the effect of a USP. A USP needs to be more than just an advertising slogan or strapline, but these often encapsulate the USP offered. A good example is M&M chocolate products that "melt in your mouth not in your hands".

Case Study

TOMS Shoes

TOMS Shoes are quirky, comfy, light and inexpensive. Most of them have textile uppers. None of this is enough to make them stand out in the shoe business. The most unique and compelling part of this business is that it gives a new pair of shoes to a child in need for every pair that is purchased.

Figure 3.3.4 ▲

1 What is the USP that TOMS Shoes offers?
2 Discuss whether this USP is enough to make customers buy from TOMS Shoes.

Key term

Product life cycle: the stages a product passes through from development to decline. It shows sales revenue through time with corresponding stages: development, introduction, growth, maturity and decline.

Product life cycle

The product life cycle describes the life of a product from when it is first thought about to the end of its life, when it is no longer produced and sold. Many products go through similar stages in this process. However, the length of the life cycle varies greatly. Some products like powdered custard are still being produced after 100 years whereas cassette tapes lasted 40 years. The product life cycle can be shown as a graph which sets out sales over time. The life of the product is then divided into five stages.

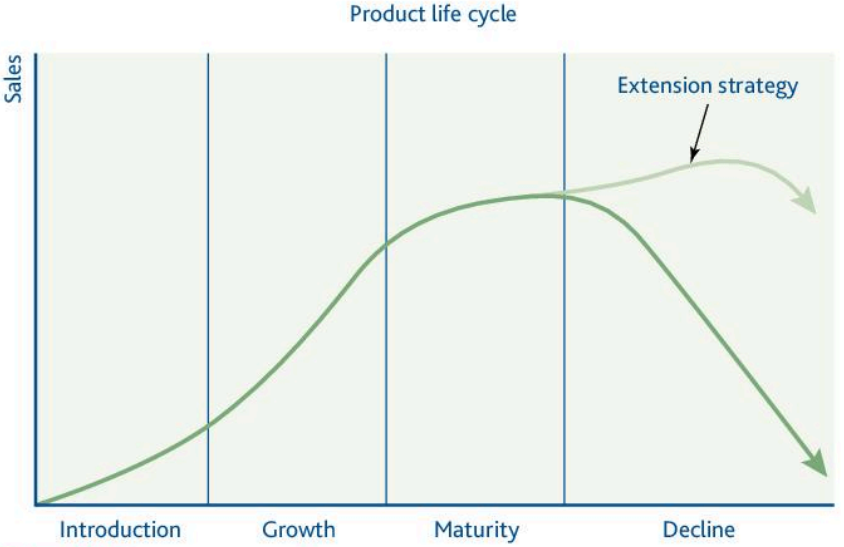


Figure 3.3.5 Product life cycle ▲

Stages of the product life cycle

1 Development

The new product is being researched and refined in order to meet the identified consumers' needs. It will not be on general sale yet though some test marketing may be carried out, often in a way that tries not to let competitors know what is going on.

2 Introduction

The new product is launched in the market. Sales will usually be low to start with as the product is not proven to be a successful seller. Retailers may not offer it full shelf space and consumers may be wary of buying something they are not familiar with. Marketing activities will often be vigorous, with heavy spending on advertising and promotion, to make consumers aware of the new product and become interested in buying it. The price may be high, particularly if it is a technologically advanced product or one that offers a significant difference to existing products. The iPhone sold at a very high price to start with. On the other hand price may be low to encourage consumers to buy. There might be introductory offers for example.

The product will be sold to those who are "innovators" or "early adopters", a market segment that is willing to try new products.

If successful, sales will start to grow as more and more consumers become interested.

3 Growth

Once a product is established sales increase relatively quickly as advertising and promotion begin to take effect. Retailers are more interested in selling the product and positive word of mouth and media interest increases. The product will be sold to the market segment of "early majority", those willing to buy a new product but only when it is beginning to show that others are buying it and it has had time to prove its worthiness. As sales grow, profitability increases, but there may be increasing competition as other businesses see an opportunity.

4 Maturity

Assuming the product has survived, sales will plateau as all the consumers who are interested in buying the product are doing so. Promotion and advertising costs may not need to be as high, average costs will fall as more units are produced, and the product is likely to be generating high profits and possibly high market share.

5 Decline and extension strategies

Consumers become less interested in buying the product. This may be because technological change has made it obsolete, in the way that downloaded music has caused sales of CDs to fall. It may be that competitors have produced products which match consumer needs more exactly. Lucozade was sold as a drink for sick people or people who needed a lift. The competition produced products which consumers preferred and Lucozade sales were in decline. It was then rebranded as a health drink for active people, supplying the needs of athletes and those in training. This change in promotion altered the perception of the drink and sales increased. This is an example of an extension strategy for a product in decline. The same is happening to a small extent with vinyl music. Sales are increasing as producers see that there are still people interested in this format as it offers facilities and sound that digital music cannot.

Key term

Extension strategy: used to try and increase sales of a product that is in the decline stage.

Getting it right

Make sure that you define marketing terms you use. Show you know what they mean and justify your recommendations by relating methods to objectives, market research and/or possible alternatives. There are always choices to be made at each stage. Using marketing methods does not guarantee success, and consideration of possible likely results is good analysis.

This stage of the life cycle offers a choice. A business could let the product continue to decline. As it is still selling it will have consumer awareness so marketing costs will be low. If it is still making a profit many businesses will opt to continue with it until sales fall so low that a loss is made. The alternative is to withdraw it from the market as it may be taking up valuable resources in the business that could be going to developing new products. This will stop consumers associating the business with a declining product.

Using the product life cycle

The position of a product in the product life cycle gives some indication to a business about how the elements of the marketing mix might be used. It can also be used to check progress against the marketing objectives of the business and indicate changes to strategy if these are not being achieved. Different stages demand different approaches to selling, though it is important to remember that there are many possibilities and the product life cycle does not give definite answers. Table 3.3.4 sets out some ways the stages might relate to marketing mix elements.

Table 3.3.4 Product life cycle and possible marketing mix ▼

	Development	Introduction	Growth	Maturity	Decline
Product	• Prototypes	• First model	• Modified model • Wider range	• Could be focus on existing models or drop poorer-selling ones or extend brand to other models	• Could only sell profitable models or extend with modifications at low cost
Price	• N/a	• Could be high (skimming) or low (penetration) or at market rate (See AS Level Chapter 3.3b)	• Could be lowered to attract more customers	• Could be lowered further to maintain sales as competition arrives	• Could be lowered or heavily discounted
Promotion	• Awareness raising just before launch	• Probably significant advertising and promotion to raise awareness	• Still significant and aimed at capturing sales and loyalty	• Could be significant to combat competition or less if there is good customer loyalty	• Could be much lower to save costs
Place	• N/a	• Could be focused on key test areas	• Increased levels for wider coverage	• Could be continued wide distribution or focus on key profitable areas	• Could be continued wide distribution or further focus on profitable areas

Case Study

Kloppers – the story of a store

Kloppers is a discount retail family business in Bloemfontein, South Africa. The business started in 1967 and sells a diverse range of products including electrical appliances, sports apparel, clothing and hardware.

Introduction

The novel business idea was to sell well-known brands at a discount, aiming for high turnover and low profit margins. Initially suppliers were resistant to this and would not sell directly to Kloppers so the business operated through a buying co-operative for independent retailers. Profit margins were very low and it was some years before consumers were more prepared to buy from a cut-price store.

Growth

Increasing sales led to suppliers agreeing to sell direct to Kloppers. The arrival of TV in 1976 led to consumers becoming very price conscious and this led to increasing success. By 1980 discount retailing had begun to spread through the country with several national chain stores opening up selling high volumes at low prices. Competition was fierce. Kloppers decided to combat this by opening small stores and continued to expand in this way. However, it was difficult to manage a variety of stores so Kloppers decided to reintegrate into one very large store in the central business district and diversify into a mix of discount and non-discount products.

Maturity and decline

Sales continued to grow but by the late 1980s were flattening out. The founder was retiring and the business was sold to PepCor, a large South African retail group, but retained its own identity. Because of severe competition from other newer stores and increasing marketing costs the Klopper store began to see falling sales and increasing difficulty in staying in the market. PepCor then sold the store back to the Klopper family in 1991.

Extension strategies and a second wave of growth

The owners of Klopper were able to halt the fall in sales by altering their marketing to stress the family values of the business and the low-price value for money it offered. They then decided to take a risk and in 1995 raised money to take over a competitor selling hardware and paint and this diversification continued to generate funds. In 2002 a large shopping mall was built and Kloppers closed all of its branches and took a very large space in the new mall. This focus has led to increasing sales and a fall in unit costs enabling a large store extension to be built in 2010. Further expansion of product lines in sporting products took place. In 2014 Kloppers has maintained its position as a leading retailer with the strap line "Kloppers the price cutters".

1 Draw a graph showing the life cycle of the Kloppers store.
2 Explain the marketing mix that Kloppers used when it started up.
3 Assess the success of the methods Kloppers used to combat competition in the growth phase.
4 How did the methods used in the extension strategies enable a second successful growth period?
5 The life cycle of Kloppers from introduction to decline spanned 24 years. Its relaunch has lasted 21 years. The initial life cycle of the drink Lucozade lasted from 1929 to 1985 – 56 years – and the relaunched product is now in maturity. The life of some toys may be less than one year. Give two reasons for this difference in life-cycle length.

Progress questions

8 List the stages of the product life cycle.
9 Explain the term "extension strategy".
10 Give an example of a product with a USP.
11 How might product differentiation help a car manufacturer?

Key term

Portfolio analysis: considers the range of products a business offers, using market sales, market share, position on the product life cycle and segmentation in order to plan the most appropriate product mix to meet objectives.

Product portfolio analysis

Portfolio analysis considers the range of products a business is selling and/or developing and how best to use this range to achieve objectives. It uses the concepts of product life cycle, market share, market growth and segmentation to help make decisions about both individual products and the range of products a business offers. It focuses on how to achieve the optimum product mix; that means getting a range of products that are going to achieve long-lasting sales and/or growth in line with the marketing objectives of a business. It will then help pinpoint exactly what marketing activities need to be employed for each product in the mix. Because it considers a range of products it is particularly applicable for businesses with more than a small number of products.

Portfolio analysis allows a business to ensure that it always has a product ready to replace products that might be losing market share or sales. It also enables a business to have a range of products so that if one fails the others can provide revenue to cover. It allows planning to take place over time so that the business will always be in a position to maintain revenue and profit, being flexible enough to deal with market changes.

Case Study

LiLight

LiLight manufactures electric light fittings. It used to have three main product lines: bathroom, kitchen and workshop lights. The directors noticed that the introduction of LEDs, increasing competition from discount producers and changing industrial practice have affected sales. Sales of bathroom lights are increasing as the designs are sound and the number of bathrooms is steadily growing. Sales of kitchen lights are steady but market share is falling, and sales of workshop lights are falling rapidly. The future looked uncertain, so after some research the directors introduced new product ranges including a UV tanning system, a sunlight bulb system and a new type of bicycle lamp.

1 What stages of the product life cycle are the three original products of LiLight at?
2 Suggest possible extension strategies for the workshop lights.
3 How might product portfolio analysis have led to the new products LiLight produce?

Exam-style questions

1 Define "marketing mix". [2 marks]
2 Explain the term "unique selling point". [3 marks]
3 a Analyse the usefulness of the "product life cycle" for a marketing manager. [8 marks]
b Evaluate the usefulness of product portfolio analysis for a large business operating in a competitive market with a wide range of products. [12 marks]

Good news for Radar Cosmetics

"Sales of branded cosmetics in Asia hit all time high!" announced the *Daily Echo* headline last month. This is excellent news for Radar. The company manufactures cosmetics, shampoos and creams. Women, and increasingly men too, buy these products to look more beautiful! The increase in sales of cosmetics and similar products has been due to rising disposable incomes amongst the 18–35-year-old, middle income market segment in country P. This is the main market for Radar products, accounting for 80 per cent of the company's total sales.

Research and development success

For years Radar had struggled with a poor brand image and lack of product focus. The business used to make products for supermarkets which sold them under the supermarkets' "own name" labels. This changed when Radar's small research and development team of scientists developed a new range of skin creams. Radar's scientists made two claims about these creams:

- They definitely reduced the signs of ageing in 75 per cent of users.
- Three separate products have been developed – creams A, B and C – to suit different ethnic skin types.

The directors of Radar made a strategic decision. The company stopped making skin creams for other companies and launched its own range of three expensive upmarket creams. The brand "Aquaskin" was created. A large marketing budget paid for advertisements on TV and in fashion magazines, which created

much consumer interest. The advertisements stated its unique selling point as: "Aquaskin is an entirely natural product, is not tested on animals and is guaranteed to make you look younger". Clever publicity was arranged with the support of an Olympic swimming gold medallist. She was paid by Radar to suggest that "Aquaskin keeps my skin fresh each day even after six hours training in the pool". Sales of Aquaskin products were 50 per cent above the company's target in the first two years despite prices being 20 per cent above those of most competitors.

4 Analyse the benefits to Radar of further investment in research and development (R & D). [10 marks]
5 Discuss the extent to which Radar created a unique selling point for Aquaskin. [14 marks]
6 Evaluate the usefulness of the product life cycle to Radar when deciding on a marketing strategy for its products. [16 marks]

Key concepts

AS **Change** can be viewed from the perspective of market developments and levels of competition. It can also be studied from the perspective of the product life cycle.

AS **Management** has a role to choose marketing methods and implement them.

AS **Customer focus** needs to be considered from the perspective of the 4 Cs (which is all about customers) and the 4 Ps which influence customer behaviour.

AS **Innovation** can be developed with respect to the impact of new products, new markets, and new technologies.

AS **Creating value** is one of the major roles of marketing through changing consumers' needs, wants and perceptions and improving value added through such techniques as branding, promoting etc.

AS **Strategy** is involved in developing the marketing mix and marketing strategy.

Progress check

You should now be able to:

AS explain the marketing mix

AS explain the 4 Cs

AS discuss the relationship between the marketing mix and the 4 Cs

AS evaluate ways in which marketing can be improved

AS recognise the importance of product development

AS discuss USP

AS evaluate the product life cycle

AS discuss portfolio analysis.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **AS** types of pricing strategies
- **AS** price elasticity of demand
- **AS** promotion methods
- **AS** channels of distribution
- **AS** using the Internet for the 4 Ps/4 Cs
- **AS** consistency in the marketing mix

Link

Price, especially market price, is discussed in AS Level Chapter 3.1 What is marketing?

Key term

Differentiated product: one that customers see as being different from any of the other similar products. This may be achieved by using one or more elements of the marketing mix.

3.3b The marketing mix: price, promotion and place

This chapter deals with the last three components of the marketing mix (price, promotion and place). It follows AS Level Chapter 3.3a on the first P (product) and all four Ps should be integrated to form a marketing strategy.

The 4 Ps: price

Factors determining price

The price businesses sell products for is a key component of the marketing mix. Demand and supply theory tells us that as the price of a product rises customers will buy less and vice versa. So if a business wishes to sell more it will reduce its price. However, this is not the whole story as it assumes all other factors are held constant. The price that is charged will send a message to customers about the product – does a low price mean a cheap and nasty product or good value for money? Does a high price mean the product is too expensive or is it a sign of quality?

Differentiated products and pricing

A differentiated product is one that customers see as being different from any of the other similar ones. This may be achieved by using one or more elements of the marketing mix. Differentiated products are aimed at particular market segments. They are sold using particular promotional techniques in carefully chosen places and these factors will be related to price. For instance, if a business can convince customers that their product is superior to others and offers a really fashionable experience it may be possible to sell it at a high price. If the target market is low-income earners, a high price will result in low sales. It may be that the price of a product at different stages in its product life cycle will vary.

Competition and pricing

Businesses must also take account of the competition when deciding a price. This may mean setting a price lower, equal to or higher than the price of similar competing products.

Costs and pricing

Businesses must set a price that covers the costs of production. Setting low prices means more sales must be made to gain a certain level of revenue, but profit margin will be small. Setting a high price means lower level of sales will generate a certain level of revenue, but customers must be persuaded the high price is worth paying. Whatever price is set, customers in the target market must see it as being at the "right" level: not too high or too low.

Table 3.3.5 Factors determining the price of a product as set by a business ▼

Factor	Factor content	Effect of factor on setting price
Cost of production	Including: • variable costs • fixed costs • total costs	• Determines lowest possible price • Add markup to give a profit
Customers' perception of price	• Fair price • Link to quality • Expectations • Link to income • Degree of need by customer • Partly determined by segment	• Influenced by past experience, promotion and marketing, competing products. • Business can influence customer • Determines highest possible price
Competition	• Number of businesses • Type of products • Marketing mixes used	• Outside a business's control. • Price in relation to competition – higher, equal or lower

Information and pricing

It is very important for a business to get as much information as possible about costs, customer perceptions and competition in the market. Market research is vital, as is accurate information about the costs of production. All this information can generate a range of possible prices. Decisions can then be made by applying business and marketing objectives to possible marketing mix strategies in the market conditions facing the business. Pricing strategies may change over time as objectives, markets and customers change.

Progress questions

1 Explain two factors a business might consider when setting a price.
2 What is meant by a differentiated product?
3 Explain how competition affects the price a business might charge.

Pricing strategies

A pricing strategy is the method a business uses to set its prices for a product over a medium or long time period. It is not a short-term tactic like holding a sale for a week. A pricing strategy will be market based or cost based. If it is market based the business sets a price based on market conditions and how it thinks customers perceive the product. It is important that the price covers costs as a minimum. If it is cost based the business will set a price by considering its costs. The resulting price must be appropriate for the market the product is sold in.

Market-based strategies for new products

These will be used for a product being introduced to a market. It is likely to be an innovative product with no real competition yet. As there is no competition the price strategy can be price skimming (set very high, well above costs) or price penetration (set very low, with a low profit margin).

Link

For more information on costs see AS Level Chapter 5.3 Costs.

Highest possible price set by
- Customer perception
- Business objectives
- Marketing objectives
- Other components of marketing mix

Possible price set by
- Position in product life cycle
- Considering market information
- Market behaviour and competition

Lowest possible price determined by
- Need to cover costs

Figure 3.3.5 Upper and lower limits to setting a price ▲

Key term

Pricing strategy: the method a business uses to set its prices for a product over a medium or long time period.

Key terms

Price skimming: setting the price for a new product very high. This enables high profit margins for the first sales and allows a business to drop the price as competition arrives.
Price penetration: setting the price for a new product very low. This allows a business to quickly gain high market share and customer loyalty.

Price skimming

A new product with no competition attracts customers interested in unique purchases, often high technology or fashion items. They want to be the first to own the new unique product or use the service. They will pay a high price for this. The product may also have heavy research and development costs or market launch costs to cover and the high profit margin will do this. Sales figures will be watched. If these are static or if copycat competition arrives, the initial high price can be reduced to maintain or increase sales, attracting new segments of customers to skim before moving to perhaps lower income groups or "later adopters". The initial high costs may fall as increasing sales and levels of production reduce average costs and this will enable the price to be reduced. Brand loyalty will be building up if the marketing has gone well and sales will increase as the price is reduced.

An example is Sony introducing high definition TV sets in Japan in 1990 for a price of $43 000. By 1995 the price was $6000 and by 2014 a similar TV sold for $300.

Price penetration

The new product is sold at a very low profit margin and price to attract as many customers as possible in a short time. The aim is to gain brand loyalty and make it difficult for competitors to compete on price. The initial high market share can then be maintained as the market for the product grows. As output rises, average costs fall and profits increase quickly. Once market share is established and competition arrives this strategy may be reviewed as it may be possible to increase prices using customer loyalty. An example is Toyota selling the Prius dual fuel car at a low price in order to gain its current high market share.

Products that are high technology, fashion driven, with high research or launch costs are likely to be suitable for this strategy, appealing to small segments of the market.

Penetration pricing is sometimes said to be a deliberate strategy for a new product entering an existing market. By selling at a much lower price than the competition the business hopes to gain significant market share, as Amazon hope to do by setting the price of their Kindle Fire well below that of the iPad.

The extreme method of penetration pricing is called predatory pricing. A company sells a product at an extremely low price, often well below what it costs to produce it. The business is prepared to make a loss for a period of time in order to take market share and drive the competition out of the market. This strategy is illegal in many countries under anticompetition legislation.

Penetration pricing is likely to be suitable for products which customers buy based on price, larger output greatly reduces unit costs, there is a mass market and industry standards are important.

Activities

1 Find examples of products you think are being sold at a very high price for their market.

Discuss the reasons why their price is so high.

2 Find examples of products you think are being sold at a very low price for their market.

Discuss the reasons why their price is so low.

Table 3.3.6 Advantages and disadvantages of price skimming and price penetration ▼

	Price skimming	Price penetration
Advantages	• High prices give appearance of quality and "must have" factor • Some customers will pay high prices for a new unique product • High price covers development and marketing costs • Price can be dropped to skim new segments in turn	• High sales volumes and low prices stop entry of competitors • High sales volumes reduce production costs • Brand awareness and distributors increase • High market share
Disadvantages	• High prices may discourage buyers • Early buyers at high prices object when price falls and will not buy again • Buyers wait as they know price will fall	• Fixes expectations of low price • May result in brand seen as low quality • Low profit margins

Market-based strategies for existing products

Competitive pricing

Key term

Competitive pricing: basing price on that charged by competitors. The price may be lower, equal to or higher depending on objectives.

Competitive pricing involves researching the price competitors charge and then setting a price based on this – similar, below, or higher. It is often applied to products that are selling steadily in large numbers and are therefore in the mature phase of their product life cycle. Setting the price at the same level as existing products in the market has the advantage that it will fit their place in customers' perception and it will be the role of the other marketing mix elements to convince customers to buy.

A business may set a price well below the competitors and use this to create a unique selling point (USP) in order to obtain market share. This is Aldi and Lidl's strategy in the high-volume grocery retail market in western Europe. Conversely, a business may charge prices above the competition to try and reflect their brand image of quality. This is often called prestige or premium pricing as the price reflects the perception of high quality. This is what many large department stores do. Another example is Heinz food products. In all of these cases the price must be supported by the other elements of the marketing mix.

Price discrimination

Key term

Price discrimination: charging a different price in different markets for the same product.

Price discrimination involves setting a different price for different types of customer for the same product. This may be on the basis of:

- Geography – e.g. a fuel company charges more to customers who live a long way from the oil refinery
- Time – e.g. a railway or electricity company charges peak-time users more than off-peak users.

Another example may be seasonal variations in price, or charging different age groups different prices.

This can only be used when it is not possible for those charged lower prices to resell to the high-price customers. It is an attempt to increase sales in some periods, places or segments yet still maintain high profit margins in the high-demand times, places or segments.

Case Study

Different menu prices

In Hampi, India, there is a restaurant which sets out two menus. One is in English and is placed on each table. The other is in a local language, Kannada. The English menu prices are double the Kannada prices listed on the menu displayed on the wall. If you cannot read Kannada you are probably a rich tourist and so you can pay higher prices.

1 What pricing strategy is this restaurant using?
2 Explain the advantages of this pricing strategy for the restaurant.

Cost-based strategies – for new or existing products

Link

For further information on different types of costs see AS Level Chapter 5.3 Costs.

These consider the cost of producing a product or service and base the price on this. The market conditions must be taken into account, particularly the price that competitors are charging. If market conditions are ignored the cost-based price might not match customer perceptions and be either too high or too low. There are different types of costs and so there will be different cost-based pricing methods.

Full cost pricing

Key terms

Full cost pricing: adding a percentage to the full average cost of production to give the price.
Marginal or **variable** or **contribution cost pricing**: adding a percentage to the direct costs of production to give a price.

Full cost pricing takes the full cost of a product and adds a percentage or a fixed amount to guarantee a certain level of profit. It is simple to calculate and can be altered according to market conditions. This assumes the full cost is accurately known (which is not always possible, especially where a business sells a wide range of products) and that all the output is sold. It is unlikely that both of these conditions will be met.

Marginal or variable or contribution cost pricing

Marginal or variable or contribution cost pricing takes the direct cost of a product and adds a percentage or a fixed amount. This guarantees a contribution to the indirect costs of the business and often gives a lower price than full cost pricing. It is sometimes difficult to calculate exactly and is appropriate where there is a wide product range.

Case Study

Country Preserves

Country Preserves makes ten different jams and chutneys. Each one costs the same to produce. It decides to sell its products in department stores and quality delicatessens. Its competition offers similar products selling at $3.00 per 250 ml jar. Country Preserves has unique recipes and a famous chef endorses and uses its products in his TV show. The chutney costs $1.00 in materials and wages per 250 ml jar to produce and on projected sales the fixed costs per jar are $0.20. However, the competition is very strong and the market research data is subject to wide variations and may not be that reliable. Country Preserves wants to make sure that it achieves a good market share in the first three months of selling which it can increase in the future.

The figures below illustrate the possible pricing methods.

Market-based pricing

Skimming pricing	– well above the competition, e.g. $4.20 per jar
Penetration pricing	– well below the competition but covering costs, e.g. $2.00 per jar
Competitive pricing	– premium/ pricing, e.g. $4.00 per jar – near competition, e.g. $3.00 per jar – low price, e.g. $2.50 per jar
Discrimination pricing	– e.g. selling in one outlet at $3.50 and another at $2.80

Cost-based pricing

Full cost pricing	– covering all direct costs at $1.00 plus fixed costs of $0.20 equals $1.20 per jar. Add on 100 per cent giving a price of $1.20 + 100/100 × $1.20 = $2.40
Contribution cost pricing	– variable cost is $1.00 per jar. Any price above this will give a contribution to fixed costs. For example, Country Preserves seeks $1.80 per jar as a contribution to fixed costs, giving a selling price of $2.80

1 Country Preserves seeks your advice. Explaining your reasons, recommend an appropriate pricing strategy for its products.

Progress questions

4 Explain full cost pricing.
5 Give an example of price discrimination.
6 When might a business use competitive pricing?
7 What sort of products often have premium prices?

Pricing strategies and pricing tactics

Once a price strategy has been decided a business may have to make decisions on the tactics used to set price. Tactics are used to determine prices in short periods of time within the framework of the strategy. They include:

- Loss leaders – selling some products at a loss to attract customers to buy. When they do, additional full price products will also be purchased. Also, once in the store shoppers often buy much more than they planned to. The loss on the loss leader will be more than made up for by extra spending on the full-price items. Supermarkets often use this tactic by selling bread, milk or other essential foods very cheaply.
- Psychological pricing – setting a price at just below a whole number, e.g. $5.99, making the customer feel they are paying much less than $6.00, so they are more likely to buy than if the price were $6.00 or slightly more.
- Bait and hook pricing – selling a product at a low price, then charging a high price for associated products, e.g. selling a printer cheaply but the cartridges are expensive. This method can only work if there are essential associated products.

Key terms

Loss leaders: products sold below cost at a loss to attract customers who might then buy other products.
Psychological pricing: setting a price at just below a whole number, e.g. $4.99.
Bait and hook pricing: selling a product at a low price but charging a high price for associated products.

Price elasticity of demand and pricing

Price is a major determinant of sales and demand. Price elasticity addresses the question of how much sales change if there is a price change. This is price sensitivity. We know that a price fall will increase demand and vice versa. If a business knows that a price rise will cause very little fall in demand it is likely to increase price as revenue and profits will increase. The amount that demand will change depends on a range of factors to do with customer perception. These include:

- Perceived benefits and quality of the product – the greater these are the less sensitive demand will be to a price rise
- The number of similar products in the market – the more of these there are the more sensitive demand is to a price change
- Customer loyalty – branded products are generally less price sensitive
- Customer need – products which are essential, like basic foodstuffs, oil and clothing, are unlikely to be price sensitive
- Income – the more income a customer has the less price sensitive they are
- Availability – if customers find it easy to obtain a product it will probably be price sensitive, especially if competitors supplying a similar product are in the market.

Getting it right

For this course you will need to be able to define, calculate and interpret price elasticity of demand, using it to help set suitable prices.

Remember, though, when using elasticity calculations in your answers they can only be a guide to setting prices. The calculations are based on demand changes that could be influenced by many factors other than simply price.

Calculating price elasticity of demand

Price elasticity of demand (PED) measures the degree of responsiveness of demand for a product to changes in its price.

Mathematically this is shown as follows:

$$\text{PED} = \frac{\text{per cent change in quantity demanded}}{\text{per cent change in price}}$$

Key term

Price elasticity of demand (PED): a measure of the relationship between a change in the quantity demanded of a particular good due to a change in its price.

Example

A radio was priced at \$50 and it sold 300 units in a week. The shop dropped the price to \$40 and sales rose to 330.

$$\text{PED} = \frac{\text{per cent change in quantity demanded}}{\text{per cent change in price}}$$

$$\text{PED} = \frac{(+30/300) \times 100 \times \$50}{-\$10 \times 100}$$

$$\text{so PED} = \frac{+10 \text{ per cent}}{-20 \text{ per cent}}$$

so PED = 0.5 (the minus sign is usually disregarded)

A 20 per cent fall in price has resulted in a smaller rise in demand of 10 per cent. This means the demand for the radio is not sensitive to changes in price. It is said to be price inelastic (PED is less than 1). The shop will have suffered a fall in revenue from \$50 × 300 = \$15 000 to \$40 × 330 = \$13 200.

Knowing PED can help a business if it is considering changing its price as it indicates how much demand will alter and how much sales revenue will change. It thus forecasts the effects of price changes, assuming all the other factors remain the same.

Table 3.3.7 Interpreting PED in relation to sales quantity and sales revenue ▼

	Price elastic more than 1 price fall	Price elastic price rise	Price inelastic Less than 1 price fall	Price inelastic price rise	PED = 1 price fall	PED = 1 price rise
Sales quantity	• Increase by bigger per cent than price change	• Falls by bigger per cent than price change	• Increases by smaller per cent than price change	• Falls by smaller per cent than price change	• Increases by same per cent as price change	• Decreases by same per cent as price change
Sales revenue (price × quantity)	• Increases	• Falls	• Falls	• Increases	• Constant	• Constant

Usefulness of price elasticity of demand

Price elastic products are very responsive to price changes – a small price change causes a large change in demand. Price inelastic products are not price sensitive. A large price change causes a small change in demand. So high pricing may be adopted where products have a high PED.

Table 3.3.7 shows the effects of a price change on sales quantity and revenue and enables a business to make an appropriate change in line with their objectives.

- A product has a price elasticity of 2.0 (price elastic). A business is considering cutting its prices in response to competition. The PED indicates that sales volume will rise by twice the per cent of the price change. Can the business supply this extra demand? Will there be an increase in costs to do so? What will distributors attitudes be?
- The PED indicates that there will be an increase in sales revenue and market share when a business lowers price. But will the lower price make customers think the product has lower quality and buy less in the long run? Will there be additional costs in marketing – new notices, advertising, etc.?

Generally businesses try and lower the PED of their products. This makes it possible to increase prices to gain revenue and profits. They can do this by branding and getting customer loyalty, by differentiating their products to

make customers think no one else supplies such a product or advertising/promotion to convince customers their product is the most appropriate.

Price changes are not the only factor affecting sales and it is important to remember that other factors may be more influential. PED can be calculated for a price change but it is difficult to ensure that the effect of other factors has not affected the result. PED is measured at a particular time and changing market circumstances may have altered customers' reaction to changing prices by the time a pricing decision is made.

Getting it right

If you are asked to recommend a price or a pricing strategy for a business it is important that you take account of the context in which the business operates. For example, price skimming will be unlikely to succeed in a highly competitive market.

Case Study

PED of Pizza

Jane and Ashif run a pizza takeaway business. Based on their past experience, they estimate that their products have a price elasticity of demand of –0.6. The average price per pizza is $6.50 and they sell 200 per week. Total weekly revenue is 200 × $6.50 = $1300.

Their landlord has recently increased the rent on the shop. Jane and Ashif have reluctantly decided to increase the prices of their pizzas by 20 per cent to $7.80. They were relieved to find that sales only fell to 176 per week because the PED estimate was correct. Sales fell by 24 pizzas which is 12 per cent of the original 200.

$$\text{PED} = \frac{-12\%}{20\%} = -0.6$$

Total weekly sales rose to $1372.80.

Total weekly sales revenue
= 176 × $7.80 = $1372.80

Three months after the price increase another takeaway business opened up in the same street. This charged lower prices than Jane and Ashif's business. They realised that demand for their pizzas would now be more elastic than before. For one week only, they reduced the prices of the largest pizzas from $10 to $8 (–20 per cent). Sales shot up by 30 per cent from 50 to 65 during that week.

1. Calculate the total sales revenue from the large pizzas:
   - **a** before the price reduction
   - **b** after the price reduction.
2. Do your results mean that the demand for these pizzas was elastic or inelastic?
3. Explain why new competition has made the demand for pizzas more elastic.

The 4 Ps: promotion

Promotion is the marketing activity that communicates to customers in order to change their attitudes or buying behaviour. Its ultimate aim is to persuade customers to buy a product, but before that happens there must be information, raising awareness and influencing customers' views. This is done through a range of methods including advertising, offers, sponsorship, vouchers and merchandising.

Key term

Above-the-line promotion: using mass media space that is paid for, often through an advertising agency.

Above-the-line promotion

Above-the-line promotion uses mass media space which is paid for, often through an advertising agency. It consists of paid-for advertising in the press and magazines, on TV and radio, in cinemas, on posters and billboards, adverts on the Internet, space on vehicles and text messages. Advertising is rarely designed to persuade customers to buy a product. Its aim is usually to make customers aware of a product or

brand name, to create a sense of desirability about the product and to influence customers so that when they consider buying they are likely to purchase the product they have seen advertised. Advertising can be expensive and needs constant renewal, but it reaches a mass audience, is vital in creating brand awareness and is important in making customers consider choosing particular products.

Figure 3.3.6 Advertising a brand ▶

Below-the-line promotion

Below-the-line promotions are a marketing method that communicate with the customer without the expense of paying for media space. These include direct selling, direct mail, point-of-sale materials, offers, vouchers, sponsorship, public relations and packaging information. These methods have varying objectives, from raising awareness of a product or brand to persuading a customer to actually buy.

Direct selling and direct mail

Direct selling methods are direct contact with potential customers, either by a salesperson talking face to face in a store, telephone or TV selling, by calling at homes or by sending material about the product or business in the post.

Point-of-sale promotions

Point-of-sale promotions include in-store posters and displays, flyers and dump bins or racks containing products. These materials are usually making customers aware of the product or drawing their attention to special offers, sales or other promotions.

Key terms

Below-the-line promotion: marketing methods that communicate with the customer without paying for media space.
Direct selling: selling through direct contact with potential customers.
Point-of-sale promotions: materials that include in-store posters and displays, flyers and dump bins or racks containing products.

Sales promotions

These are methods used to try and obtain a sale and persuade an actual purchase. They may include buy one get one free (BOGOF), sales (e.g. 20 per cent off this week), joint sales (e.g. buy this pie and get free sauce), free product samples, competitions, free draws, loyalty reward programmes and money-back coupons.

Sponsorship

Sponsorship is a way of getting free media space and making customers aware of a business without directly paying for this. A business will pay another business and receive the right to have its name, logo or words on shirts, TV credits, programmes or other materials. This way the name of the sponsor is appearing in the mass media. The most obvious examples are professional sports teams whose kit has the sponsor's name and logo on it. Product placement is a form of sponsorship in which a business pays to have its product appear in a TV programme or stage play, e.g. a breakfast cereal in a film meal.

Key terms

Sponsorship: paying another business for space with the right to display a logo, name or product.

Public relations (PR): getting media space without paying for it, e.g. newspaper articles.

Public relations

Public relations is a method used by a business to gain media space without paying for it. It can be done by using press releases, stories containing information about the business's activities, conferences with invited media, exhibitions, charitable activities and community involvement. Sponsorship can be regarded as public relations.

The role of packaging in promotion

Packaging products can be an important part of promotion. The packaging is what the customer sees as they consider buying a product. Packaging acts as protection and security, enables grouping of several items, portion control and convenience and is used for transmitting information and marketing communications. Packaging must reflect these purposes.

Customer packaging is what the potential customer sees in the store. There may be legal requirements about labelling ingredients or weights or how to use the contents. The words and graphics can be used to integrate with advertising and other promotional methods to reinforce a brand and make the customer decide to purchase. With the increasing importance of environmental concerns, packaging itself can be a selling point if it is recyclable or biodegradable. Transport and distribution packaging will be more concerned with secure transport than customer communication.

Packaging must be able to protect the product, meet legal requirements and be an integral part of the marketing mix, reflecting and complementing the other mix elements. For example, luxury chocolates are packaged in appropriate expensive materials that use colours that signal the type of contents and that will appeal to likely buyers. Basic foodstuffs are sold in inexpensive functional packaging.

Packaging is a key component for new or updated products or for giving technical information that buyers are interested in.

Case Study

Promotion in action 1: HBO Voyeur Project

HBO is a USA TV channel. It showed a video on the side of a large building in New York: the film looked like viewers could see into eight apartments with fictional stories of murder and romance. This created a lot of media interest, with articles in newspapers and magazines and on the Internet. HBO then continued with a dedicated website, other Internet media sites like myspace, Flickr and YouTube, cellphone messaging and an interactive phone line. Sixty per cent of those surveyed who had interacted with the campaign said they were more interested in the HBO brand as a result.

1 Explain the purpose of this promotion.
2 Who do you think it was aimed at?
3 To what extent did the promotion succeed?

Case Study

Promotion in action 2: Kellogg's Star Wars

Kellogg's produce breakfast cereals. It based a promotional campaign using the release of new Star Wars films as a link. The mix included 30-second TV adverts featuring Star Wars characters and Kellogg's products. Thirty million packs containing Star Wars toys and a competition were sent out or placed in stores. It ran the competition on the cereal packaging. In-store display material was made available to Kellogg's stockists. Regular press releases featured interviews with customers. Kellogg's share of the ready-to-eat cereal market rose from 45 per cent to 53 per cent.

1 To what extent did Kellogg's succeed with this promotion?
2 Explain how it achieved this success.

Getting it right

If you are asked to recommend a promotion strategy it is important to take account of the size of the business, its likely marketing budget and its target audience. For example, a small business is likely to find TV advertising too expensive. Marketing objectives and the nature of the market are also important.

Progress questions

A business is introducing a new chocolate bar that contains some plant extracts that are designed to make the consumer more mentally active and healthy. The chocolate bar will be a little more expensive than other bars and will be sold initially in health stores.

8 Suggest an objective for the pre-launch promotional campaign. This must be SMART. (Specific, Measurable, Achievable, Realistic and Time specific – see page 51).
9 Suggest, with reasons, an appropriate promotional method for the new bar.
10 Suggest how the business might measure the success of this promotional method.

The bar is successfully launched and achieves its sales targets. The business now obtains a large contract to supply a national supermarket chain.

11 Suggest an objective for a promotional campaign associated with this increased distribution. This must be SMART.
12 Suggest, with reasons, an appropriate promotional method for the new bar.
13 Suggest how the business might measure the success of this promotional method.

Key term

Branding: the marketing practice of creating a name, symbol or design to identify and differentiate a product or business from other products or businesses.

Branding

Branding is the marketing practice of creating a name, symbol or design that identifies and differentiates a product or business from other products or businesses in the mind of the customer. If a business can achieve a brand presence in a market there will be customer loyalty and a real competitive edge. It can take a long time to build up a positive brand image which is then itself a form of promotion.

A good brand will have little difficulty in finding distribution outlets, and new products use the brand image to gain quick market acceptance. Branding is brought about through using the promotion mix to communicate with customers. There might be individual brands for products (Mars bar), business brand (Virgin, Tata, Lipton) or a company plus product brand (Toyota Lexus). The product must support and be part of the branding identity so it is no use promoting a product as being high quality if it is not. Once brand status is achieved many customers will always buy that brand in preference to others.

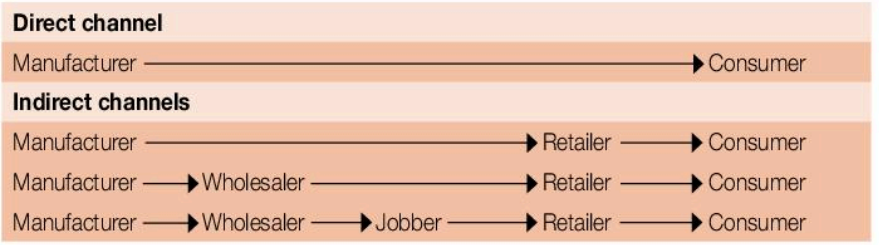
The 4 Ps: place – channels of distribution

Key term

Channel of distribution: the method by which a business gets its products or services to the customer.

The fourth P of the marketing mix deals with the methods by which a business gets its products or services to the customer, the channel of distribution. It includes the locations where products are sold, whether physical or not, and the ways in which products are moved to these locations.

Figure 3.3.7 Channels of distribution ▼



Key terms

Direct distribution channel: the producer supplies the final customer directly.

Indirect distribution channel: the producer supplies other businesses who sell to the final customer.

Direct channels of distribution

In a direct distribution channel the producer supplies the final customer directly. Examples include direct sales, mail order and selling from websites. There is no intermediary to add to costs or to take profit. The producer will keep all the selling price but has to be able to store products and communicate with customers directly.

Indirect channels of distribution

Indirect distribution channels involve an intermediary. The producer sells to another business – a retailer, wholesaler or agent who then supplies the next link. A disadvantage is that the producer does not receive all the final selling price, but the advantages are that marketing costs are smaller as sales have to be made to a small number of intermediaries, not a mass market. Storage costs are smaller and distribution is to a wide market. Indirect distribution involves convincing the distributor to buy.

In the past the most common form of distribution was the traditional one in which smaller producers sell to a wholesaler who supplies to retailers, often smaller or medium-sized stores. The retailer is too small to send large orders directly to the producers.

More modern channels of distribution are focused on a retailer who obtains products directly from producers. The retailer organises the way products are distributed to its own outlets. This means it can get

favourable contract terms as it is buying large quantities and can control the selling environment.

Multiple channels

Many businesses employ more than one distribution channel – e.g. a publisher will sell via an Internet bookseller, directly to the public and via bookshops. Multiple channels are used where several market segments are being targeted.

Whatever channels are used they must reach the targeted segment, but there is no need to make products available everywhere. The choice of channel of distribution must be integrated with the rest of the marketing mix.

Factors influencing choice of distribution channel

Type of product

A product with a short shelf life, like food or a fashion item, must have a quick channel that is likely to be indirect. This is because specialist distributors will be involved and they are likely to be supplying a number of small retail outlets. Using them means the producer does not have to worry about the costs of storing perishable items or items that might go out of fashion. This makes it easier for the producer to get its products into shops quickly. Non-perishable, long-lasting bulky items may be better suited to direct distribution, less-bulky items may move through intermediaries.

The type of market

Mass market products need a channel that will reach millions of customers so they are often sold via indirect traditional or modern channels, though using the Internet for selling has made it possible for direct channels to function with some mass market products.

Customer preference

Customers like to buy some products from particular places. Some prefer stores or the Internet, others buy directly from salespersons. Some products require pre-sales information to be given or after-sales servicing, and customers may prefer to buy from a place where these services are readily available.

Producers' preference

Some producers do not want to lose control of the selling process or allow the costs of an intermediary to push up the final price. On the other hand, they may feel that they do not have the skills to sell to the customer or the finance to acquire these skills.

Getting it right

When deciding on the choice of distribution channel it is essential for a business to consider the nature of its product, the way the market operates and the needs of its target consumers, as well as the possible loss in profits that comes from employing an indirect method. It is also useful to consider the costs and benefits of different methods in relation to these factors. Businesses offering a service will generally supply their customers directly.

Key term

E-commerce: trading in products or services using computer networks, particularly the Internet and mobile phones.

The role of the Internet

The Internet, particularly through e-commerce, enables huge changes in the marketing mix to occur and has opened up a whole range of possibilities. Typical statistics show Internet sales are rising by 10–20 per cent per year in all countries. Many older companies report online sales running at 30–40 per cent of total revenue. Setting up a website is relatively cheap and online payment methods

Activities

Think of five products or services you use.

1 Identify the channels of distribution you obtained the products through.
2 Explain why the producer of each product chose its distribution channel.

Key terms

Dynamic pricing: charging different customers a different price for the same service e.g. early travellers may pay a higher price than latecomers.
Social media: forms of electronic communication using Internet sites that enable users to communicate ideas and share information.
Viral marketing: marketing in which users of social networks act as advertisers for products by spreading knowledge of them to other users of the networks.

Link

The 4 Cs are covered in AS Level Chapter 3.3a The marketing mix: elements and product.

are sophisticated and secure. It is easy to monitor website use, and online surveys and panel groups provide clear, cheap information. The technical expertise to design and produce effective websites is readily available and selling requires no retail outlet costs.

Websites enable online catalogues and product displays and the addresses can easily be sent to target customers via email distribution lists made up from visitors to the site or bought from agencies. Forums, chat rooms and online help give potential customers valuable information and maintain communication channels with customers.

Online advertising via pop-ups or hover ads can be targeted at particular sites or types of sites and increasingly to specific Internet users.

- Dynamic pricing, particularly for services, is an increasingly common feature that would be difficult to manage on a non-electronic distribution channel. This is where different customers pay different prices for the same service. For example, the price of an air ticket often depends on when you book. An early booking may attract a high price (guaranteeing the seat) or a low price (making sure of the early sale). Booking late may attract a high price (only a few seats left) or a low price (making sure all seats are sold).
- Internet selling effectively passes on costs of time spent in searching and booking to the customer, saving the costs involved in physical selling locations.
- The Internet allows customers to download digital copies of music, films and theatre productions as well as interactive products such as games. Tickets and bookings can all be managed online with no physical paper.
- Social media or networking sites like Facebook, Twitter, myindospace and Tripadvisor allow businesses to connect to customer networks and feed their marketing communications into these as well as receive valuable market information from millions of people.
- Large databases show how individuals make their purchasing decisions and enable people to be targeted with direct offers aimed at them individually.
- The links people have on social network sites enable viral marketing. This is increasingly important as users of sites act as advertisers by passing on information and recommendations to their friends and networkers. Online communities may be general (Facebook) or linked to particular interests and activities. Businesses can use these to reach mass markets or particular targeted groups quickly at no cost. However, messages that show a business in a bad light can also be passed quickly.

For many products the Internet has significantly altered the way the 4 Ps and 4 Cs are managed by producers and sellers. The Internet enables a much more direct relationship between producers and customers and has led to an increasing emphasis on marketers considering the 4 Cs because these reflect the marketing experience from the customers' viewpoint.

Progress question

14 Analyse the reasons why the Internet has increasingly become an important method of selling.

Consistency in the marketing mix

Factors influencing the promotional mix

Businesses have a huge choice of promotional methods, some of which are very expensive. Producing flyers to hand out is cheap – producing 10 000 will cost less than a few hundred dollars, but a 30-second advert on Chinese TV can cost $20 000. Most businesses use more than one method of promotion. When choosing it is vital to consider the following:

- What is the purpose of the promotion? To inform or persuade? To build a brand image?
- Who is the promotion aimed at? Customers in general or someone about to decide whether to buy? A mass market or a small niche? Customers or industrial buyers?
- How much money is available for promotion? What is the cost of the methods considered?
- What stage of the product life cycle is the product at?
- How are competitors promoting their products? How competitive is the market?
- Are there any legal constraints?

It is essential that the marketing mix elements are consistent and integrated with each other. Each one must give the same message to customers. A famous example comes from Alliance Boots, a multinational pharmacy/health and beauty group. Boots No. 7 cosmetics range was priced at a much lower level than other cosmetics. It sold very badly as customers thought the low price indicated low quality. This perception conflicted with the other mix elements. Boots kept the product, the place and the promotion methods the same and increased the price to be close to the competition. Sales soared as customers saw a consistent integrated mix.

Apple computer products are another example of how a higher price is supported by innovative products, targeted promotion and distribution via modern stores and websites.

Progress questions

An inventor produced a plastic shoe with a built-in pedometer which measures speed of walking, distance covered, heart rate and other biometric indicators to be consulted during walking. New technology means the shoes can be produced for $6 a pair. A consultant identified two possible marketing mixes after considering possible target markets.

Option 1

Sell at a high retail price, much higher than other training/walking shoes. Sell in luxury department and specialist stores using expensive in-store displays and dedicated sales staff. Communicate by mailshots to targeted high-income customers with a public relations campaign focused on media consulted by those customers.

Option 2

Sell at a low retail price. Stock the shoes in discount warehouses and stores with a minimum of display. Use a concentrated national TV advertising campaign, with adverts also in popular papers and magazines.

15 To what extent do these two options each present a consistent marketing mix?
16 Suggest, with reasons, a third option for a marketing mix for this product.
17 Consider these three options and recommend one to the inventor.

Case Study

Shooz

Shooz has been established for 11 years and makes shoes for young children. It sells them from three shops in a big city. The owners buy in the shoes from low-cost suppliers and customers are happy with relatively low quality because children's feet grow quickly and the shoes are not expensive. The market for children's shoes has become more competitive and there have been increasing complaints from customers about the poor customer service at the shops.

The owners have been investigating other possibilities and have decided to extend their product range by branching out into another area of footwear. They are planning to sell shoes to secondary schools that have a strict uniform policy. They will be able to match the shoe types to the uniform in each school and are confident that they will be able to offer two types of shoe – a shoe for classroom use and another one for sports activities. They realise that there are existing suppliers, but these are all large businesses that do not offer a personalised service with advice.

1 Analyse possible changes to the marketing mix if Shooz goes ahead with its planned product extension.

Exam-style questions

1 **a** Explain the role of place in the marketing mix for a business. [8 marks]
b Discuss the advantages and disadvantages for a cinema of setting up a website to market its services. [12 marks]

Green School

The Business Studies course at Green School has a practical component. Students are setting up their own business called Breaktime – a shop selling sweets and drinks. They have gained permission for this as long as they keep to health and hygiene regulations. They have arranged a suitable location with staff and agreed to raise start-up finance by selling shares. The marketing director has carried out market research and decided on a range of products based on the results. The next step is to concentrate on pricing and promotion. The table shows some information for three of the main products.

Table Pricing information $ ▼

Product	Wholesale price paid by Breaktime	Supermarket price	Local shop price
Fizzy drink	0.40	0.60	0.70
Fruit juice	0.20	0.30	0.40
Chips	0.10	0.15	0.20
Made up chocolate assortment	1.20	Not sold	2.40

2 Recommend and justify a marketing mix for Breaktime. [10 marks]

Key concepts

AS **Change** can be viewed from the perspective of market developments and levels of competition. It can also be studied from the perspective of the product life cycle.

AS **Management** has a role to choose marketing methods and implement them.

AS **Customer focus** needs to be considered from the perspective of the 4 Cs (which is all about customers) and the 4 Ps (which influence customer behaviour).

AS **Innovation** can be developed with respect to the impact of new products, new markets, new technologies.

AS **Creating value** is one of the major roles of marketing through changing consumers' needs, wants and perceptions and improving value added through such techniques as branding, promoting etc.

AS **Strategy** is involved in developing the marketing mix and marketing strategy.

Progress check

You should now be able to:

AS evaluate different pricing strategies

AS understand how price elasticity of demand might be useful when making pricing decisions

AS evaluate above- and below-the-line promotion methods

AS understand the role of packaging and branding

AS choose between different types of channels of distribution

AS understand the use of the Internet for the 4 Ps/4 Cs

AS understand the need for the marketing mix to be consistent with the business, product type and market.

You should be able to relate these to a range of businesses in different situations.

4 Operations and project management

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **AS** inputs, outputs and the transformation process
- **AS** the process from an idea to a final product or service
- **AS** the resources needed for the process: land, labour, capital
- **AS** effectiveness, efficiency and productivity
- **AS** how value added is linked to marketing and operations
- **AS** capital versus labour intensity

Key term

Operations: often called operations management, this deals with designing and controlling the systems that produce products or services to meet customer expectations.

Getting it right

When answering questions it is *very* important that you apply the concepts covered in Chapters 4.1–4.6 to service sector businesses such as banks, supermarkets or airlines and to charities and public services. The terms "products" and "production" can refer to businesses providing services as to those in the secondary or primary sectors.

4.1 The nature of operations

Operations

Every day we use products and services produced by businesses using a number of processes. For example, paper for books is often produced from wood. The wood is obtained from trees which are grown using human labour and equipment. The wood is processed into paper and then distributed to businesses that print onto it and make it into a book. Operations or operations management considers how processes like this happen. In the individual business it is concerned with how products and services are produced and delivered to customers as efficiently and effectively as possible, using the minimum amount of land, labour and capital (machinery). Operations deals with designing and controlling the systems that produce products or services to meet customer expectations. Operations management is also relevant to many service industries so we should remember that the terms "production" and "product" apply not just to physical products but also include the provision of services.

Process: the functions of operations

In a large business, operations may be a separate functional area, with operations managers responsible for the range of activities that are essential in getting from an idea for a product based on a customer need to finally providing customers with the product. Smaller businesses may not have a dedicated functional area but operations decisions will still have to be made by managers or the owner in a single-person enterprise. These decisions focus on managing assets (buildings, equipment, inventory) and people used in production in order to minimise costs. Activities included will be:

- Working with the marketing department on what products to produce
- Designing machinery to produce a product/service
- Choosing an appropriate production method
- Choosing suppliers who deliver quality and value
- Working to quality standards
- Working to health and safety standards
- Deciding on the scale of production capacity
- Choosing what stock levels to keep
- Working with the human resources department to achieve desired productivity levels.

These activities all form part of the operations process. Figure 4.1.1 shows this process and traces the stages by which a product or service

goes from being an idea through to finally being presented to the market. Each stage is equally important and involves the co-ordination of a number of different functional areas. Operations is very important in making sure that products and services are produced efficiently and effectively in order to give a business competitive advantage. Operations deals with the practicalities of the production process in assembling all the required inputs to produce the required outputs of products or services for the customer.

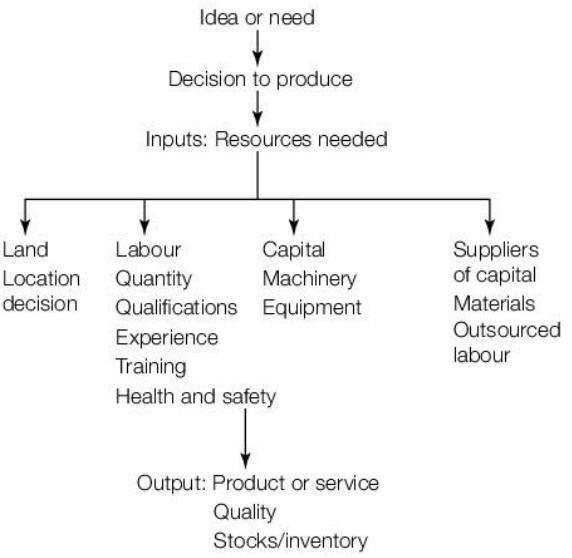


Figure 4.1.1 Operations process ▲

Key terms

Land: the material physical ground including space occupied by buildings, minerals and the atmosphere.
Labour: the work carried out by people, either manually or mentally.
Capital: the machinery and equipment used in production and also the intellectual capital: knowledge, skills and expertise, built up from qualifications, study and experience.

Operations are about the transformation of inputs into outputs. In general terms inputs are resources. These are land, labour and capital that combine to produce an output such as a product or service.

- Land is the ground and includes the space occupied by buildings, the atmosphere and the materials obtained from land such as wood, oil and other minerals.
- Labour is the contribution made by people as they work, either with their hands in manual labour or with their minds in managing and organisational decision-making.
- Capital is the machinery and equipment used in production and includes intellectual capital. This is the knowledge, skills and expertise of employees, plus their experience. It may be represented by academic and vocational qualifications and used to make production more efficient, to generate ideas and to build a better organisation structure and working environment.

These resources can be combined in different ways and this decision is a key area for operations managers. Transformation from inputs to outputs may involve a number of steps with different processes at each stage.

Figure 4.1.2 Factors of production ▶

Example of a transformation decision

A business decides to make warm woollen clothes. It is going to transform inputs of wool, equipment, and labour into clothes. It has a choice. It can use a machine-orientated process, involving relatively large amounts of capital, with machines supervised by a few employees or it can employ many people working on low-technology equipment to hand knit the clothes. Which is best? The answer will depend on the objectives of the business and what the target market is. A high-quality unique design item of clothing for sale at a high price in exclusive fashion stores is likely to be hand knitted and labour intensive. A garment aimed at a mass market and sold cheaply may be produced by more capital-intensive methods (relatively more capital than labour). Another possibility for the mass-market garment may be saving on spending on machines and mass producing using many hand knitters and paying them a low wage. Decisions such as these are usually taken by senior managers with advice from operations staff. It is then up to operations to implement the decision.

Key terms

Labour-intensive production: costs of labour are a higher proportion of total costs than costs of capital, e.g. a hand-worked farm.

Capital-intensive production: costs of capital are a higher proportion of total costs than costs of labour, e.g. an oil refinery.

Progress questions

1 For each of the following businesses list three important inputs and the main output.
   - **a** Restaurant
   - **b** Driving school
   - **c** Fish farm
   - **d** Golf club
   - **e** Car manufacturer.

Feedback can come from customers, from employees or from managers. As production takes place the inputs can be adjusted to achieve better results. It is important to build in ways that the transformation process can be monitored so feedback can improve it.

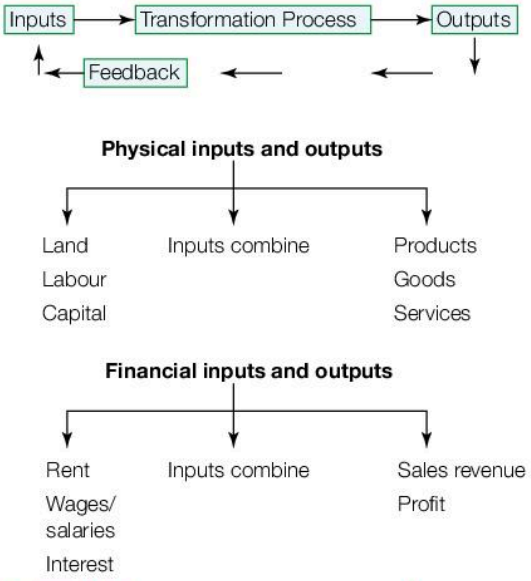


Figure 4.1.3 The transformation process ▲

Effectiveness, efficiency and productivity

Key terms

Efficiency: measures the amount of resources that production uses. Lower resource use for a given output is more efficient and less costly.

Effectiveness: relates to how well the product meets the needs of customers including availability, price, function and value for money.

Business operations' efficiency measures the amount of resources that production uses relative to its output. A business will be more efficient if it uses fewer resources to produce a given output and this will also reduce costs.

Business operations' effectiveness relates to how well the product meets the needs of customers. Customers' needs are concerned with:

- Availability of the product.
- Price, which is related to the cost of production (efficiency).
- Function, which is related to the design process.
- Value for money, which combines price and function. A customer may want a cheap throwaway pen or an expensive pen to keep for special occasions. Both offer value for money and meet the customer's needs.

Productivity

Productivity is a measure of the efficiency of production and can be applied to any input. One common application of the concept of efficiency is to labour, another to capital.

Labour productivity measures the amount an employee produces in a given time.

$$\text{Labour productivity} = \frac{\text{Output in units}}{\text{Number of employees in a given time}}$$

Example

A hairdressing business has four employees. In one working day of eight hours they cut 128 heads of hair and are paid $10 per hour.

Labour productivity in this hairdresser is:

$\frac{128}{4} = 32$ customers per employee per day or 4 customers per employee per hour

The cost of labour for each haircut is $2.50 from $\frac{(8 \times 10 \times 4)}{128}$

Getting it right

Productivity is a measure of efficiency, not simply a change in output. It is often expressed as a measure of how efficient labour is at production in a given time using the formula output divided by number of employees in that time. Productivity can also refer to the land or capital. Higher productivity will result in lower costs per unit of output as more is being produced using the same inputs.

Importance of productivity and efficiency

If productivity increases, the ratio of outputs to inputs rises and average cost of the output will fall. This explains why productivity is such an important concept for businesses. In the above example, if productivity can be increased so that each employee can deal with five haircuts in an hour instead of four, the average cost will fall to $2. The business can then reduce its price and maintain its profit margin or keep the price the same and increase its profit margin or a combination of these.

The same thinking will be true for capital and land as well. If more efficient use can be made of these, costs will fall and the business will be in a position to decide whether to reduce price, which is likely to increase sales at the same profit margin, or to keep price the same and gain increased profits through increased profit margin.

Increasing productivity

There are four ways to increase productivity.

Invest capital

Spending money on more efficient modern machinery and equipment should lower unit costs in the medium to long term. However, spending on capital may be expensive and it might be possible to increase the productivity of existing equipment by better maintenance and more careful use.

Link

AS Level Chapter 3.3b
The marketing mix: price, promotion and place considers pricing decisions in detail.

Train employees

A skilled workforce is more likely to make fewer mistakes and finish their tasks more quickly. They are likely to solve problems more quickly and will not need to refer them to someone else, thus saving time. However, training may be expensive and disrupt existing production and must be targeted on the right people and the right tasks.

Link

AS Level Chapter 2.2
Motivation discusses ways to improve employee motivation and possible effects of this.

Improve employee motivation

Better motivation should lead to higher productivity.

Link

A Level Chapter 6.4 Strategic implementation explores reaching the business's objectives.

Getting it right

If you are asked for strategies to increase productivity, this is different from simply increasing production. For example, to increase labour productivity you would need to increase output per employee, and this clearly has HRM implications.

Getting it right

Productivity, efficiency and effectiveness have different meanings so it is important to use the right terminology in your answers.

Key term

Value added: the increase in value a business adds from one stage of production to another.

Link

Creating value is dealt with in AS Level Chapter 1.1 Enterprise.

Change the organisation's culture

Employees will function more efficiently if the organisation structures and culture are changed to increase the efficiency of the procedures and working practices.

Evaluating changes leading to increased productivity

Increasing productivity is a valuable activity – it reduces average cost and enables more choice in marketing strategies. However, this does not mean that any change to increase productivity should necessarily be adopted. There are likely to be costs that might include the cost of new equipment, training and an increase in wages to match increasing skill levels, a lack of sufficient demand or the cost of reforming organisation structures and operating systems. In addition the estimates of increased productivity might be inaccurate. A business should take each of these implications into account when deciding to go ahead with a change to increase productivity.

Case Study

Habasit

Habasit manufactures conveyor belts for use in food-processing industries. Conveyor belts in this industry are vital as they transport food products from one process to the next. If the belt breaks, production is disrupted. If the belt is dirty or unhygienic the food will be contaminated and made worthless. The belts are made of a strong flexible material. They are covered with several coatings which provide protection against infective bacteria, make cleaning easy and importantly provide a non-slip surface so less food material sticks to the belt. The belts last longer than previous models. One pastry manufacturer was able to reduce flour consumption by 30 per cent as less stuck to the surface. The Indian food-processing industry is worth $135 billion and is estimated to grow at an annual rate of 10 per cent to reach $200 billion by 2015. The Indian government is actively trying to make this happen with the long-term view of making the country a world leader by 2050.

1 How will the use of conveyor belts like the ones Habasit makes increase productivity?
2 The article lists some factors a business might consider if it was thinking of investing in this kind of belt. Discuss other factors the business would also need to consider.

Value added

Value added may be looked at from the point of view of the business and the customer. Both are related. A business adds value when it engages in the production process, and the added value in the product as seen by the customer is a factor in any decision to buy.

Value added and the operations process

This is looking at value added from the point of view of the business. Products and services that are to be sold have more value than their starting points. The inputs that they represent have to be transformed

into output. This output may have been through several stages, each one adding more labour, land and capital.

When a business transforms inputs into outputs it is adding more value to the initial level of the raw materials, labour and equipment. For instance, a coat made of wool has more value in terms of the inputs it represents. Inputs including grass, sheep, spinning equipment, dyes, a loom and the skills of people are needed to produce the coat. Once the coat is made it has to be sold, and this is another use of inputs including transport, shop premises and labour skills. As each stage of the production process takes place value is added to the starting inputs because these have to be transformed, adding value.

The operations process may take place inside one business enterprise or a number of them. If the product or service is sold, at each stage there will be financial outputs of sales revenue and profit that are money measures of value added.

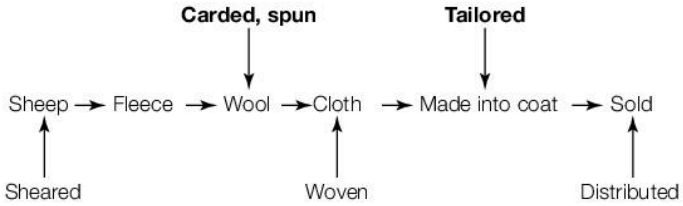


Figure 4.1.4 Added value and the operations process: a woollen coat ▲

Value added and operations decisions

Each stage of the production process adds more value. In financial terms this is shown by the higher price that each stage can command and may be expressed as price minus costs, i.e. surplus. The role of operations decisions is to achieve a desired value added, in terms of productive efficiency in reducing unit costs (minimising inputs in relation to outputs) and in terms of financial value (sales revenues and profits). The operations decisions should lead to efficiency and effectiveness so that customers' needs are met by the value added through the productive process.

Getting it right

Value added is a key concept for businesses. It can refer to the value added at each stage of production. This may be measured in the increase in money value. It can also refer to added value in the mind of the customer. This is giving the customer something that makes the product more valuable and appealing. This means it is more likely to be bought and/or a higher price paid. Added value for the customer may come from a promotion, from branding or from an additional service offered, like aftercare.

Value added and marketing

As well as adding value through design and production processes, value can be added through marketing. This is looking at value added from the point of view of the customer. Marketing is the process of meeting customers' needs, and the process of adding value is making sure that the production process is effective in doing this.

Added value in marketing is giving something to customers that is of high value to them but is low cost to the producer. Added value marketing gives customers what they really want by making the product have improved performance or better looks, giving advice on using it, making it more easily available to the customer, providing discounts, accessories or quality assurance. This will mean the customer sees an increased value in the product. Adding this value depends on a business

really understanding what customers want. The added value will make a product different from competitors' offerings and lead to customer loyalty, possibly a higher price, and confidence so that they will buy other products the business is selling. It also means that a business must constantly engage in market research and modifications of a product to maintain the added value

Case Study

Two added value case studies

Marks & Spencer

Throughout 2011 many countries suffered falling or static incomes and customers were frightened for the future. There was a temptation for businesses to appeal to customers by cutting price and/or quality to maintain sales. Marks & Spencer chose not to do this with its ready-meal range. Instead it added value to its products by creating the idea that buying them was a "treat". One example was the promotion of "Dine in for two". This offered a two-course meal with a drink at a price cheaper than if a customer bought each item separately. Customers saw this offer as having added value because it was a more convenient way to buy a whole meal.

Rachel's Organic and This Water giveaways

Rachel's Organic range of yoghurts used a different added value strategy. The business sold yoghurts at a premium price and to stop customers leaving for cheaper alternatives Rachel's Organic developed a partnership with a pottery specialist and offered a collectible bowl to yoghurt buyers. Three promotional pack vouchers enabled a customer to buy the bowl for one-third of its usual price. It also matched the brand value which is "Made with Love". Steve Clark, marketing director, commented, "Rachel's Organic is a small brand, relatively speaking … we didn't have the budgets … to do any larger-scale advertising."

This Water gave away prizes with every bottle sold. These ranged from flip-flops to festival tickets. Sarah Smart, marketing manager, explained, "The whole strategy was to tackle our low penetration. It really helps to give consumers that extra value on an everyday, on-the-go product like This Water. By adding that extra value for consumers, it was giving them an extra reason to pick us up."

Both businesses used extensive online Internet promotional activities to support their added value technique.

Another example of business exploiting added value in marketing is Starbucks with text, picture and Facebook messaging plus vouchers which give lower prices in store. These kinds of promotions are all ways of building extra added value in the eyes of the consumer as they are made to feel that the producers see them as "special".

1 Marks & Spencer sells its whole meals for less than the cost of buying the parts separately. Explain how this adds value for the customer.
2 Rachel's Organic and This Water use a different technique. Explain how they add value for the customer.

Activity

Think of two different products you have bought and consider the reasons for choosing them. To what extent does the concept of added value explain your decision to buy them?

Added value marketing is about making a product different from its competitors. It is about not cutting prices but offering something special that customers are willing to pay for because they cannot find it anywhere else. This added value is not necessarily in the product. Surely one yoghurt or coffee is just like another? The added value is likely to come from the promotional activities which are aimed at personalising the product to each customer.

Case Study

The Whole Foods Market

In many countries there is a growing market for organic food grown without the use of chemical pesticides or fertilizers. This food tends to be more expensive than non-organic food.

The Whole Foods Market company employs 78,000 people and sells organic vegetables, rice, meat, coffee and fruit. Its 373 stores are spotlessly clean and the food is set out in eye-catching neat displays. Customers are encouraged to touch and taste samples of the products and there is a smell of fresh food products throughout the stores. It stresses the need for the producers, consumers and governments to act in more environmentally friendly ways and it actively supports "green" initiatives. The Whole Foods Market does very little advertising. It offers tremendous customer service by giving recipes, advice and help with packaging. In 2014 global sales rose by 11 per cent.

1 How does Whole Foods Market use value added marketing?
2 To what extent has value added marketing been successful for Whole Foods Market marketing?

Progress questions

2 How might a luxury car manufacturer add value?
3 How could value added relate to the 4 Cs?

Benefits and limitations of capital- and labour-intensive production

Capital and labour are two of the three inputs needed for production. These two factors are often substitutes for each other. For instance, a field can be ploughed by one person and a tractor (capital intensive) or by 20 people using hand ploughs (labour intensive). It is the relative proportions and costs of each input that are important. Capital-intensive processes require a relatively high level of capital investment and are likely to be automated to produce on a large scale for a long time. Labour-intensive processes require a relatively high level of labour and are likely to produce individual customised products or on a small scale over a short time.

Businesses have to decide on the proportions of labour and capital to use in their production process. This decision will be influenced by:

- The method of production. Mass production like car manufacturing is likely to be capital intensive; one-off production like making sculptures is likely to be labour intensive.
- How personal the product is. Personal services like hairdressing are likely to be labour intensive; an oil refinery is capital intensive.
- The relative costs of labour and capital. Businesses in high-income developed counties like the USA are more likely to be capital intensive compared to businesses in low-income countries where labour is relatively cheap.

- The size of the business. Small business are more likely to be labour intensive compared to large businesses that can afford the initial cost of capital.
- Customer's preference. Businesses in markets where personal service is valued are more likely to be labour intensive.

Table 4.1.1 Benefits and limitations of capital- and labour-intensive production ▼

	Benefit	Limitation
Capital intensive	• Mass production requires large-scale output using repeated tasks, e.g. assembly processes. Machinery can deliver this much more quickly than labour • Where capital is relatively cheap lower unit costs are available. Enables economies of scale • Increased labour productivity • Skill levels may be lower so costs are less and it is easier to recruit employees	• Difficult to produce a range of varied one-off or very short run products • Difficult to deliver personal services • High start-up costs: cost of capital may be too high for a business to buy machinery • Unreliable machinery can be very costly • Employees may be bored and become disruptive • Difficult and expensive to vary amount of capital in short run
Labour intensive	• Can produce one-off unique products • Well suited to deliver personal services • Where labour is relatively cheap lower unit costs are available, especially where mechanized operations are difficult • Relatively easy to vary labour force – recruit or retrench • Low start-up costs	• Cannot produce large-scale output quickly • Limited economies of scale • Production is dependent upon skills, which means employees can disrupt production easily by industrial action or absences • Legal constraints may make it difficult to vary labour force

Progress questions

4 You are a consultant advising a number of businesses on starting up. The managers of these businesses ask for your advice on how to set up their production processes. Advise them in relation to the relative amounts of capital or labour they should use. Include in your responses any factors they need to think about.

Businesses seeking advice:

a A board-games manufacturer
b A sports car manufacturer producing kit cars
c A personal sports coach
d An accountant specialising in farm accounts
e A bottle manufacturer.

5 Explain the meaning of the following terms:

a Capital intensive
b Labour intensive.

Exam-style questions

1 Explain the meaning of the following terms applied to operations:
   a Efficiency [3 marks]
   b Effectiveness [3 marks]
2 Discuss the factors that the directors of a computer manufacturing business should consider when deciding between labour-intensive and capital-intensive production processes. [20 marks]
3 Explain **one** way of measuring efficiency and **one** way of improving effectiveness. [6 marks]

Ling and Chas serve food

Setting the scene

From an early age Ling was determined to become a chef owning her own restaurant. Chefs had to work under great pressure but they were paid a good hourly wage. Chas, another young employee, was unhappy with their working conditions but both he and Ling tried to ignore the problems as they wanted to progress their careers.

The business start-up

Ling and Chas struck up a friendship and decided to use their experience to set up a restaurant together. They were offered premises in the centre of town. They did not want to lose this site so they hurriedly signed a ten-year lease. They decided that the restaurant would specialise in curries and other Asian dishes – they called it Curry Cuisine. They could not afford any market research but they often cooked this type of meal for their friends and it was always very popular.

They had to employ a trained restaurant manager as their own experience had been gained in kitchens. The building needed more work doing to it than they had predicted. However, the choice of location turned out to be crucial to the success of the business. They realised that a newly completed large office development was leading to many new customers. The key selling point of the restaurant was that every customer had food that was freshly prepared, even if there was a wait before it was served. This involved very labour-intensive production.

Expansion – then problems occur

The success of this first restaurant surprised Chas and Ling as they spent little on promotion. It soon became clear that the existing premises were too small and a new location was found. The building was three times larger than their first restaurant with a huge kitchen. Ling recruited many more staff. She was careful to follow all of the legal requirements in the selection of staff. She wanted skilled employees who could work in a team with the minimum of management supervision.

Chas took charge of fitting out the kitchen with new equipment. This included huge new fuel efficient cookers that allowed very accurate temperature settings. Strict health and safety laws had recently been passed. Chas was determined that the new restaurant would exceed all minimum standards. This would encourage good employees to look for jobs there and would give customers confidence too. Initially the restaurant was popular but sales soon started to fall. Other restaurant businesses offering freshly prepared food had opened in the same area. This increased competition. Ling had to make some staff redundant which she did after a careful appraisal of every employee including an interview with each one.

4 Analyse the operations process in Ling and Chas's first restaurant. [8 marks]
5 The choice between the relative importance of capital and labour is a vital one.
   a Discuss the factors which Ling and Chas might have considered when they set up their first restaurant. [16 marks]
   b Analyse the reasons why they might have changed to the different operations process in their second restaurant. [14 marks]

Key concepts

- AS **Management** can be seen in the way managers manage inputs.
- AS **Customer focus** can be developed through consideration of what customers want in terms of outputs.
- AS **Creating value** can be studied through the concept of "value added".

Progress check

You should now be able to:

- AS understand, analyse and evaluate the way that inputs are transformed to outputs in the production process including the stages of the production process and the resources of land, labour and capital it uses
- AS understand the difference between efficiency and effectiveness
- AS understand how added value is linked to marketing, the operations process and operations decisions
- AS understand, analyse and evaluate capital- and labour-intensive processes to enable a choice between them.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- AS the influence of marketing, resources and technology
- AS the need for flexibility and process innovation
- AS decisions about which operation method to use
- AS factors determining location decisions
- AS the scale of operation: economies and diseconomies of scale
- A the use of enterprise resource planning to increase efficiency

4.2 Operations planning

Operations decisions

The influence of marketing on operations decisions

Operations decisions are about the organisation of resources for producing products and services. However, before resources can be organised it is important to know what products/services are needed. That is where marketing comes in. Marketing is the process of identifying, anticipating and satisfying customer requirements profitably. This means that marketing will have to be taken into account when operations decisions are taken. So, an operations manager in charge of production should not invest in the most expensive machinery producing products of extremely high performance if this results in a price that customers will not pay. A restaurant should not be located in a wonderful building if it is so far away from where people live that nobody will come to eat there. Key areas where marketing will influence operations include:

- Ideas decisions – market research can generate ideas for products or services that customers will buy. These ideas will help determine the design process.
- Production decisions – market research can indicate how much customers are willing to pay and this will help determine the production methods and the balance between labour and capital. Marketing can give an assessment of the quality of the product or service customers want and this will determine how the product or service is produced.
- Location decisions – marketing can indicate where customers are likely to buy the product or service. This will help determine where to locate a production facility or a service provider.

The influence of the availability of resources on operations decisions

While sufficient resources may be available for any planned production process, the question is at what cost to a business? It is possible to grow tropical vegetables in arctic regions but the cost of glasshouses, heating and sun lamps is so huge that no one does this. The resources needed for operations must be available at a cost which means that the product or service can be produced at a price appropriate for the customer. The key areas where the availability of resources will influence operations are:

- Ideas decisions – whether a business has an R&D facility with trained, inventive employees will influence the extent to which ideas can be generated and explored. It may be possible to pay another business to carry out development work but this is risky as the ideas could be used by that other business.

- Production decisions – the resources needed here are land, labour and capital. A business may have suitable premises, employees and equipment. In this case operations decisions can be made with no constraints in this area. If a business is changing its products/services or looking for more efficiency it must take account of the resources it has available. For instance, a Chinese restaurant thinking of offering Indonesian menus may not have a chef who knows how to cook in that style. The restaurant may not have the finance to hire another chef who does. Equipment costs and some projects may not be able to be undertaken because appropriate premises, employees and equipment are not available.
- Location decisions – a business thinking of setting up or moving must be able to find suitable premises and employees. The availability of the right skills is also an important factor in a location decision.

The influence of the availability of technology on operations decisions

Technology is increasingly important in business activities. Using appropriate technology can reduce costs and enable activities to be undertaken that could not be done before. For example, microwave cookers have altered the way that fast-food suppliers offer their products; computers and information systems have changed office work; and robots have completely altered working practices in factories. The key areas where technology will influence operations are:

- Ideas decisions – computer-aided design (CAD) involves the use of computer software in the design of products. The software tools enable designers to produce drawings that can be shown in 3D, animated, or zoomed into or out of, and each change can be saved. This is done by using a mouse, light pen or a digital graphics tablet. It is an important example of how technology has made design faster and also made sure that designs can actually be made to meet the constraints of the market. Computers have enabled the fast processing of information, making it much easier to gather and analyse market information in order to design products to meet market requirements. The software also enables designers to "play around" with designs, and to create images of what the final product might look like. Computer-generated designs can also feed into automated production processes.
- Production decisions – developing technology has led to many changes in this area. Computer-aided manufacture (CAM) has enabled businesses to set up efficient low-cost automated production systems using computer-controlled robots or machines that replace employees and produce consistent quality with personalised orders. Specialists are still needed to programme the robots or machines to carry out tasks. Once set up there is no need for humans to be involved in production, other than to change

Key terms

Computer-aided design (CAD): the use of a combination of computer software and hardware to design products.
Computer-aided manufacturing (CAM): use of computer software to control and manage equipment, robots and machine tools to manufacture products.

the program if required. CAM may enable computer-controlled machines to be directly linked to CAD programmes, integrating design and manufacture. Computers have been used to plan work processes smoothly and efficiently to minimise costs. Other examples include:

- reducing stock levels by using computer-based information systems
- computerized payroll and employee review systems reduce costs
- electronic point of sale (EPOS) monitoring reduces cost of reordering for stores
- new materials have changed the way clothing is designed and produced
- CAM can also be part of an ERP system (see later in this chapter).

- Location decisions – communication systems have become so advanced that technology now is a major influence on a location decision. The Internet and emails enable many businesses to be located almost anywhere in the world, especially if they are offering a service. Examples include:
  - many call centres for businesses in the USA and Europe are located in South Asia
  - Amazon sells products in many countries using an Internet-based ordering system and computerized stock-holding and tracking systems. This would not have been possible 20 years ago.

Table 4.2.1 Advantages and disadvantages of CAD/CAM ▼

Advantages	Disadvantages
• Accuracy of design and manufacture are much higher than with hand drawn designs or operations. Design can be done in animated 3D and errors can be corrected quickly. • Ideas and settings can be saved, meaning that repeated operations will be exactly the same and a database of designs easily maintained. • Ideas and settings can be edited to take account of changes or design changes. This means there is great flexibility. • Labour productivity will be much increased. • Design and manufacture can be seamlessly linked.	• Software and hardware can be very expensive, making initial set-up costs high. • Training costs for staff can be high. • Introducing CAD/CAM often means organisational change, including making staff redundant and hiring new staff with different skills. This can be expensive. • Designs and machine settings can be lost if not backed up.

Progress questions

1 Jack is thinking of setting up a business to make boiled sweets.
Explain how marketing might affect the operations decisions he has to make.
2 Kigsaw Ltd produces soft toys. The business is thinking of producing board games which would be suitable for converting into computer games.
Explain how the availability of resources might affect the operations decisions it has to make.
3 Petra runs a management consultancy to give advice to businesses thinking of expanding their production. She currently employs four people. She has so much work she is thinking of expanding her own business to cover the whole of the country she lives in.
Explain how the availability of resources might affect the operations decisions she has to make.
4 Analyse ways in which the following can influence operations decisions:
a A market research project
b Highly skilled and flexible employees
c The Internet.

Flexibility in production

The need for flexible volumes, delivery times and specification

Key terms

Operational flexibility: the ease with which a productive system can adapt to a changing market environment.
Specification: an exact description of a product in terms of size, materials, performance and aftercare.

Operational flexibility is the ease with which a productive system can adapt to a changing market environment. In particular this means being able to vary the quantities produced, the time of delivery to the customer or the exact specification details of the product or service. The specification can be a design that the producer intends to sell or a description of what the customer is looking for. Flexibility is very important in today's rapidly changing business environment. It enables a quick response to a market change or a buyer's different demand. It allows businesses to exploit new opportunities. The greatest flexibility comes from mass customisation (see below).

The need for flexible volumes

Volume flexibility is the ability to operate efficiently, effectively and profitably over a range of output. Demand can change quickly or more slowly over a longer time period. Volume flexibility is needed to guard against uncertain demand for a product.

Long-term volume flexibility

Link

The product life cycle model is discussed in AS Level Chapter 3.3a The marketing mix: elements and product.

Flexibility enables a business to respond to the different demand for a product at different stages of the product life cycle. As the product begins to sell in the introduction stage the demand will be for small quantities and this demand will increase as the product moves through the growth and maturity stages before declining, though there may be increased demand from a successful extension strategy. The time span involved could be from a few months in the case of a novelty toy to many years in the case of a breakfast cereal. A business must be able to vary its volume of production to deal with the changes over time.

This will involve preparation and planning. If there is no flexibility the business will be unable to meet demand as this increases and eventually it may find that it is producing products that are not selling.

Short-term volume flexibility

A business receives orders from customers. It never knows exactly when these orders will come in so it must be prepared to produce products for a range of volumes. Some orders may be for particular quantities over a period of time, e.g. "please supply 200 items per week for the next two years". But even an order like this might change as perhaps the customer finds it needs to change the order for some reason.

Other orders may be for a single time or for varying quantities, e.g. "please supply ten items this week. We hope to continue ordering from you in the future". These orders demand the ability to be flexible as failure to meet an order may result in the loss of any future contracts. This applies particularly where a business is supplying another business that is using a just-in-time production system where materials are ordered just in time to use them for production immediately. Businesses must therefore have the ability to be flexible about the quantities they can produce. This flexibility must include being able to supply at a quality and price the customer is happy with.

Link

Just-in-time production is dealt with in AS Level Chapter 4.3 Inventory management and A Level Chapter 4.5 Lean production and quality management.

The need for flexible delivery times

Products which are ordered have to be delivered. This can apply to services as well as physical products. Education and training is a good example. Colleges increasingly offer flexible learning experiences which suit the demands of their learners. This can be done through the use of the Internet, offering part-time courses or by agreeing times for lectures and seminars with the customers. In a competitive market this kind of flexibility can be an important factor in winning customers. In the domestic consumer market many customers are demanding flexible delivery times for products they have ordered. Increasingly businesses are finding that offering to deliver at a time that suits the customer is an important reason for getting a sale. The Knowhow case study illustrates the way that businesses are emphasising flexible delivery as a selling point.

The need for flexible specifications

Consumer expectations are growing in line with the developments of technology. In many countries, people who buy new cars want them built to their own specification, with a bewildering choice of engine sizes, colours, accessories and so on. People buying laptops want to choose many of the features such as processor, hard disc, memory, operating system and software. Services, such as insurance and banking services, are expected to be "tailor made". In response, many manufacturers and providers of services want to offer as much flexibility as possible. Their production systems need to be able to respond to this wide range in specification demanded by customers. To achieve that many producers adopt mass customisation and enterprise resource planning, both of which are discussed later in this chapter (see pages 211 and 223).

Case Study

KNOWHOW delivery services

We'll deliver your product at a time to suit you on behalf of Currys.

The key to our delivery service is flexibility; you can choose your delivery in the morning or the evening and even over the weekend – just select an option to suit you. Our first delivery is made at 7 a.m. and last at 8 p.m. and we will always phone you 30 mins before we are due to arrive.

Great news! KNOWHOW offers you the choice of 4-hour time slots for your delivery to ensure that your large product arrives when you want it to, as an alternative to our standard free all-day delivery. Simply choose at the checkout which slot suits you best, giving you greater control over your delivery time.

Subject to availability, you can select from:

7 a.m.–11 a.m. ☐ 9 a.m.–1 p.m. ☐
11 a.m.–3 p.m. ☐ 1 p.m.–5 p.m. ☐
3 p.m.–7 p.m. ☐

This flexible delivery slot leaves you free to carry on with what's important to you and relax with the KNOWHOW that we'll deliver to you between those times.

1 Explain the advantages to the customer of flexible delivery times.
2 What problems might flexible delivery cause for Currys?

Taken from www.currys.co.uk/gbuk/Delivery-1021-theme.html

In markets where businesses supply other businesses with materials or components the increasing use of just-in-time manufacturing systems, where businesses order materials just in time to use them for production immediately, means that flexible delivery times are essential for obtaining an order.

Case Study

The importance of flexibility

Red Prairie (now a part of JDA) serves 60000 clients in 50 different countries. It offers process and performance solutions to businesses. It says, "We're here to help you keep products moving, help employees work more efficiently and reduce transportation costs. Leading companies trust Red Prairie inventory, transportation and workforce solutions to help deliver an increase in productivity—with the flexibility to adapt as business needs change." Its products are IT systems which enable a business to track and monitor stock, build customer databases, plan delivery arrangements and employee management, integrating these into a seamless whole. It has a flexible delivery model which is the key to success. "Part of that power and agility is the fact that you can choose how to deploy our solutions based on the configuration that works best for you. So you get the results you need—where and how you need them." An example of its product is as follows. A business receives a sudden increase in an order. The IT system can find where stock to meet that order is, or a production plant that can quickly increase stocks. Employees are allocated to get the extra production to the customer.

1 Analyse how this case study illustrates the influence of resource availability and technology on operations decisions.
2 Red Prairie claims to operate a "flexible delivery model". Explain how it does this.
3 Explain why 60000 businesses are willing to buy from Red Prairie.

Key term

Process innovation: the implementation of a new or significantly improved production or delivery method.

Process innovation

An important and recent development in the efforts to improve efficiency and flexibility is process innovation. Process innovation seeks new approaches to organising and managing business systems and processes. It will seek to implement a new or significantly improved production and delivery methods. This includes significant changes in techniques, equipment, software and the way systems are managed. It can be applied to the provision of services (including public services) as well as the production of products. It can be a small improvement or affect the whole operation of a business. It can take place in number of ways. For example it could involve introducing a new technology,

such as computer-controlled robots or nanotechnology. Another way could involve a change in the way production is organised such as re-organising production into teams rather than an assembly line. Process innovation is so important that a Centre for Process Innovation has been set up in the UK to help and encourage businesses to use more innovative production processes.

Process innovation can be used in production, e.g. by introducing automation/robotics, or in delivering services, e.g. by reordering workflow/distribution methods. Process innovation is particularly important for small businesses as it can give them a competitive advantage that makes up for the costs associated with small size.

Process innovation has the following advantages:

- It can reduce total and average cost
- It can deliver a product or service that matches customer needs more closely
- It provides incentives for employees and motivates them.

However, because it is a change, it requires planning resources and the development of a positive attitude to change by employees, especially if fewer employees will be needed as a result.

Key terms

Automation: the use of electronics and machinery to control a production system.
Robotics: the use of robots – machinery that resembles a human being in the operations it can perform – in a production system.

Examples of process innovation

Hospital

Referral systems for emergency and routine eyecare can be made faster and more directly related to particular patients' needs by using a web-based database linked to doctors and other hospitals meaning that communication is improved, waiting times reduced and the most appropriate specialist is seen by patients.

Car insurance company

An accident occurs. Instead of asking the customer to get quotes from businesses to correct the damage, the insurance company offers on-the-spot assessment and an immediate cash payment.

IT management systems

See the Red Prairie case study for an example of how an IT system is a process innovation.

Mobile ordering systems

Sales staff with mobile devices like computers or phones can record orders and transmit them immediately to the producing facility.

CAD/CAM

Introducing CAD/CAM technology can reduce costs and make design directly integrated into the production process. For example, plasma cutting could be used instead of drilling.

Innovation by reorganising

A mortgage company found that 95 per cent of the applications received were straightforward and easy to deal with. It dealt with the 5 per cent

Activities

1 Carry out a survey of local businesses to find out if any of them have engaged in process innovation.

   If you find they have, explain the possible reasons they did this.

2 Research examples of process innovation in larger businesses.

   Compare what they have done with the local examples. Analyse the differences and similarities.

that were difficult by setting up a different system for them. Average time spent on the 95 per cent fell from three weeks to three days.

Types of operations methods – job, batch, flow and mass customisation

Businesses can plan to produce products in different ways. These operations methods (sometimes known as production methods) mostly refer to the production of products rather than services but there are examples that can be drawn from both products and services.

Job production

Key term

Job production: producing products one at a time as a single item.

Job production is producing products one at a time as a single item. It is usual where products are unique or being produced on a very small scale. Often job production is carried out by skilled experts and allows for flexibility, the product being customised for the customer. Job production is relatively labour intensive (see page 193), even for a large project, as specialist designers and planners are involved. Many employees involved in job production are motivated, e.g. those producing craft or art. However, unit costs are high and production may be slow. Examples include a potter, hairdressing and constructing a single large building, e.g. the Kuala Lumpur Tower.

Batch production

Key term

Batch production: where production is broken down into separate operations that are each completed in turn on a group or batch of products at the same time.

Batch production is where production is broken down into separate operations that are each completed in turn on a group or batch of products at the same time. The batch size can vary from small to large so there is the possibility of flexibility. Batch production is more capital intensive (see page 193) than job production and has lower unit costs. If one of the products fails, the equipment is still available for use with others. These advantages may be offset because work is less motivating, machines need resetting between batches, raw materials or batches between stages are inventory cost and production has to be in batches. Examples include baking loaves or cakes, and making coloured inks.

Flow production

Key term

Flow production: a continuous production method where one operation is completed on a unit that then moves on to the next operation.

Flow production is a continuous production method where one operation is completed on a unit which then moves on to the next operation. Flow methods mean that when work at a particular stage is complete, it is passed directly on for processing at the next stage. When it arrives, work must start immediately on the next process. It is usually used for standardised products being made on a production or assembly line. These have workstations where an unskilled or semi-skilled employee or a robot carries out a particular specialised task before the unit moves on to the next stage. Unit costs are low, standard products mean quality targets are easier to meet and some flexibility is possible with preset options. However, it requires high-quality machine tools, well-defined tasks and it is capital intensive. Flexibility is low, set-up costs are high, and varying demand can lead to the build-up of costly inventory. All stages must meet quality requirements, if there is one fault the whole line stops. Repetitive tasks lead to low motivation.

Examples include car manufacture, TV assembling and soft-drinks production. Mass production is a production method which produces products in large quantities at a low cost per unit. This may be done through flow production methods and sometimes batch methods. Mass production requires standardised parts, the use of machinery and a system for organising large quantities of materials. Because of this most mass production takes place as flow production using assembly lines.

Mass customisation

Key term

Mass customisation: a flexible mass production system enabling customers to specify what features of a product/service they want.

Mass customisation is a production system that is so flexible that customers can specify what features of a product/service they want. It is usually achieved through extensive use of computers in all stages of the process between the customer order and the eventual sale of the product/service to the customer. This involves having the flexibility to vary the specification for each product being produced as and when it is produced. Job production is easy to customise as each product is unique and can be made for one customer at a time. Batch and flow production are less easy to customise; however, with the aid of computer technology and robots it is possible to build in some elements of customisation, often by offering a large range of options that can be ordered, e.g. cars or computers. So, for example, BMW now claims that no two cars from its production lines are the same. Just think of it, if a car manufacturer offers five different engines, five different seat colours, five different body colours and five different options for the radio, then there are $5 \times 5 \times 5 \times 5$ different models of the same car, which amounts to 625 models. In fact customers often have many more choices than those in this example.

Progress questions

5 Explain the different methods of producing products and services and give examples for each of them.

6 Explain why mass customisation is not suitable for Coca-Cola.

Case Study

Ventura Foods

Ventura Foods produces a range of food products including oils, margarine, sauces and soups. It uses a batch operations method with multiple lines so that a number of different products can be produced at the same time. One line will perhaps produce margarine for a number of batches, then a soup. Another possibility is that a line will produce a batch of mushroom soup then a batch of onion soup. The machines and linking conveyor belts have to be prepared by being cleaned and the new ingredients placed ready to feed into the line. Many of the lines use the same ingredients and oil is a basic component of many of their products. Ventura has to minimise the amount of time that the machines are not working. It has to make sure that the raw materials are brought to the production lines at the right time in the right quantities. If stocks of raw materials fall too low production has to stop. Ventura was meeting more and more problems in changing the production lines between batches and making poor

decisions about which products to make on which line. Ventura decided to work with ESE, an operations software company. The result was it consolidated three factories into one with 33 operating production lines and 12 more in reserve. The IT batch optimising system was purpose built and designed to enable employees to quickly and easily make decisions about what to produce and on which line. It integrated the availability of stocks into these decisions and allowed production line machines to be controlled, recipes to be changed, a more consistent product produced and prevented stock levels running down. The result was more flexible production, less time when machines were not running, more consistent quality and lower costs.

1 Explain why Ventura Foods chose to use batch production.
2 What problems did batch production produce for Ventura Foods?
3 What role did technology play in the changes to its operations method?
4 To what extent did the changes bring greater flexibility?

Advantages and disadvantages of operations methods

Each operations method has advantages and disadvantages. The choice of method must also be linked to other organisational factors including the objectives of the business and the motivational methods used for employees.

Table 4.2.2 Advantages and disadvantages of job production

Advantages	Disadvantages
• High-quality product • Customised production meets customer's needs • Employee has high job satisfaction • Flexible design and production	• High cost of each unit • High cost of training • Specialist skilled labour needed • Slow

Table 4.2.3 Advantages and disadvantages of batch production

Advantages	Disadvantages
• Lower unit cost due to machinery, especially due to time savings in producing multiple products • Reduce capital outlay as equipment can be used to produce several products • If one product is unsuccessful equipment is still usable for other products • Varied customer needs can still be met if these are in groups, e.g a baker can make fruit cakes and bread • Flexible production possible but whole batch needs to be made to keep unit cost down • A changed product may mean only one stage needs replacing, not a whole production line	• Lower unit cost • Less-motivating work • Machines need to be reset between batches, taking time out from production • Not fully flexible in volume or meeting customer needs as whole batch needs to be produced • Cost of holding stocks of materials – either raw materials or batches waiting the next stage

Table 4.2.4 Advantages and disadvantages of flow production and mass production ▼

Advantages	Disadvantages
• Low unit cost • Low-skilled employees needed • Fast and quick high-volume production • Standardised products so quality targets easy to meet • Possibility of flexibility by changing speed of production line and building in preset differences, e.g. colour, different components	• Requires constant demand: if not then stocks of finished products build up or production line is idle • Less flexible as tasks are standardised • Relies on standard materials delivered on time: otherwise production stops • High planning, set up and start costs • High quality assurance/control costs: all stages must meet standards, no reworking possible. If the line stops for one fault all production stops • Less motivation for employees as standard repetitive tasks

Advantages and disadvantages of mass customisation

Mass customisation means meeting the needs of individual customers on a large scale. This is a real advantage because it will satisfy customers. However, customisation other than by using job production is very difficult and/or expensive. Customisation through batch, flow and mass production will sacrifice the high volume, speed and low cost per unit produced that is associated with those methods. Although some flexibility is possible by producing batches of different products or building in some variations to tasks on production lines this is limited.

However, since 2005 more and more businesses have been moving to mass customisation. As previously explained, this approach modifies the method of flow/mass production by reducing choices and enabling customers to have the benefit of the low cost of mass production and still be able to have a product which is exactly what they want. This has enormous benefit for the marketing of the product and can be essential when challenging competitors. It is likely to be a result of a programme of process innovation and is also likely to include ERP (see later). However, mass customisation like this requires significant investment in equipment such as IT systems, and possibly robots if manufacturing is involved, and changes for the organisation and its employees.

Problems of changing operations methods

Setting up an operations method takes time, planning and capital. To change from one method to another would mean taking apart the machinery and equipment and redesigning the whole production system. It would also mean that it might be necessary to redesign the product.

For example, two pots made as one-off examples may not have precisely the same amount of clay in each of them. The potter will know this, but their skill will still enable the pot to be made. Batch or flow production might mean that each pot must have exactly the same clay at the same consistency and this would mean designing a standard pot rather than the slightly different job production pot. On the other hand, a potter would not be able to produce a number of identical pots in the same way that flow production could.

It would be extremely difficult and very expensive to produce some batch produced products by flow production. For example, coated spectacle lenses or computer screens are produced in batches. There are a number of different coatings and each may take several hours to be applied, processed and then dried. Flow production would be extremely slow unless there were many machines carrying out the same task – this would be really expensive.

Products made by flow production could be produced in batches or as one-offs, but this would generally be much slower and involve large spending on new machinery, equipment, training and re-organisation.

It is important that a business puts plenty of time and thought into any decision about a production method as it can be very difficult and expensive to change. Growing businesses might change production methods, but this will usually take place as part of a planned expansion with sufficient resources to make the change possible.

Progress questions

7 Explain three advantages and three disadvantages for each of the following operations methods:
- **a** Job production
- **b** Batch production
- **c** Flow production.

8 Feliho Associates is a management consultancy. It asks you to provide some training for three new employees. The focus is how businesses take decisions on choosing an operations method.
- **a** Prepare some materials you might use with the three employees to help them give advice on whether job, batch or flow production is most suitable for their clients.
- **b** They need to understand the advantages and disadvantages of these methods. You could explain this using tables, lists or written notes.

Location decisions

A business has to decide where it is going to put its production facilities. Similar factors will influence the decision to locate somewhere or to change the location if the original site becomes unsuitable or less attractive. The two main determinants for location are the desire to minimise costs and the need to reach the market. Some industries and businesses are footloose – that means they are not tied by any particular location factor and can set up almost anywhere: for example, many online businesses offering consultancy advice or retail services.

Factors determining location or relocation

Geographic

Physical geography and climate can affect location decisions. For example, some industries require a large expanse of flat ground. Businesses will assess locations for their risk of flooding or snowfall. Some businesses have particular requirements. For example, a business making delicate lab equipment may not want to be in an earthquake zone, and a business making cotton cloth may need a damp atmosphere.

Demographic

A business will need employees. A possible location must have enough people living within reach who are able to form a workforce. An area of low unemployment may mean that wages are going to be higher as there are other businesses competing to get employees. However, the availability of lots of employees is not necessarily all that is required. A business will have particular types of work available and will be looking for employees with particular characteristics. It will be important that the area has enough people with the desired skills, experience and qualifications. This will save training costs. For example, an agricultural area with low educational levels may provide employees unskilled in industrial processes. This might be suitable for a mass production facility with unskilled work on assembly lines but not so good for a science-based high-technology business looking for graduates.

Demographic factors largely determine the cost of wages and salaries. For most businesses labour costs are a vital factor in making a location decision. Many call centres are located in India for this reason, and Dyson moved its manufacturing from the UK to Malaysia for this reason.

Legal

Different countries and even different regions within a country may have different laws regulating business activity. Some countries may require inspections and reporting at regular intervals and these will add to costs. It will be important to find out about tax rules, grants, subsidies available, government assistance with premises, rent, training and ongoing advice. An increasingly important concern is with laws and regulations about waste disposal, health and safety and handling dangerous chemicals. Another area is the laws that deal with industrial relations and the power of trade unions. Where unions have significant power and can negotiate higher wages and better conditions costs will be higher, and the reverse is true where unions are weak. A key factor in General Motors' decision to produce the Astra in the UK in 2012 was that UK employment law promoted weaker unions than in other European countries. This was also a significant reason for European and US businesses using businesses in Asian countries to produce their products. All these factors can affect costs.

Political

Most businesses welcome political stability and freedom from government interference. There are not many businesses looking to set up in North Korea at the moment. Political stability offers a degree of certainty for the future and businesses will think twice before setting up in a place where they might be likely to suffer sudden changes in industrial policy. In 2012 the Argentine government took over a major oil company and this caused many large businesses to reconsider Argentina as a possible place to set up in. On the other hand, some governments actively encourage investment from overseas in their country, sometimes offering direct incentives such as "tax breaks" and sometimes allowing the free movement of capital, which helps facilitate location into the country.

Resources

The availability of raw materials and components can be a major influence on location. Having a location close to raw materials or components will reduce transport costs and make deliveries more certain. This is especially true for businesses whose final products are much smaller than the materials that produce them, like steel making or coal-fuelled production. For these businesses this factor will be very important. On the other hand, a business that produces bulky products from less-bulky materials, like soft drinks, will find it advantageous to be nearer the market than the raw materials. Land is a resource and its availability now and for possible expansion in the future may be a key factor; so too is the cost of land, whether it is bought or rented.

Infrastructure

Key term

Infrastructure: the network of utilities in a location, including transport links, communications, education and health facilities, and support services.

Infrastructure is the network of utilities in a location, including transport links, power supplies, communications, education and health facilities, and support services. Aluminium smelters require large amounts of cheap electricity and must locate to where this is available. Governments are often prepared to invest in providing or improving the infrastructure in order to attract businesses. The Brazilian government, for example, has invested in huge hydroelectric power schemes in the Amazon basin to provide heavy industries with cheap power.

Marketing: being close to the market

Being close to the market can save on transport costs. If there are many customers who value convenience, being close to them is an advantage. Retail stores are often found grouped together in high streets near population centres or located in shopping malls that customers can reach easily. In both cases there are other stores nearby, encouraging convenience for customers. Businesses that supply materials to a manufacturer may find it an advantage to locate near the buyers to reduce transport costs. Some manufacturers and providers of personal services may see this factor as being particularly important in a location decision, for example car makers and hairdressers.

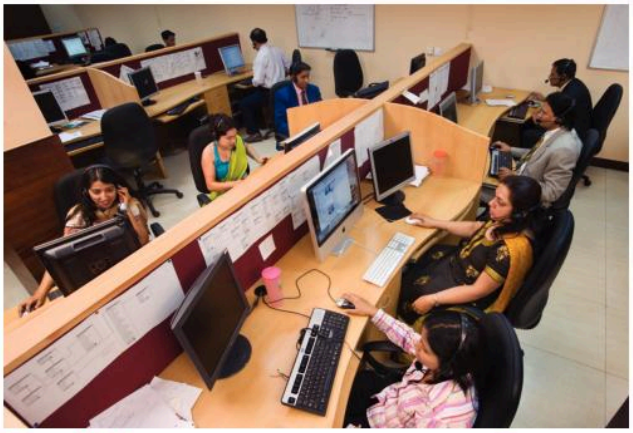


Figure 4.2.1 Closeness to customers: far and near ▲

Relocation: industrial inertia

The factors that led to a business setting up in a particular location may change. This could be because of:

- Changing production costs in other possible locations, e.g better transport and infrastructure or cheaper labour costs
- Changing objectives or strategies, e.g. a decision to enter a new market
- Changing location of suppliers or customers
- The impact of the Internet on trading
- Changing government policies, e.g. on subsidies, trade barriers, other assistance.

Key term

Industrial inertia: occurs when a business stays in its current location even though the factors that led to its original location no longer apply.

If an existing business is considering relocating it will consider all the factors above. It will also be faced with the fact that there will be costs in moving. Industrial inertia occurs when a business stays in its current location even though the factors which led to its original location no longer apply: the costs of moving seem to be greater than the costs of staying. Reasons for staying include the presence of an appropriate labour supply, existing training facilities, suitable infrastructure, and existing suppliers. Relocating may involve the costs of:

- Finding and training new employees
- Lower morale and productivity before the move
- Finding new suppliers and customers
- Administrative costs of the change
- Redundancy payments
- Adjusting to the new set-up.

Large-scale industries like iron and steel production often display industrial inertia.

Progress questions

9 Outline five factors that a business might consider when taking a decision to relocate.

10 How might the importance of these differ for the following?

a A factory making garden tools

b A manicurist

c A company making TV documentaries.

Location decisions at different levels

Businesses can in theory locate anywhere. In practice most businesses face a more restricted choice of locations. Small enterprises will have to decide where to set up locally, a very large business may have the choice of locating in any country in the world. Between these two extremes

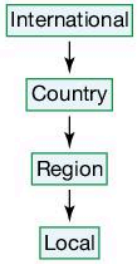


Figure 4.2.2 Location decisions at different levels ▲

there are the possibilities of locating regionally or nationally. Many businesses have the option of operating in more than one location by setting up several offices, factories or stores.

Local decisions

The decision to set up in a particular location will be determined by costs and market factors. A business must consider the cost of renting or buying, the ease and cost of obtaining products to sell, the availability of labour with the right skills and the closeness of customers. There might be local or central government help and advice available. All this information will have to be researched in detail in order to make the best decision. If the business is a store it will also be interested in the number of people passing, what other stores are nearby and the income levels in the immediate area.

Regional decisions

These decisions will focus on wider factors. The choice of one region rather than another will depend on the characteristics of that region rather than those of one particular place. A business may be interested in population centres as a source of labour or a market, transport links to other regions, regional government incentives (such as regions with investment tax breaks or employment subsidies), the competition and the closeness to materials and supplies.

National decisions

The decision to become a business operating across the whole of a country will involve a large investment. The business must be sure that it has the ability to obtain its supplies across the whole country and a distribution system for getting the product everywhere. Each must be able to be achieved at a cost that allows prices to be appropriate for the customers. It must have the resources to engage in national advertising and promotion campaigns.

International decisions

International location decisions focus on trying to reduce costs, reaching global markets, avoiding taxes on imported products and reducing corporation tax on profits. The decision to become an international business will depend on the opportunities for these things as well as the resources a business has. Once the decision has been made to go international a particular country must be chosen. This decision will depend on what policies the government has regarding business and its development, especially its tax system. Labour costs will be important, as will the exchange rate of the chosen country. Legal and political factors including the possibility of grants, tax incentives, help with premises and policies on taxing imports or subsidising exports will also be key.

The possible market in the country is important too. Opportunities to sell to an expanding market with the money to buy will be important. Market research can identify these. Many international location decisions are taken by large businesses that may use different locations

to enable cheaper production of products that can then be moved to another country for final assembly. Rapid economic growth in a country will encourage a business to set up there to access the growing market. The business must also come to terms with different cultural, ethical and marketing concerns.

Examples of reasons for international locations

Reasons for seeking locations in other countries include:

- Seeking reduced costs: the German tyre manufacturing company Continental and the Netherlands sportswear business Head have been gradually relocating production to low labour cost countries, closing factories in Europe and opening them in China. A minor factor in the decision was the increased access to a growing market in China. The Japanese Yazaki group opened a factory in Lithuania to access cheap labour and has now moved this to Turkey for the same reason. Many businesses outsource particular parts of their production or services – call centres or clothing/footwear businesses like Nike and Reebok taking advantage of cheaper labour costs. This is called outsourcing or offshoring, both A Level topics.
- Seeking skilled labour: Siemens makes electrical products and chose to move some consultancy and support services to India because of the availability of skilled IT graduates.
- Gaining government assistance: Tata, producing steel and vehicles, has acquired businesses in the UK to gain access to the European market and a skilled labour force, but government subsidies and help were key factors in the choice of the UK.
- Seeking new markets: as tobacco use declines, British American Tobacco has been shifting production from Europe to Asia as it is seen as an expanding market for its products.

Link

Outsourcing is also covered in AS Level Chapter 1.2 Business structure.

Link

See A Level Chapter 4.4 Capacity utilisation for more on outsourcing and offshoring.

Evaluating location decisions

Many businesses see reducing costs as being the most important reason for locating or relocating. These costs may include marketing costs, but for many companies the most important factor is the cost and availability of the skills they are looking for. Labour forms a high percentage of costs, and businesses are keen to find a location which minimises this cost. Businesses that require specific skills are likely to locate in areas where these are available, e.g. a finance business may be in Hong Kong, Singapore or London. Those that require unskilled or semi-skilled labour will seek areas where wages are low, e.g. clothing manufacturers in Bangladesh. The second key factor is the institutional arrangements for employing labour. Many businesses rank legal constraints and the role of trade unions as important. Businesses want flexibility, and the ability to reduce costs by finding a location where health and safety law is not enforced, employees can be hired and retrenched easily and unions are not strong is often valued.

Key term

Scale: the size of production facilities of an operation which is fixed at least for the immediate future. It is related to capacity (see A Level Chapter 4.4 Capacity utilisation).

Link

Scale of operation and business size are not the same thing. Business size is covered in AS Level Chapter 1.3 Size of business.

Getting it right

Economies of scale are about the *scale* of production, not the *level* of production. So, falling average cost could occur as output rises, but this on its own is not an economy of scale. Economies and diseconomies of scale only apply where the scale of production changes, e.g. by the addition of some more machinery or equipment (capital).

Key terms

Economies of scale: advantages from the fall in costs per unit produced as the scale of output is increased.
Average cost: the total cost of production of all units divided by the number of units produced.
Diseconomies of scale: the disadvantages from the rise in costs per unit as the scale of output is increased.

Scale of operation

The scale of an operation is the size of its production (given a fixed amount of capital). A large-scale business has more output than a small-scale business in the same industry. An increase in scale is not simply an increase in the level of output. It must be accompanied by an increase in capital to shift the business to another scale of production.

Factors influencing the scale of a business

The factors which determine the scale of operation include:

- The position of the business or product in its life cycle because a new business or product is likely to have low levels of production. As sales rise new equipment may be purchased and output increases.
- The financial resources of the business. If these are limited it will be difficult to invest in more equipment to increase production.
- The objectives of the business; if these do not include expansion there will not be a change in scale.
- Market conditions, because to increase scale involves selling more output. If this is not possible there will not be an increase in scale.
- The likely reduction in unit costs as a result of expanding the scale of production.

Economies and diseconomies of scale

As a business expands and invests in new equipment, capital efficiency will increase and the cost per unit will fall. Economies of scale are the fall in average costs (costs per unit) produced as the scale of output is increased. As output increases and unit costs fall competitors will find it harder to compete and may not even be able to enter the market. This process will increase until A Level of production is reached at which average costs are at their lowest. As scale and output increase from that point average costs per unit will rise. Diseconomies of scale are the rise in unit costs as the scale of output is increased.

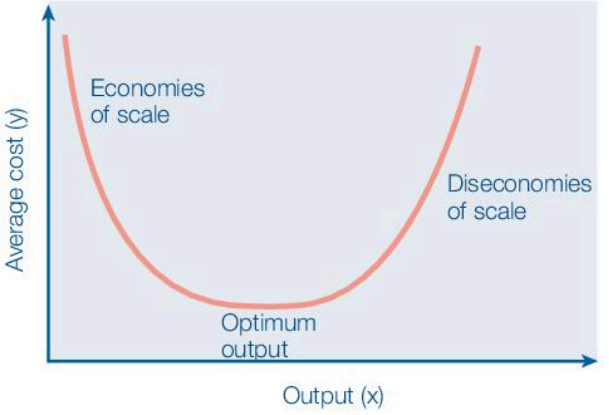


Fig 4.2.3 Economies and diseconomies of scale ▲

Link

Average costs and variable costs are discussed in AS Level Chapter 5.3 Costs.

Causes of economies of scale

As output increases, the fixed costs which are incurred whatever the level of output will be spread over increasing units of product, so costs per unit will fall. Variable costs (such as raw materials) will also fall with increasing output because the business can organise itself more efficiently. These economies may result from internal causes or from causes external to the business.

Key term

Variable cost: a cost that will vary directly with the level of output, e.g. raw materials.

Internal economies of scale

Internal economies of scale arise from the operations of the business.

Link

See AS Level Chapter 5.4 Accounting fundamentals for more information on costs.

Purchasing or bulk buy economies

These result because a business that orders a large quantity of materials or a service will often receive a discount because it is providing the supplier with a large order. This is also true for the interest rate on borrowing money. Larger businesses may get discounts because the smaller business wishes to keep the large orders. For example, 10 per cent discount for orders of more than 100 units. This will lower the variable cost per unit and so average cost will fall.

Technical economies

Investment in advanced equipment will improve efficiency and reduce unit costs. New technologies will be cheaper to operate or capable of dealing with much larger levels of output so unit costs will fall. This is especially true of IT systems for managing production, communications and staff.

Key term

Internal economies of scale: reductions in average costs arising from decisions made internally by the business in relation to its operations.

Larger units bring their own economies. For example, transporting 40 tonnes on a lorry costs less per tonne than transporting 20 tonnes, or doubling the size of a package uses less than double the packaging material. Variable costs per unit falls and so average cost falls.

Managerial or specialist economies

As a business grows, specialists can be employed to run each functional area. Specialist managers will be more efficient at managing and the employees they manage will be organised more efficiently, so raising productivity. Larger businesses can pay higher salaries and attract better managers. All these effects will lower average costs.

Administrative economies

Administrative processes often are the same whatever the size of the task. For example, the paperwork for an order of two items is the same as the paperwork for ordering 1000. The cost is therefore spread across more units so average cost falls. This will be true for marketing as well; the cost of an advertising campaign is the same whatever the quantity of output or sales so average cost falls.

External economies of scale

External economies of scale arise from factors that are outside the business and will benefit all similar businesses.

Key term

External economies of scale: reductions in average costs resulting from influences outside of the business.

Infrastructure economies

New infrastructure projects will often produce lower costs for a business. A new road, better broadband access or a new airport can produce lower costs so unit costs will fall.

Research and development economies

Local universities may develop R&D facilities that can be accessed by businesses. This will reduce the cost of developing new products and processes and so unit costs fall. For example, Nanyang Technological University in Singapore has business-orientated research programmes.

Marketing economies

If there are a number of similar businesses in the same area customers will visit knowing that they will be able to find a business offering what they want. This means each individual business does not have to advertise as much so unit costs fall. Jewellery quarters in cities are an example.

Another example is a promotional campaign by an industry organisation. For example, the egg producers association may run an advertising campaign to encourage egg buying. All egg producers stand to benefit and save on advertising themselves so unit cost falls.

Production economies

Businesses whose suppliers are nearby will face lower costs. They are so close that transport and communication costs are less. Mumbai and the development of many IT businesses in that city is an example, Dubai and the concentration of financial industry businesses is another.

Causes of diseconomies of scale

The causes of diseconomies of scale are linked to the fact that increasing size means managers spend more and more time performing tasks not related to the primary function of production.

Co-ordination diseconomies

As a business goes past its minimum efficient scale of production it may become more difficult to monitor and co-ordinate the processes and functions in the organisation. Production becomes more complex requiring more management. This will increase the unit costs as more resources are diverted for co-ordination rather than production.

Control diseconomies

As size increases, it may become more costly to ensure quality in the way that processes are carried out. This is heightened because employees will feel increasingly alienated and not part of the business as it grows larger, and industrial relations difficulties appear, with loss of morale. More supervisors and motivation experts are needed to try and offset this, thus increasing unit costs.

Communication diseconomies

As an organisation increases in size and scale the difficulties of communicating between its various functions increase and managers spend more time on this, thus increasing unit costs. However, emailing, video-conferencing and the communication possibilities that the Internet makes possible have helped to reduce this reason for diseconomies of scale.

Progress questions

11 Explain the difference between:
- **a** Economies of scale and diseconomies of scale
- **b** Internal and external economies of scale.

12 Outline:
- **a** Three causes of economies of scale
- **b** Two causes of diseconomies of scale.

13 Hiscocks makes and sells a range of clothing in a large African city. The business started in 2000 with a small workplace and shop selling to local customers. From 2000 the business steadily grew its sales and now has two factories and 15 shops. The factories are located near the edge of the city where the markets are. The increase in sales was largely because Hiscocks was able to drive down its costs and sell at steadily lower prices.

Explain how Hiscocks might have been able to continually reduce its costs since 2000.

Enterprise resource planning (ERP) (A Level)

Key term

Enterprise resource planning (ERP): a software-based system that integrates management information from all functions in a business into a single computer system that serves all those functional needs.

Enterprise resource planning (ERP) is a method of integrating production systems so that product planning, manufacturing, marketing, inventory and delivery are all linked together in an automated integrated way. ERP involves the use of carefully designed computer software and other techniques to improve the efficiency of an organisation. It integrates management information from all functions in a business into a single system that serves all those functional needs. This enables a business to key in one set of information (e.g. a sales requirement) and the ERP software then orders materials, arranges employees, sets up machines, and notifies customers of delivery details.

ERP tries to make information flow freely within the organisation and between it and outside stakeholders like customers, suppliers and government. Typically, ERP systems are supplied in modules which match functions like finance and marketing. These modules will replace standalone computer packages in these areas and all of them will access a central database so information can be shared. The modules allow different functions to maintain their own systems but now they will all be linked, so communication is easier. Putting in more modules will increase the integration but will increase the costs, the amount of change and the risk of losing data in the transition.

ERP is not cheap. The average cost of an ERP system is $15 million – the range is $400 000 to $300 million. Currently 70 per cent of ERP systems deal with finance. Ninety-three per cent of businesses report net benefits but these often take at least eight months to appear.

Figure 4.2.4 shows the processes involved in getting a meat pie to the customer. In this example the ERP system is being used by all the businesses involved. All of them will be able to find out at any time the progress of an order, in terms of where products are and what the flows of money are. All departments in the supermarket will have the same information. The supermarket will know the details of the customers who buy pies.

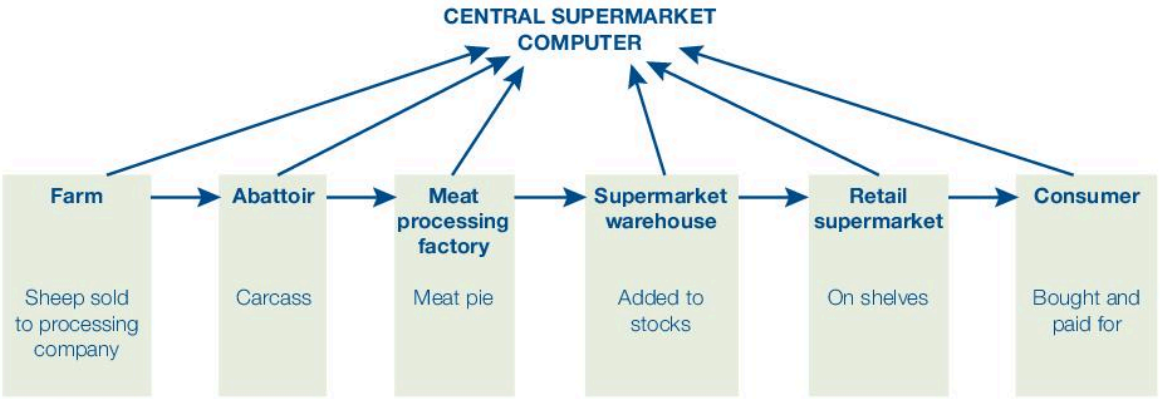


Figure 4.2.4 ERP in action ▲

ERP enables businesses to deal with the three main management issues in operations:

- Supply chain management – the process of obtaining materials and energy
- Production – the process of converting these resources into product/service output
- Customer relationship management – the process of dealing with customers, their orders and delivery.

ERP software is usually supplied by a specialist in ERP. These businesses can provide off-the-shelf modules. This may involve the buyer changing its processes to fit the ERP software. The more expensive option is to buy customised software. In either case the buyer and the supplier will work closely together to make sure the ERP system meets the needs of the buyer.

How ERP can improve efficiency

Inventory control

The inventory of a business is the stocks it holds. These can be raw materials, work in progress or finished products. In all cases ERP enables all departments to know exactly what inventory is held, how much raw material is needed and when, how much unsold stock exists, and by linking customer orders to these things inventory can be minimised keeping stock-holding costs down. A customer's order is entered into the ERP system. The business can then produce the products from stock or send an order to make them. This will trigger the release of raw-material stocks or an order for more. The finance needed will be generated and so will the employee input needed. The ERP system will know exactly what the position is so the customer can be kept informed and the products delivered as soon as they are produced. This means that inventory levels and associated costs are kept to a minimum so that efficiency is increased.

Costing and pricing

ERP enables the precise cost of each order to be calculated, so it is much easier to set a price that will yield a profit. Costs of employees, materials, production and fixed costs are built into an integrated system.

Link

Inventory is discussed in AS Level Chapter 4.3 Inventory management. Costing and pricing are discussed in AS Level Chapters 3.3b The marketing mix: price promotion and place, and Chapter 5.3 Costs.

Prices can be easily customised for individual clients and orders. This reduces the administrative costs of setting a price to the customer and therefore increases efficiency.

Capacity utilisation

Capacity utilisation is the proportion of full capacity being produced by the business. It is calculated by the formula:

$$\frac{\text{Current output} \times 100\%}{\text{Maximum output}}$$

For example, in a 200-bedroom hotel, with 80 rooms occupied the capacity utilisation is 40 per cent.

Link

Capacity utilisation is covered in detail in A Level Chapter 4.4 Capacity utilisation.

ERP enables a business to know exactly what orders there are, what orders might be coming in, when the orders must be fulfilled and what materials are needed for them. Because all departments have this information production can be planned to ensure that the equipment is being used as near to full capacity as possible as often as possible, with all the materials ordered and stocked to make this possible. There is no waiting until finance has paid an account or for order forms to be found, completed and sent off. All of this reduces the cost of production, so efficiency is increased.

Responses to change

ERP enables all functional areas to know what is happening in each of the areas. It will indicate changes in orders, employee profiles, price of materials, hold-ups in production and financial shortfalls or surpluses. This means that the business is able to respond to changes quickly and with the best possible overall approach. The full information enables management to make the organisation more flexible and able to respond quickly to changes. This quick response reduces the cost of identifying and reacting to change, so efficiency is increased.

Management information

ERP is all about information. It can cover all the functions in a business so management will know at the time what is happening. This means that decisions can take account of all the functional areas and be based on accurate up-to-date information. This ready availability of information reduces the cost of obtaining it so increasing efficiency.

ERP and production

ERP can be an important part of modern production systems particularly where processes such as mass customisation are involved.

Examples of how ERP can improve efficiency

- Accurate sales and order information allows optimum amount of inventory
- Orders can be tracked by process and finance arrangements can be matched to supplies needed
- Everyone has the same financial information, not slightly different biased versions

- Real-time information is available to all so decision-making is improved
- Security is improved as there is only one system that deals with all aspects of production.

Results: production is quicker, cheaper, more efficient and management decisions are better informed.

Progress questions

14 Explain what enterprise resource planning (ERP) is.
15 Describe three advantages of ERP.
16 Describe the main disadvantage of ERP.
17 What type of businesses would ERP be most appropriate for?

Case Study

A leading tyre manufacturer in India

Since 1991 this business has supplied tyres. After 15 years of growth it was aware it lacked the management resources to cope with further growth following a dramatic year when sales increased by 49 per cent. In 2011 it worked with Ramco, a major ERP supplier, to help improve its edge in a competitive market. The major problem was identified as the difficulty of co-ordinating manufacture and supply to 200 depots and 3200 dealers in 50 countries. It had a different IT system for each of the three main regions it divided its market into. Ramco provided a system that took data from the existing information systems and made this available on a daily basis to all divisions of the company.

Stock

All departments now know the stock available for sending out from the factory, stock on the way to the dispatch sites and stock in each of these depots.

Distribution

A daily plan for allocating products from the factory to the depots can easily be produced.

Marketing

The decisions on which depots will supply which dealers are more straightforward and data on customer buying patterns and intentions are available.

Production

Linked to this is a production module that enables management to plan production schedules to meet the demand identified by the marketing module.

Finance

A built-in performance tracker enables material cost data, sales data and wages based on the planned and actual production, marketing and distribution plans to produce financial accounts and forecasts, allowing performance targets to be set and monitored.

The results have been a large increase in efficiency due to full integration of information for management functions, time saved, better more accurate decision-making and quicker delivery of products to customers.

1 Explain why this tyre company was willing to consider investing in ERP.
2 Analyse the ways that ERP brought benefits to this company.

Exam-style questions

1 **a** Analyse the differences between batch and flow production methods. [8 marks]
b Discuss the implications for a manufacturer as it changes production from batch production to continuous flow production. [12 marks]

(A Level)

2 Discuss the factors a medium-size electrical goods manufacturer might take into account when deciding whether to introduce enterprise resource planning. [12 marks]

ASC

The current situation ASC is a public limited company which produces steel. It was privatised in November 2005 after 35 years of state ownership and control. Since privatisation, the profit-focused objectives of the shareholders and the directors they elected have led to many changes within the business.

Long-term plan and corporate objectives One of the first actions taken by the new directors was to establish a five-year plan for ASC. This contained the long-term objectives of the business and details of the main strategic decisions needed to achieve them.

Long-term corporate objectives are:

- Become one of the five most efficient steel producers in the world.

Strategic decisions include:

- Close least-efficient steel works
- Acquire, through takeovers, smaller competitors with good productivity records.

Fluctuating global demand for steel Steel is used in many industries such as construction, car manufacturing and shipbuilding. There are seasonal changes in demand for steel in some countries due to poor weather conditions affecting output in major industries. The ASC marketing department uses the moving average method and other techniques to forecast these seasonal demand changes. These forecasts are used by both the human resources and the operations management departments.

The global recession cut demand for steel by 15 per cent in 2009 and demand fell again in 2010. ASC, like all of the world's steel makers, has been greatly affected by this fall in demand. The chief executive officer reported to directors at a board meeting in 2010 that: "Our long-term strategic plan may have to be radically changed as a result of this recession. This will have great effects on the objectives and strategies used by all departments of the business."

The directors of ASC took very rapid action as soon as it became clear that the fall in demand for steel would be serious and prolonged:

- Two steel works were closed, reducing the overheads of the business
- Some staff in steel works kept open were either offered redundancy or re-employment on flexible employment contracts
- Steel stocks were increased to prevent output being reduced at some works
- Investment in fully automated computer-controlled equipment was increased to make ASC's steel more competitive.

Further closures seem inevitable Even if global steel demand increases, the directors of ASC are determined to continue closing low productivity works that have spare capacity. The directors are going to decide which of two works to close at the next board meeting. They think that closing one of these works, both of which are located in the same country, will increase demand for the output of the other.

Global recession – it is not all bad The global economic downturn led to the closure of several major steel works owned by ASC's competitors. This reduced competition in some countries. ASC was able to take over a small maker of specialist steel, forced into liquidation, at a price the directors believed was below net asset value. Substantial increases in unemployment in many countries have made recruitment for most businesses much easier than when the world economy was booming.

3 ASC has taken measures to reduce the impact of the global fall in steel demand. Evaluate the likely effects of these measures on operations. [8 marks]

Key concepts

- AS **Change** can be developed through exploring changing production opportunities and studying the need for flexibility.
- AS **Management** is required to make decisions about operations such as location decisions, operation decisions, production method decisions.
- AS **Innovation** can come through the use of techniques such as CAD, CAM, product design, process innovation.
- AS **Strategy** can be considered from the point of view of location and production decisions.
- A **Change** can be considered in the context of the role enterprise resource planning (ERP) takes in an environment of change.
- A **Management** will be involved in the implementation of ERP.
- A **Customer focus** will benefit from the improvements to products/services brought about by ERP.
- A **Creating value** can be developed through improvements to products/services resulting from ERP.
- A **Strategy** is involved in making decisions about ERP.

Progress check

You should now be able to:

- AS understand the influence that marketing, the availability of resources and technology has on operations decisions
- AS understand the need for flexibility in volume, delivery time and specification to suit customers
- AS understand process innovation and its importance
- AS analyse the differences between different types of operations methods and the difficulties in changing from one to another
- AS evaluate the factors that determine location and relocation
- AS discuss the differences between local, regional, national and international location decisions
- AS evaluate factors that influence the scale of a business
- AS analyse causes and examples of internal and external economies and diseconomies of scale and how these relate to unit costs
- A understand the main features of enterprise resource planning and how these can improve business efficiency.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- AS the purpose of holding inventory (raw materials, work in progress, finished products)
- AS the costs and benefits of holding inventory
- AS managing inventory
- AS buffer inventory, reorder level and lead time
- AS interpretation of simple inventory control charts
- AS inventory control methods (buffer inventory and just in time (JIT)

Key term

Inventory: the inventory of a business is the raw materials, partly made products (work in progress) or finished products held as needed to supply customer demand.

Getting it right

Another word for inventory is stock or stocks – you might find these words used in other books but this course uses the term inventory.

4.3 Inventory management

Purpose of inventory

The inventory of a business is the raw materials, partly made products (work in progress) or finished products held as needed to supply customer demand. These are all part of the operations function. The raw materials are an input, work in progress is part of transformation from inputs to output, and finished products are output. Each of them is essential.

- **Raw materials** form a vital input for manufacturing businesses. Without them no transformation to output is possible. A business making products must have raw materials to be combined with other inputs, so some will be held in the business so that production can take place when required. Inventory is also held so that a sudden increase in orders can be supplied without having to wait for new raw materials to be delivered.
- **Work in progress** are products in the process of being made (semi-finished products) and are an inevitable part of operations. For example, hard cheeses require maturing over a long period. While they do that they are work in progress.
- **Finished products** are the output that will be sold and supplied to customers. Before they are dispatched they will be held as inventory. Many businesses sell products from inventory so they must have them ready for when an order arrives. A retail store or wholesaler has to hold inventory for this purpose.

Holding inventory has benefits and costs and an efficient business will hold enough stock to meet its needs but not more than is necessary for production or to meet demand. Inventory that is held as raw materials acts as a buffer between sudden unexpected increases in production and the ability to produce. Finished products act as a buffer between customer demand and the ability to meet it.

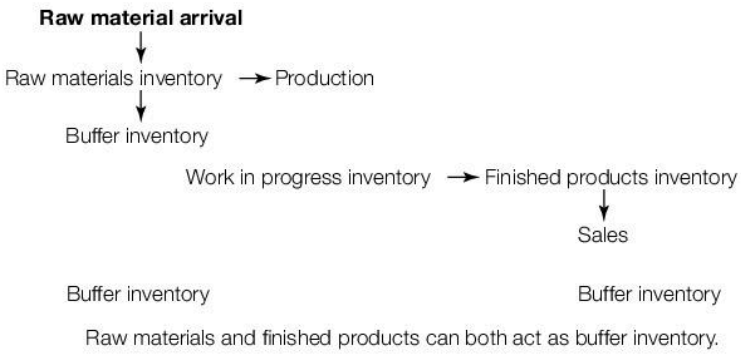


Fig 4.3.1 Types of inventory ▲

Progress questions

1 Outline two reasons for holding inventory.
2 How does work in progress differ from finished products?

Costs and benefits of holding inventory

Costs of holding inventory

All types of inventory are a cost to a business. This is because they represent resources that are not actually generating revenue. Money will have been spent on producing inventory and this money could be used in other ways. This is an opportunity cost. Other reasons for the costs of holding inventory include:

- Rent for the space where inventory is held
- Employees, machinery, cost maintaining appropriate storage facilities for keeping inventory
- Insurance and security
- Any interest due on money borrowed to pay for storage and inventory
- Products may become obsolete (out of date or replaced by superior products) and cannot be sold for a price that covers the cost of production
- Products may get damaged, stolen or perish in storage
- In addition inventory ties up space which could be used for other purposes and it may slow down a business's response to change.

There are also inventory costs due to the process of ordering and these include:

- Administration costs in monitoring and tracking inventory
- Inspection and returning low-quality items
- Transport and handling costs.

Getting it right

Make sure you show understanding of the costs and benefits of the different types of inventory. This can influence decisions you make relating to production, inventories and meeting customer demand.

Figure 4.3.2 High and low inventory businesses ▲

Benefits of holding inventory

Keeping up with demand

Holding high inventory levels means that the chances of selling out of finished products and missing revenue are less.

There will be enough inventory to meet expected demand. If demand for a product varies, holding some inventory will be essential to supply the increases in demand that occur. Uncertainty will be reduced.

Preventing shortages that halt operations

Holding raw-material inventory is an insurance against unexpected shortages of supplies. It will enable production to continue even if raw materials cannot be obtained for a period of time. This continuity may be valuable and enable a quick response to a change in the market.

Obtaining discounts

Suppliers often offer a lower price for materials bought in bulk (purchasing economies of scale). Unit costs can be reduced by taking advantage of this and holding the raw materials as inventory. Ordering and transport costs may also be reduced by a single large order. The reduction in costs must be balanced against the cost of holding the inventory.

Guarding against the effects of inflation

If commodity prices are rising it may be cost effective to buy large amounts of raw materials before their price rises thereby gaining protection from the effects of inflation or gaining greater revenue by holding finished products for sale later at a higher price.

Holding too much inventory is an additional unnecessary expense, holding too little can result in lost production and sales revenue. Many businesses look for certainty of supply so a failure to meet demand can lead to lost goodwill. A customer who cannot be supplied may never return to buy. Businesses generally attempt to hold as little inventory as possible in order to minimise the costs while taking advantage of the benefits.

Link

AS Level Chapters 5.1 and 5.2 Business finance and its sources contain more detail on inventory as a component of working capital and A Level Chapter 4.5 Lean production and quality management deals with inventory control in just in time as part of lean production.

Progress questions

3 Explain three reasons why a business might hold inventory.
4 Explain three reasons why a business might hold as little inventory as possible.
5 Supermarkets often hold as little as two days' sales in inventory. A steel fabricator may hold up to eight weeks' sales in inventory.
Explain the difference in the way these two industries hold inventory.

Key term

Buffer inventory: the products or raw materials of an organisation maintained on hand or in transit to stabilise variations in supply, demand and production.

Managing inventory

Managing inventory is a major part of business activity. Many businesses use IT systems to do this so that inventory management is linked to other functions including sales, ordering, distribution, employee work allocation and the production process. Many inventory managing procedures are based on the buffer inventory model. This is

Key term

Inventory control chart: shows the level of inventory held over time.

based on a business holding inventory "just in case". Buffer inventory is the products or raw materials of an organisation maintained on hand or in transit to stabilise variations in supply, demand and production. The inventory control chart (discussed below) is a method for helping to control the quantity of inventory to minimise costs while still holding enough inventory to meet customers' needs.

Using inventory control charts including reorder and lead time

The buffer inventory model primarily deals with how a business decides to order raw materials, though it can be adapted to finished products. It considers the costs and benefits of holding inventory and assumes that there will be a minimum quantity of inventory (buffer inventory or safety stock) that a business will wish to hold. As production occurs the inventory level of raw materials will fall as it uses up the materials. Inventory then takes time to arrive after it has been ordered; this is the lead time. This means that at some level the business must reorder so that inventory does not fall below the minimum level. The reorder level is this level of inventory at which more is ordered.

Key terms

Lead time: the time taken for inventory to arrive from when it was ordered.

Reorder level: the level of inventory at which more inventory will be ordered.

This model can be shown graphically, as in Figure 4.3.3.

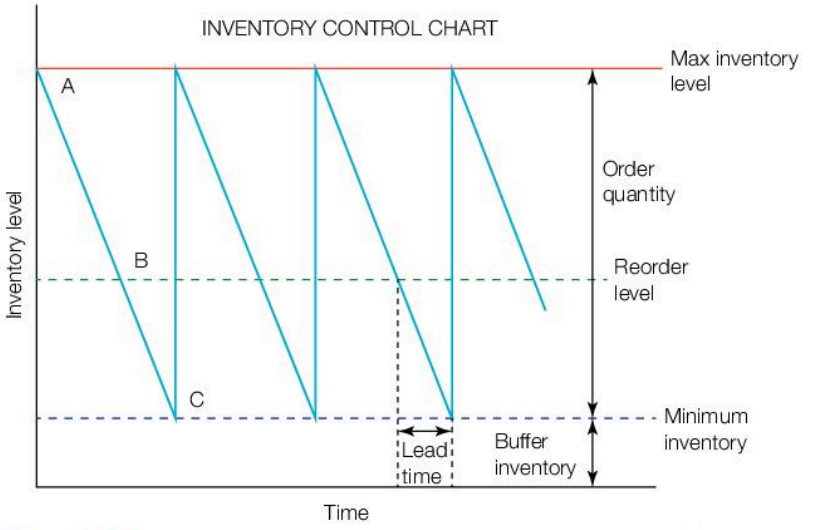


Figure 4.3.3 Raw material buffer inventory, reorder level and lead time ▲

Starting at point A the graph shows that the inventory level of raw materials falls as they are being used up as production takes place.

- The buffer inventory level shows the minimum amount of inventory the business needs to hold to maintain production to meet demand requirements.
- The lead time is the time taken for inventory to arrive from when it was ordered. This means that the raw materials must be ordered at B (amount to be ordered is the order quantity) so that they will arrive at C.
- The reorder level shows the level of inventory at which more inventory will be ordered. The buffer inventory is therefore always maintained.

The process of production continues and new raw materials are ordered each time the reorder level is reached. The quantity that is ordered is shown as being enough to take inventory above the reorder level and enable production to take place before there is a need to reorder. The graph shows smooth regular production. In reality many businesses face less regular, more complex production patterns, but the principle is the same.

Figure 4.3.4 shows this process numerically.

- Production starts at Week 0 with an inventory of 300 tonnes.
- Inventory is used up at the rate of 50 tonnes per week and at the end of Week 2 is at the reorder level of 200.
- The order quantity of 200 tonnes is ordered and this takes two weeks to arrive.
- At the end of Week 4 production reduces inventory to the buffer level of 100 tonnes.
- The new inventory arrives and takes the inventory level to 300 tonnes. The process is repeated.

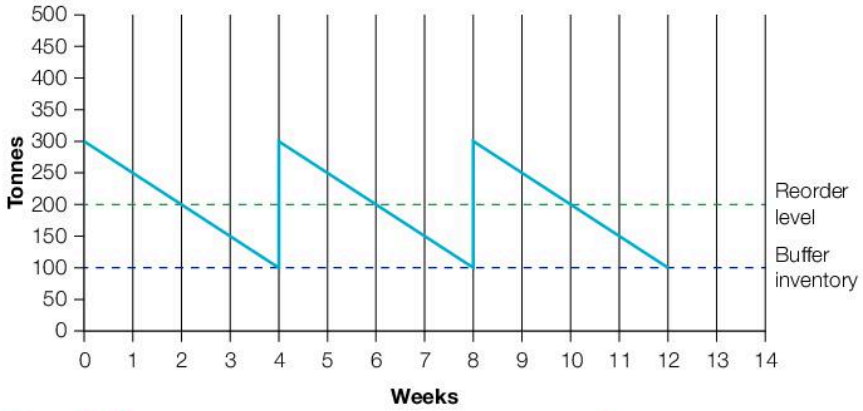


Figure 4.3.4 Numerical example of an inventory control chart ▲

Interpreting simple inventory control charts

Managing inventory levels means that decisions have to be taken about:

- The size of buffer inventory
- The maximum level of inventory
- The quantity to be reordered
- The level at which reordering will take place.

These decisions are made after determining production methods and levels, customer requirements, demand levels and the time it takes for orders to arrive. The steeper the gradient of the inventory level line the faster inventory is being used up. Tracking inventory levels on a chart enables a business to detect if there are variations that mean that reorders have to be made earlier or later than usual. The correct order size for regular orders can also be determined. The effect of changing the maximum and buffer inventory levels on reordering decisions can be measured.

Getting it right

The reorder level depends on production speed, lead time and the level of buffer inventory.
You will not have to draw an inventory control chart though you may be given one to interpret. Questions are unlikely to focus on the way businesses decide on the quantity of inventory to order or on the mathematics of inventory control methods.

Progress questions

The inventory control chart in Figure 4.3.4 comes from a business that is considering reducing the level of inventory it holds.

6 Predict the result of each of the following changes, assuming no change in any other variable:
   - **a** Reducing lead time
   - **b** Reducing buffer inventory
   - **c** Reducing reorder level.

7 How do these exercises demonstrate the importance of inventory control for dealing with costs?

Inventory control methods: buffer inventory and just in time (JIT)

The appropriate values for the variables shown on the inventory control chart (buffer inventory, reorder level, order quantity lead time) will be different for different businesses and industries. Businesses can plan to achieve changes in these values to increase efficiency. Choices can be reduced to two alternatives:

1 Hold a large quantity of inventory: inventory does not run out and managing inventory levels is easy but incurs high costs in inventory holding.

2 Hold very little or no inventory: to stop inventory running out will require high management resources but very little cost in inventory holding. This choice will be linked to the lean production method of just in time (JIT).

Inventory and just-in-time (JIT) production

Key term

Just-in-time inventory control: involves managing inventories of raw materials, work-in-progress and finished products so that these are available exactly when they are needed and not before.

The phrase just in time refers both to a production system, which is organised in such a way that products become available to customers just when they need them, and just-in-time inventory control, which refers to a system of managing inventories (raw materials or finished product) so that they are kept to an absolute minimum. In this section of the syllabus we are concerned with just-in-time inventory systems. Just-in-time inventory control involves operating with as low a level of inventory as possible, in some extreme cases no inventory at all.

Just in time involves:

- Raw materials being delivered only when needed
- Work in progress being kept to an absolute minimum through changes in production methods
- Finished products that are sent to customers as soon as completed.

JIT will require a very short lead time. It relies on being able to forecast customer demand as well as having an integrated production process. This way there is very little or no inventory of any type. It requires businesses to have complete confidence in, and co-operation from, their suppliers. Enterprise resource planning (ERP) systems will enable the links between suppliers, production and the customer to be integrated and streamlined.

Link

Just-in-time production is covered in A Level Chapter 4.5 Lean production and quality management.
Enterprise resource planning systems are dealt with in A Level Chapter 4.2 Operations planning but are A Level only.

Just-in-time inventory control can be achieved by changing the variables in the inventory control chart to achieve a smooth flow through the production process with a minimum of all types of inventory held.

Buffer inventory

This can be reduced because raw materials are only ordered when they are needed for production and finished products are immediately sent to the customer, not held in the business. The costs of holding inventory then become very small.

Lead time

This can be reduced by finding suppliers who can supply on demand with the right quantities of products of the correct quality. This will involve an integrated ordering system so orders are decided, dispatched quickly, with associated payment arrangements. The raw-material suppliers must be co-ordinated with the purchasing business, especially regarding expected quality assurance and standards as any shortfall here means there will not be enough raw materials for production.

Order quantity

This can be reduced by integrated production processes facilitated by IT systems. The order quantity will be determined by what is needed to be produced. This will depend on the customers' orders as in a JIT system products are only made to order, not for inventory.

Reorder level

This will depend not on the lead time before buffer inventory is reached but on when raw materials are needed for production. The quantity needed for production will be ordered.

It is difficult to see how inventory can ever be reduced to zero but achieving these changes can bring about a large reduction in the costs of holding inventory without compromising the benefits.

It is important to recognise that although there are significant benefits from using JIT, it is not suitable in a variety of situations:

- Small businesses may not be able to implement it due to lack of finance or facilities
- The businesses cannot risk being out of stock because of the damage caused through losing dissatisfied customers
- The business may not be able to rely on suppliers delivering on time
- The business may find holding stocks attractive particularly if the business anticipates significant price increases
- The product or service may be subject to unpredictable demand.

Activity

Research businesses in your country that operate a just-in-time system of production. What advantages do they gain from doing this?

Progress questions

8 Explain the difference between reorder level and order quantity.
9 Explain why an oil company always needs buffer inventory of crude oil.
10 Give three situations in which JIT is not suitable.

Case Study

Anixter helps cut inventory costs

A major manufacturer of medical equipment was having problems. It used two factories and had 2000 inventory storage facilities in seven places in the two factories. It was ordering 900–1000 different parts between 300 and 800 times a week. Delivery of parts was taking a long time from when they were ordered and the delays were leading to slower production. In response the business had increased its own on-site inventory holdings of components.

To solve the increasing costs it approached Anixter, who not only supplied vital fasteners for medical equipment but also reorganised the inventories. An IT system linked to final orders forecast the demand for the components required. Anixter's distribution centre then prepackaged 1200 parts into easy-to-store-and-recover bags. These bags were placed in the bins ready for production. The production forecasts gave a minimum and maximum demand for the components. This enabled much lower quantities of components to be stored in the factories and avoided all the delays that used to occur due to late delivery. Tracking customer orders and the components needed is now linked to the associated payments by customers and to Anixter. The costs of handling inventory have fallen significantly and there is much more inbuilt flexibility.

1 What problems were being caused by poor inventory control?
2 How did the solution by Anixter affect the following?
   a Lead time
   b Buffer inventory
   c Reorder level.
3 Explain how the change in inventory control was related to just-in-time production.

Exam-style questions

Wu Washing Machines

Wu Washing Machines (Wu WM) is a medium-sized private limited company which manufactures washing machines. In its factory it assembles components largely produced by other businesses. Wu WM has been successful in increasing sales but is now finding it difficult to expand further in an increasingly competitive market. Other businesses have invested heavily in new equipment and in more efficient management methods. Profits are starting to fall. The managing director holds a board meeting and argues that Wu WM must reduce its relatively high selling prices and address the problem of late deliveries to major customers. All the directors agree that these problems must be solved and costs must be reduced, particularly through improvements in inventory control.

Inventory control issues

Charles, the production manager, has produced the following information relating to inventories.

Inventory data ▼

Component	Source of supply	Reliability of supply	Delivery time (weeks)	Inventory level
Engine	Imported	Reliable	4	Enough for 3 weeks' production
Drum	Local	Reliable	6	Enough for 1 weeks' production
Casing	Imported	Not always reliable	2	Enough for 2 weeks' production
Electrical control system	Local	Reliable	1	Enough for 6 weeks' production

1 Explain the meaning of:
   a Buffer inventory [3 marks]
   b Lead time. [3 marks]
2 Using the table and other information, recommend improvements to Wu WM's inventory control. [10 marks]

Key concepts

- AS **Management** can be viewed through decisions about inventory methods/systems and the management of those systems.
- AS **Customer focus** can be viewed through the impact of inventory methods/systems on customer behaviour.
- AS **Innovation** can be introduced when inventories are linked with process innovation.
- AS **Strategy** is involved when senior management decide on changes to inventory methods.

Progress check

You should now be able to:

- AS discuss the reasons why businesses hold inventory of raw materials, work in progress and finished products
- AS evaluate the costs and benefits of holding inventory
- AS explain the use of inventory control charts
- AS interpret simple inventory control charts as an aid to reducing inventory costs
- AS discuss the role that inventory control methods might play in achieving just-in-time-production
- AS recommend inventory control methods in a given situation.

You should be able to relate these to a range of businesses in different situations.

5 Finance and accounting

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **AS** the reasons why businesses need finance
- **AS** the difference between start-up capital and capital used for business expansion
- **AS** why businesses might need to use different sources of finance
- **AS** the importance of the distinction between revenue expenditure and capital expenditure
- **AS** factors influencing choice and selection of sources of finance
- **AS** the importance of working capital and its significance as a source of finance

5.1 and 5.2 Business finance and its sources

This chapter covers both syllabus sub-topic 5.1: The need for business finance, and sub-topic 5.2: Sources of finance.

Why do businesses need finance?

Business start-up

Businesses require finance for different reasons. When a business is first started, finance will be required to buy premises, equipment or materials to work with. If the business is providing a service rather than producing a product there will still be items that need to be acquired in order for the business to function. For example, if an accountant is opening an office, they will need to purchase an office or pay rent for one. They will also need a desk and somewhere to file documents. It is usual for them to need a telephone and a computer. All of these will either need to be paid for or rent will need to be paid if the office and equipment are not owned. If people are employed then money is needed to pay their wages or salaries. A lot of this expense takes place before the business has received any income from the sale of its products or services.

This is known as "start-up capital".

Key term

Start-up capital: the money required when a business is first started. This can be to buy premises, equipment or raw materials.

Business expansion

Once a business is established there may be an opportunity for it to expand its scale of operation. Expansion often requires additional finance. This can be for the purchase of additional premises or equipment or it might be to pay for market research to be carried out into possible new markets. This kind of finance differs from start-up capital because the need for it arises after the business is established.

Different needs; different sources of finance?

The reasons why a business may need finance vary according to the stage of development of the business and changes in the business environment. A business might experience the arrival of an international competitor to the market which can threaten its business. In order to remain competitive the business might need to finance additional research and development. The research and development might be so that new products can be developed or existing products can be improved so that the business can continue to compete. The finance required for such development work is likely to be substantial and may not see any return for a long time. This will necessarily influence where the extra finance is sourced.

Compare that with the need to cover short-term costs. For example, a cheque that has been received from a customer has not been cleared by the bank and the business needs money to pay the weekly wages. The amount involved in this instance is probably small compared to research and development costs and can be covered by a short-term source of finance.

Key terms

Working capital: the cash and near cash (liquid assets) that a business uses for its day-to-day operations. It is not used for buying. It is calculated by current assets – current liabilities.
Liquid assets: assets that can be quickly turned into cash, e.g. inventory (stock) can be sold for cash.
Short-term liabilities: debts to be repaid within 12 months.
Illiquid: When a business is unable to pay its short-term debts.
Working capital cycle: the time between buying stock and materials and receiving payment from customers for the product produced or provided.

Link

Working capital is discussed more in AS Level Chapter 5.5 Forecasting cash flows and managing working capital.

Getting it right

Where the international accounting terminology has changed, in the short term both current and past names will be accepted in answers. For example, profit and loss account will be accepted as well as income statement. In the longer term it is expected that all students will use the latest terminology.

Activity

In small groups, make a list of the current assets that you would expect a manufacturer of wooden furniture to have. Discuss how the time of the working capital cycle might be affected for a business that changes from cash sales to credit sales.

The meaning and significance of working capital

Working capital is used to finance the day-to-day running of a business. If working capital is positive this means that the business has more current assets than current liabilities and is deemed to be able to continue trading. However, if current liabilities exceed current assets then the business is lacking liquid resources. Liquidity means the ease with which an asset can be turned into cash. This situation must be resolved perhaps by arranging an overdraft with the bank in order for the business to be able to cover its current liabilities.

Current assets are made up of inventory (stock), trade receivables (debtors) and cash and cash equivalents. These are known as liquid assets. Current liabilities consist of trade and other payables (creditors) and overdrafts.

Cash is used to fund materials and other short-term costs such as wages. A failure to pay wages to its employees or to pay its suppliers for materials could result in the business being forced to close. An inability to pay its short-term liabilities means that the business is illiquid.

Many businesses fail due to a lack of working capital even though they are profitable.

Businesses need to monitor their working capital cycle.

The working capital cycle

To have a satisfactory working capital cycle a business needs to get paid by its customers as quickly as possible. This means that the time between paying for materials and receiving payment from customers for the finished products must be as short as possible. If a business pays for materials and produces and sells the products on credit but then has to wait a long time for their customer to pay for the products it is in danger of having a negative working capital. Whether a customer pays cash or receives products on credit is irrelevant; it is the time between payment for materials and payment received for the finished product that is critical. The length of time that a product is in production before being sold will affect the working capital cycle.

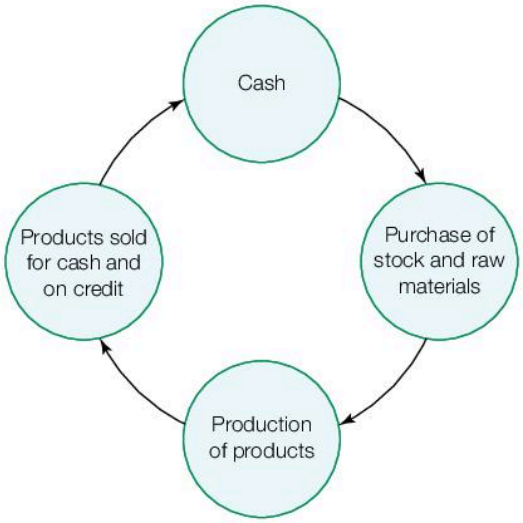


Figure 5.1.1 The working capital cycle ▲

A positive working capital does not necessarily mean that a business has cash to spend, but it does mean that its liquid assets are greater than what it owes in the short term. If a business held high levels of inventory (stock) this would be included in the working capital figure, but a business cannot use that stock to pay the wages of its employees.

Distinction between revenue expenditure and capital expenditure

Key terms

Revenue expenditure: money used to pay for current assets such as materials and wages that are used in the short term.
Capital expenditure: money spent to purchase fixed assets; items that will be used over a long period, such as premises and machinery.

Revenue expenditure is expenditure on everyday running costs of a business such as tea and coffee for the canteen, paper for use in the offices, raw materials or components, or wages for employees. They are items that will generally be used in the short term.

Revenue expenditure is shown as an expense in the income statement (profit and loss account).

Capital expenditure is expenditure on non-current assets (fixed assets) such as buildings or machinery. These are items that will be used for a long time. Capital expenditure is recorded in the statement of financial position (balance sheet). The payment for a fixed asset will show as a reduction in the cash balance of the business or an increase in the long-term liabilities (non-current liabilities), for example as a bank loan that was taken out in order to purchase the asset. It will also show as an increase in the non-current assets (fixed assets) of the business.

Progress questions

1 What is meant by "start-up capital"?
2 Explain what is meant by the term "working capital".
3 Explain the difference between revenue expenditure and capital expenditure.

Sources of finance

Link

The structure of a business is covered in AS Level Chapter 1.2 Business structure.

Legal structure and sources of finance

The legal structure of a business influences the sources of capital that may be available to it. For example, a sole trader or a partnership cannot raise finance through issuing shares to the general public. Similarly, it is unlikely that a public limited company such as HSBC would expect a chief executive to use personal savings as a source of finance.

Short-term or long-term source of finance

Different business needs will determine whether finance is required for a short period of time or whether the need is for the longer term.

Short-term finance is usually classed as that which is repayable within 12 months. Long-term finance can be for terms as long as 20 or more years, e.g. a mortgage taken out to purchase the premises.

The sources of finance can be internal or external to the business.

Internal sources of finance

Internal sources of finance are those that can be made available within the business itself. These include retained profit, the sale of assets and working capital.

Retained earnings

This is the profit that the business has earned in the past. In any business this is readily available for use, but in a public limited company the agreement of the shareholders might be needed before it can be used.

Table 5.1.1 Advantages and disadvantages of using profit retained in the business ▼

Advantages	Disadvantages
• It is available immediately. • It is a permanent source of finance because it does not have to be repaid to anyone. • It does not incur any interest payments. • There is no reliance on any person or organisation outside the business.	• The amount of finance might be limited if past years have not been very profitable. • The shareholders might object because this might mean that their dividends are reduced.

The sale of unwanted assets

If a business requires additional finance it is possible that it can raise the finance through selling off assets that are no longer required. Businesses are just like many households; there will be items in businesses that have not been used for a long time, just as there are in many homes. It makes sense when finance is required that these items are sold to someone who might have a use for them.

If a business decides to sell some of its assets to raise additional finance it must be sure that there will not be a need for those assets in the future. Frequently someone in a household throws an item away or sells it and then later finds that they need it and have to purchase a similar item again! Sometimes this cannot be foreseen and it is a chance that a business might be prepared to take if it needs funds quickly.

Sale and leaseback of non-current assets

Selling off assets does not always mean that the business has no further use for them but that it no longer has a need to own these assets. For example, the use of some equipment might be essential to a production process but it is possible that the business could sell the equipment to a leasing company and then pay the leasing company on a regular basis for the use of the equipment. This is known as "sale and leaseback".

Table 5.1.2 Advantages and disadvantages of selling assets ▼

Advantages	Disadvantages
• In most cases this is a quick source of finance although this can be different if, for example, the asset is a building because it can sometimes take a long time to find a buyer. • It is permanent finance because it does not have to be repaid to anyone. • There are no interest payments to be made.	• Once sold the asset is no longer owned by the business. • If sale and leaseback is used the business will be making regular payments for the use of the asset. • The business might not be able to raise very large sums of money with this method.

Key term

Sale of assets: the sale of assets such as unwanted buildings, machinery etc. so that the income received can be used to finance a different activity.

Key term

Sale and leaseback: when a business asset is sold to a third party but then payments are made to the new owner by means of a lease to continue using that asset.

Some businesses make their profit from owning equipment and leasing it out to other businesses.

If finance is raised through sale and leaseback the business will have an inflow of funds initially, but will then be making regular payments to the lease company for the use of the asset.

Working capital

Link

Working capital is discussed more in AS Level Chapter 5.5 Forecasting cash flows and managing working capital.

Businesses also have the opportunity to make adjustments to their working capital in order to raise finance. For example, a business may choose to have a sale and sell off some of its inventory in order to raise funds. It might also request that its customers who bought on credit settle their debts with the business earlier. However, both of these actions can have harmful effects for the business. There is a danger that the business might reduce its current assets too far and leave itself in a vulnerable position with regard to its current liabilities. It might result in the business being unable to meet its short-term liabilities.

Table 5.1.3 Advantages and disadvantages of reducing working capital ▼

Advantages	Disadvantages
• Usually a quick means of raising finance. • The business can get rid of old inventory, that is items that are perhaps no longer in fashion. • It is a permanent source of finance.	• The business might leave itself with insufficient current assets to be able to cover current liabilities. • Its debtors might be unhappy about being asked to pay for products earlier than originally agreed. • If the customers are new ones they might feel that the shorter credit period is too short and therefore decide to purchase from another business in the future. • The amount of finance that can be raised can be very limited.

The extent to which internal sources of finance are able to satisfy the financial requirements of the business will depend on the amount that it needs to raise and the amount that can be found within the business. If a business is looking to raise sufficient finance to build and equip a new production facility it is unlikely that sufficient funds will be raised from the sale of assets or a reduction in working capital. Some businesses might have sufficient retained profits to finance a large undertaking, but most organisations use their retained profit to generate future income rather than just hold on to them.

Progress questions

4 Explain the difference between short-term and long-term sources of finance.
5 Give one advantage and one disadvantage of using the sale of assets as a source of finance.
6 Explain one advantage and one disadvantage of using retained profits as a source of finance.

External sources of finance

These are sources of finance that are found outside the business, for example from banks or venture capitalists. Raising finance externally means that the business must involve outside agencies or individuals.

Key terms

Short-term finance: money that is needed by a business for a short period of time, usually less than a year.
Long-term finance: money that is needed by a business for a longer period of time. Sometimes money needed for 1–5 years is known as medium-term finance.
Overdraft: a flexible source of money from a bank based on an upper limit of what can be borrowed for a short period of time. Usually very expensive and only used in emergencies.

External sources of finance can be divided into short-term finance or long-term finance sources.

Short-term sources

Bank overdraft

An overdraft is an agreement between the business and its bank that the business will be allowed to draw more money from its account than it actually has in there. The bank will state the maximum amount of the overdraft and the business will be able to draw out or use up to that amount but must not exceed it. Even though many bank accounts will allow an overdraft to be taken, it is advisable to agree that the overdraft can be used before actually withdrawing funds from the account. Overdrafts that have not been agreed often require a higher rate of interest to be paid to the bank.

An overdraft can usually be arranged quickly and is normally used for short-term financial needs such as paying the wages for that week or paying a supplier for materials that have been delivered. Banks will usually agree to an overdraft facility for a business if the business can show that it will have funds arriving in the business soon. For example, a business might be able to show that a credit customer is due to pay a substantial amount to the business. The overdraft is often used to cover a short-term shortfall in funds.

Table 5.1.4 Advantages and disadvantages of overdrafts ▼

Advantages	Disadvantages
• They are usually quick to arrange. • The bank does not require any involvement in the running of the business in return for the finance provided. • Overdrafts are flexible in that the full amount of the agreed overdraft does not have to be used if it is not required. This reduces the interest payments to the bank.	• They usually require a high rate of interest to be paid to the bank. • The bank can call in the overdraft, which means that the business can be required to repay the overdraft immediately. This can cause the business to be unable to meet its short-term obligations and therefore become illiquid.

Short-term loans

Banks will provide either short-term or long-term loans depending on the financial background of the business requiring the loan and the purpose for which it is to be used.

Table 5.1.5 Advantages and disadvantages of short-term loans ▼

Advantages	Disadvantages
• Usually a lower rate of interest must be paid than if an overdraft was taken. • The term of the loan is fixed. • Repayments are made on a regular basis which can help with cash flow. • Security is not always required.	• The term of the loan is usually fixed and there can be financial penalties if the loan is repaid earlier than agreed. • The money borrowed is a fixed agreed amount and cannot be varied as and when required as in the case of an overdraft. The whole of the agreed amount must be drawn and interest paid on the full amount.

Short-term loans can be a cheaper solution than using an overdraft facility. The loan can be obtained from banks or from other financial institutions. There are some businesses that make their money from lending money to individuals and other businesses. The borrower will agree to pay interest to the lender and to make regular repayments of the finance given.

Progress questions

7 Identify two short-term sources of finance and give one example of when a business might choose to use each of those sources.

8 A small manufacturing business has not received payment for a large order that it delivered three weeks ago. The wages are now due to the employees but the business does not have enough money in its bank account to pay them.

Explain what short-term sources of finance the business might use to pay the wages.

Long-term sources

There are occasions when a business can require a longer-term source of finance. If a business requires a large of amount of finance for a project that is unlikely to be highly profitable in the short term then a long-term source of finance is more appropriate.

Some long-term sources of finance provide a permanent source of funds for the business with no repayment being required. Others will require repayment at some future date. Repayment might involve the total amount being repaid as a lump sum at some agreed time in the future or it may require repayments to be made on a regular basis from the time the funds are received.

Hire purchase

A business can choose to purchase equipment on credit and spread the payment for the asset over a stated period of time. This is known as hire purchase. An agreement is reached with the vendor of the equipment that involves the payment of a deposit (an initial payment) followed by payment of the balance by equal instalments over an agreed period of time. This method of purchasing equipment allows a business to keep money in the business rather than paying the full cost of the equipment at the time of acquiring it. However, the asset remains the property of the vendor until the final payment has been made by the purchaser. Interest payments will also be added to the cost of the asset.

Leasing

Leasing enables a business to have the use of equipment without having to purchase it. For example, a business might choose to lease its vehicles, which means that it will not have to bear the cost of purchasing the cars and/or lorries that it uses. Instead the business will make a regular agreed payment to the leasing company in return for the use of the particular asset. The asset remains the property of the leasing company at all times. There are some forms of leasing agreements where the leasing company also bears any repair and maintenance costs. This form of acquiring equipment is a means of a business having the use of much more equipment than it can

Key terms

Hire purchase: a form of purchasing assets by means of regular payments rather than having to pay the full amount at the time of purchase. The ownership of the items remains with the hire purchase company until full payment has been made.

Leasing: rather than buying major pieces of machinery, vehicles, buildings etc. a business can pay another business (the leasing business) for the right to use its buildings etc. The leasing business retains ownership.

actually afford to purchase and can allow new businesses to start out with a much larger range of assets at its disposal than if it tried to buy everything that was needed for the business to function.

Hire purchase is similar to leasing except the payments made to the other business are larger and ownership of the asset eventually passes to the hirer.

Introduce new partners

In the case of a sole trader or a partnership, the solution to needing additional finance can be to introduce new people into the business. If a sole trader was to do this the business would then become a partnership and would be governed by the rules of partnerships according the legislation in their particular country. The introduction of a partner can be a quick way to gain additional finance.

An existing partnership might choose to recruit another partner to the business in order to gain an injection of additional finance. This would require the agreement of all of the existing partners.

Link

See also AS Level Chapter 1.2 Business structure.

Table 5.1.6 Advantages and disadvantages of introducing new partners ▼

Advantages	Disadvantages
• A quick means of bringing additional finance into the business. • It provides a permanent source of finance; repayment is not required unless the partnership is dissolved.	• In the case of a sole trader some independence is lost. • The ownership and control of the business is spread between more people.

Share capital

Key terms

Share capital: finance obtained through the selling of shares in a business.
Stock exchange: a market where stocks and shares can be bought and sold.

Share capital is obtained through the sale of shares in the business. Shares entitle the holder/owner of the shares to some ownership of the business.

Share capital can be raised in two ways:

- The purchase of additional shares by existing shareholders
- The sale of shares to new shareholders.

Raising finance through share capital is an option that is immediately available to private limited companies and to public limited companies. A sole trader or a partnership business also has the option to issue shares, but a change in its legal structure would be required before they can use this source of finance.

Getting it right

When answering questions it is important to recognise the ownership of a business. Remember, share capital is only available to incorporated businesses.

If a private limited company, sole trader or partnership wanted to sell its shares to the general public it would have to change to a public limited company. This process can be lengthy and very expensive.

In a private limited company the shares can only be sold to new shareholders if the existing shareholders agree. If new shareholders were to be brought into the business the proportion of the business owned and controlled by each shareholder would change. This is known as the dilution of ownership.

The shares in a public limited company can be sold to the general public through the stock exchange and may be bought by new or existing shareholders. There are occasions when existing shareholders are given

an opportunity to purchase additional shares at a discounted price. This is known as a rights issue.

Link
Public limited companies are discussed in AS Level Chapter 1.2 Business structure.

Table 5.1.7 Advantages and disadvantages of raising finance through issuing shares ▼

Advantages	Disadvantages
• It provides permanent finance for the business. • It does not have to be repaid. • It can raise a large amount of finance.	• If new shareholders purchase shares, the ownership of the business is spread amongst more people or organisations. • The share capital raised will be limited by the authorised share capital. That is the agreed total amount of shares that can be sold in the business.

Long-term loans

As mentioned earlier, long-term loans might be appropriate if the business is embarking on a large project that might take some time to become profitable or if the sum of money required is large.

Many banks are willing to offer long-term loans to businesses but might want some guarantee that the business will be able to repay the debt in the future. The bank might insist on seeing details of what the money will be used for so that the likelihood of the loan being repaid can be assessed.

Banks also frequently ask for some form of security or collateral. This means that the business must promise to give the lender the right to sell an asset if the loan is not repaid as agreed. Usually the asset that will be sold if the business does not meet its obligation to repay the debt will be specified when the loan is first agreed. It is often the premises or some other non-current asset (fixed asset) that is identified as security for a loan. An individual who approaches a bank for a loan might offer their home as security. In this way the lender knows that they cannot lose their money because if the borrower fails to repay the loan the asset that has been given as security would be sold in order to recover the money.

Interest would be payable on the money borrowed and the rate of interest can vary according to the amount borrowed and the length of time of the loan. The amount of security offered can also have an effect on the rate of interest demanded by the lender. The higher the risk to the lender, the higher will be the rate of interest that must be paid on the money borrowed.

Table 5.1.8 Advantages and disadvantages of long-term loans ▼

Advantages	Disadvantages
• A fixed sum of money can be borrowed for a specified time. • If the money is borrowed on a fixed interest rate and the interest rates in the country rise in the future, the business will benefit from only having to pay the lower rate. • Payments will be made regularly and therefore can help with budgeting. • There is no loss of ownership or control of the business.	• Interest must be paid on the money borrowed. If the interest rate was agreed at a fixed rate the business might feel that it is paying a high rate of interest if the general interest rate in the country falls in the future. • Payments usually begin immediately the loan is taken out, but the returns from a project might not begin for some time. • If the business has difficulty repaying the loan then whatever asset it offered as collateral (security) will be sold and therefore will no longer be available to the business.

Mortgages

Key term

Mortgage: a long-term loan normally used for buying property that has the property as security for the loan. If the loan is not repaid, the lender takes the property.

A mortgage is a type of long-term loan that is usually used for the purchase of property such as offices or factory buildings. It is a means of acquiring an asset and paying for it over a long period of time.

The building being purchased will act as security for the lender for the duration of the mortgage. Once the mortgage has been fully repaid the property belongs to the purchaser. The borrower has full use of the property during the term of the mortgage. The business also has the opportunity to raise extra finance by taking an additional mortgage on a property. For example, if a business had an office building that was valued at $200 000 and it currently owed only $50 000 to the mortgage company, there is a possibility of borrowing additional finance against the value of the property. In this example that would mean that it might be able to borrow up to an additional $150 000. However, the recent banking crisis has shown that there are dangers for the borrower and for the lender of additional finance being raised in this way.

If a loan was taken out for the full $150 000 and the business failed to repay the debt, the lender would seek to sell the property to recover its money. However, if the value of the property had fallen to perhaps only $100 000 then it would be unable to fully recover the money owed to it. The movement in property prices can be a crucial factor when considering raising finance through a mortgage.

Table 5.1.9 Advantages and disadvantages of mortgages ▼

Advantages	Disadvantages
• Large amounts of finance can be raised. • There is no loss of ownership or control of the business. • The borrower has the right to sell the asset provided that any mortgage debt is cleared when the sale occurs.	• The full amount of the loan must be repaid even if the value of the property has fallen below that of the debt. • The asset can be repossessed by the mortgage company if repayments are not made. • The ownership of the property remains with the mortgage company until the debt is fully repaid. • Interest must be paid on the amount borrowed. • Repayments must be made regardless of whether a profit is made.

Debentures

Key term

Debentures: loans sold by businesses to raise finance from investors. They are like shares and can be traded, but the investor does not have ownership rights.

Debentures are another type of long-term loan. They are loans from investors but, unlike shares, the holders of debentures do not have any ownership rights in the business. Debentures can be bought and sold in the same way that shares can.

Debentures, sometimes known as "bonds", will be for a specified time. The holders of debentures will received a fixed rate of interest each year and will be repaid the amount of the loan at the maturity date.

Table 5.1.10 Advantages and disadvantages of debentures ▼

Advantages	Disadvantages
• The full amount of the loan does not have to be repaid until a specified maturity date.	• A fixed amount of interest must be paid to debenture holders each year whether the business is profitable or not.

Advantages	Disadvantages
• Large amounts of money can be raised. • The business does not sacrifice any ownership or control.	• The debenture might be linked to an asset, in which case if the business cannot repay the lender when the debenture matures the asset will be sold to repay the debt. These are known as "mortgage debentures". • If a substantial amount of the business has been gained using debentures then it might preclude the business from further borrowing even if there is a good business opportunity. For example, a bank might not be willing to provide further finance due to the commitment of the business to service the debentures.

Venture capital

Key term

Venture capital: finance provided by lenders (individuals or businesses) who specialise in investing in risky business ventures such as start-ups.

Venture capital is finance that is loaned by people who are willing to take more of a risk than some other lenders. They are sometimes individuals who are looking for business opportunities or who make their money by lending to other businesses.

Venture capitalists are often willing to lend money to businesses that have been refused loans by other institutions perhaps because they are seen as too risky. However, venture capital comes at a price because, due to the higher degree of risk involved, a higher rate of interest is likely to be charged on any money loaned out.

When venture capital is being used to finance a new business, it is not unusual for the person or business providing the venture capital to insist on having some share in the ownership of the business. This can be to protect their investment or because they want to maximise the returns on the money invested.

Table 5.1.11 Advantages and disadvantages of venture capital ▼

Advantages	Disadvantages
• It might be available when all other sources of finance are not. For example, if the business is a new one and cannot prove that it has the resources to be able to repay a loan, banks might not be willing to lend. • Sometimes business advice is available along with the finance. • The money does not always need to be paid back.	• The venture capitalist might insist on some involvement in the running of the business. • The finance is sometimes given only if the venture capitalist gains part ownership of the business.

Government grants and loans

Key term

Grant: an amount of money made available that does not require repayment.

Governments are often committed to helping and supporting businesses, sometimes with advice and sometimes with financial help.

The financial help from governments can come in the form of loans or grants. Loans must be repaid whereas grants do not have to be repaid.

Loans

These can be either short-term or long-term loans and often carry a lower rate of interest that would have been charged if the loan had been provided by a bank. Governments often use the offer of cheaper loans when they feel that business and the economy need help to grow. Economic activity within a country is greatly affected by business

activity. If businesses within a country are unable to develop and grow then the economy is unlikely to grow either. Therefore governments will offer loans to businesses in order to help to stimulate business activity and help the economy of the country.

Loans from governments are frequently offered to businesses that would otherwise find it difficult to get a loan. For example, new businesses might be seen as too risky for banks to lend money to. Lending to small businesses has also been considered too risky at a time of economic recession. This was certainly the case in the years following the global financial crisis that began in 2008. Banks became extremely cautious about giving loans where there was even the slightest doubt about the loan being repaid.

In some countries like the UK the government used loan guarantee schemes to help small and medium-sized businesses get loans from banks. The government would guarantee the amount of the loan if the business was unable to repay the debt. This action was intended to give banks the confidence to lend to businesses.

Grants

Grants are often linked to a specific form of business development, e.g. for the introduction of new technology. Alternatively they may be given to businesses in order to persuade them to locate in a particular area. Grants are frequently used to try to encourage businesses to move to areas of high unemployment and to encourage a move of some industries away from residential areas into areas that have been designated as industrial sites.

The great advantage of a grant is that it does not have to be repaid, but it might be given with strict guidelines about how it must be used.

Crowd funding (crowd sourcing)

Key term

Crowd funding: obtaining loans from a large number of individuals.

Crowd funding is when business finance is acquired from a "crowd", i.e. numerous individuals pool money to support a business venture. This method is frequently used by new businesses seeking some start-up capital. A person might have a good business/product idea but lacks the finance to actually set up the business. The Internet has provided a vehicle for potential entrepreneurs to reach out to people who might be willing to provide finance for their business venture and there are now many websites that facilitate the raising of finance in this way. Many contributors are only committing a small amount of money, but with numerous contributions the total sum can be large. The contributors will sometimes receive shares in the business therefore benefitting from future profit, or they might benefit from receiving some of the product being made, for example receiving copies of a new magazine that they help to finance.

This source of finance is available to businesses that find it difficult to get bank loans perhaps due to the fact they are seen as too new and therefore a big risk.

Low-budget films have been financed in this way. Another example of crowd funding is when a natural disaster occurs somewhere in the world charities appeal for funds to allow them to help the victims of the disaster. Many donations, some of them very small, are made by individuals to allow that work to take place, but the total amount raised can be huge.

Key term

Micro-finance: provides a source of finance and financial services to businesses that are unable to have access to conventional banking, perhaps because they are new.

Figure 5.1.2 Micro-finance could help this business grow

Activity

Research two businesses that have used crowd funding and try to identify why this source of finance was used rather than a more traditional source such as a bank loan.
In small groups, discuss and make notes on the reasons why an individual might decide to make money available to businesses that are raising money through crowd funding.

Activity

Investigate sources of micro-finance in your country.

Micro-finance

Micro-finance is the lending of usually a small amount of money to people (sometimes groups of people) who would not be able to get a loan from a bank or other financial institution. The recipients usually have low-incomes or are unemployed and are therefore seen as too risky to be given a bank loan. There are many economies worldwide where it is accepted that getting a job is so unlikely that the best chance a person might have is to become self-sufficient in some way. This can involve starting up a small business enterprise for which some initial finance would be required. Many of the borrowers have been women who have been left without any means of support for themselves and their family. Without the aid of a small loan they would have been unable to buy the equipment needed to start their business. Some loans have been for the purchase of a sewing machine or for the initial expense of buying a weaving loom. The equipment has then allowed a person or group to begin to make items for sale. Another example is the purchase of woodworking equipment that has allowed a small group of men to begin making wooden furniture for sale. It is the initial injection of finance that makes these business ventures possible. Some micro-finance schemes are government backed in some countries. A good example of an organisation undertaking this type of lending is the Grameen Bank in Bangladesh.

Progress questions

9 Explain two reasons why a business would apply to the government for a loan.
10 Outline two situations when it would not be advisable to use a short-term source of finance.
11 Name two external, long-term sources of finance.
12 Explain one disadvantage of using a venture capitalist as a source of finance.

Factors influencing selection of sources of finance

Different sources of finance are appropriate in different circumstances. The chosen source of finance could be for any one of a variety of reasons.

The financial history of the business

If the business has been established for a long time and has a history of well-managed finances, banks might be willing to agree a loan. Shareholders might have the confidence to buy more shares or, in the case of a small sole trader or partnership business, friends or family might be willing to give some financial support.

However, if the business's financial records show evidence of poor financial management or of a previous inability to repay a debt then the choice of a source of finance might be very limited. Any bank or individual lending to a business with a poor financial history would seek some assurance that their money would be repaid. For example, they would demand some form of security or collateral.

Link

Gearing is not examined at AS Level and will be discussed in A Level Chapter 5.8 Analysis of published accounts.

The financial history will also include looking at any debts that the business already has. If a business has already borrowed money and is still repaying previous loans then a lender might consider whether another loan could prove too difficult to repay. This is known as "gearing".

Whether the finance is required for the short term or the long term

If funds are required to cover a temporary shortfall in liquid assets then it would not be appropriate to remortgage a property. The remortgaging of a property would involve the business taking on a long-term liability, and a temporary shortfall is likely to be a very short-term problem. An overdraft facility would possibly be the best option to choose in this instance. It would not be wise for a business to commit to a loan that is to be repaid over two or three years when the need for finance might only be for two or three months.

However, it might be that a bank will not allow a business to have an overdraft because of previous financial performance, in which case a short-term loan would be chosen with some security given to the lender.

The use to which the finance will be put

If a business needed a large amount of money to finance the development of a new product, the length of time before any profit might be realised would have to be taken into account.

If it was expected that profit would not be seen for a long time then a form of finance that would not require immediate repayment would be preferable, e.g. debentures. This allows time for a long-term project to be completed and for profits to begin to be received. For example, pharmaceutical companies often have medicines in the research and development stage for many years before they gain the approval that is required for their use. Large amounts of finance would be needed to support the development of such products and it could benefit the company if the repayment of any borrowed funds was delayed until profit begins to be made.

The extent to which any loss of ownership and control is acceptable

If a business does not want to lose any control or ownership then a share issue would not be considered. Similarly, venture capital might also be rejected if part ownership was demanded as one of the terms of financial support.

The cost of various options

Some sources of finance bear an obvious and specified cost. The interest that is due to be paid on any money borrowed would be paid at a specified rate. The interest might be paid along with regular repayment of the sum borrowed, as in a bank loan.

Loans will carry various rates of interest. The rate charged can depend on the risk to the lender or the type of loan taken. The rate of interest charged on overdrafts is usually much higher than that charged on secured bank loans.

Getting it right

When you recommend a source of finance for a business, be sure to take account of the context relating to that business. So, for example, a sole trader cannot sell shares and is often more likely to raise finance from friends and family.

Alternatively, in the case of raising finance through an issue of debentures, only the interest due is paid for the years between the issue of a debenture and its maturity date. For a project that is unlikely to yield any profit in the short term a debenture might be a good choice because the sum borrowed will be repaid only in the longer term when the maturity date is reached. The cost of repayment is initially lower because it is only the agreed interest that must be repaid before the maturity date of the debenture.

Case Study

Stage Productions Ltd

Bacari and Agnes are the only shareholders in their company. They organise venues for music and drama events. They will book the venue, organise all of the publicity and the printing and sale of tickets. They will also arrange for all of the sound and lighting equipment to be ready for the day of the event. Everyone who is employed to work at any stage of the preparation for the event or on the actual day of the performance is paid by Stage Productions Ltd. All that the musicians or actors have to do is turn up on the day of the performance! If the performances are popular Stage Productions Ltd achieves a good return on the money spent.

This business model has worked very well until now. The business is being asked to organise more events now than ever before and this is requiring it to spend more money than it has ever had to. In the past the business might have been organising two or three events at the same time but recently it has had five or six in the planning stage at the same time. This has caused some financial worries because there have been times when it has only just been able to meet its weekly wage bill because of the money that needs to be spent in the preparation of any event.

The growth of the business means that it needs to buy more sound and lighting equipment because, at the moment, it is unable to accept work for events that are to be held on the same day due to needing the equipment at both venues.

1 Discuss the sources of finance that would be most appropriate for Bacari and Agnes to consider at this stage in their business development.

Exam-style questions

1 State two sources of finance that might be used to fund revenue expenditure. [2 marks]
2 Explain why a short term source of finance might not be appropriate to fund the development of a new product. [5 marks]
3 Discuss the sources of finance that might be used by a new business that designs and produces wooden furniture. [20 marks]

Andre's Fish Bar

Andre was recently made redundant after working for the same business for several years. He has always wanted a business of his own. He has decided to open a mobile food van selling different kinds of cooked fish. He plans to sell the fish with a choice of vegetables or salad. Some of the food will be complete meals such as fish curry and fish-ball soup with noodles.

He lives in the suburbs of a major city and is sure that his food will be popular with people rushing home from work with very little time to cook. He also believes that it would be popular with people going out for the evening but wanting a snack while they are out. He has seen several vans in his area selling different kinds of food but no one selling fish dishes.

4 a Discuss the sources of finance that might be available to Andre. [10 marks]
b Explain why Andre might find it difficult to get a loan from a bank. [4 marks]

Key concepts

AS **Change** can be explored through the changing needs for business finance.

AS **Management** need to be aware of different types of need for finance.

AS **Change** can be viewed through changing needs for finance and changing factors involved in decisions about which are the best sources of finance.

AS **Management** has a role in the choice of source of finance.

AS **Strategy** is necessary for strategic decisions involving finance.

Progress check

You should now be able to:

AS explain why businesses need finance to start up and to grow

AS discuss the different sources of finance and their appropriateness in a given situation

AS explain the meaning of working capital, revenue expenditure and capital expenditure

AS explain the difference between short- and long-term sources of finance

AS assess the internal and external sources of finance and the appropriateness of each in different situations

AS evaluate the factors that can determine which source of finance is most appropriate at a given stage of business development and in a given situation.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- AS the need for a business to have accurate cost information
- AS the various types of costs and the problems associated with allocating them in given situations
- AS cost information used for decision-making purposes
- AS the use of costs in pricing decisions and how cost analysis helps in the calculation of payments for resources
- AS the usefulness of costs in monitoring and improving business performance and in the calculation of profits
- AS the concept of break even and the margin of safety
- AS the possible uses and limitations of break-even analysis
- A full and contribution costing

5.3 Costs

Cost information

The need for accurate cost data

Cost information is an essential element of business calculations. The reasons why businesses need accurate information for costs are numerous.

Pricing

Without such information a business is unable to determine whether the price that it charges for its products or services is sufficient to cover the cost involved in providing the product or service to its customers.

Profit calculations

The information is equally crucial to a calculation of the profit earned through business activity. Profit is the difference between the revenue obtained for a product or service and the cost of providing it to the customer.

Profit = Total revenue − Total costs

(Revenue = Price × Number sold;
Total costs = Fixed costs + Variable costs)

If inaccurate information is used a business might be expecting to make a profit from selling its products when in reality the costs of production will not be covered when selling at the price that has been set. To make a profit the price charged must cover the total cost of producing a product or providing a service and allow for some amount of profit to be gained. Businesses exist to make a profit, and without accurate cost information there is a danger that they might set a price that is too low to allow a profit to be realised.

If detailed and accurate cost information is not available a business might be unaware that it is paying too much for some materials. For this reason it is essential that a business knows the cost of each input in the business. For example, a business must know how much of the cost of producing a product is for raw materials, for labour, for packaging, for transport and for electricity. This breakdown of costs is required so that, if the cost of one of the inputs changes, the business can calculate the impact that this will have on the total cost of the product.

For drawing up a cash flow forecast

Accurate cost information is essential if a business is producing a cash flow forecast. Although a cash flow forecast is only an estimate and therefore cannot be guaranteed to be totally accurate, the tendency towards inaccuracy would be increased if inaccurate cost information was used. An overestimation of some costs could lead the business to expect a shortfall in cash when, if accurate data had been used, this would not have been predicted to occur. If the information used was incorrect then the overdraft might have been under- or overestimated.

Key term

Cash flow forecast: a prediction of the future cash inflows and outflows for a business over a specified time period.

Link

See AS Level Chapter 5.5 Forecasting cash flows and managing working capital.

An underestimation of costs could mean that the business does not agree a sufficiently large overdraft facility with its bank and will then be unable to meet its short-term financial obligations.

To produce the final accounts for a business

When a business is required to produce a set of final accounts it is important that they are a true representation of the costs and revenues of the business. This is important because the accounts of the business will be used as a basis for calculating how much tax must be paid to the government. The final accounts will also be used by various stakeholders, e.g. shareholders, to decide whether or not they will continue to be associated with the business. For example, if a business does not show a sufficiently large profit, shareholders might decide to sell their shares, suppliers might begin to fear that the business will not survive and will look for other businesses to sell to.

To compare cost information over time

Most businesses want to know that they are controlling their costs and will often look for trends that can be identified. If a business wants to compare the cost of raw materials this year with the cost of the same materials two years ago, the comparison is useless if the cost data was not accurate.

Case Study

SLD Plastics

SLD Plastics manufactures a range of plastic products for industrial and domestic use. Its main products are plastic buckets for industrial customers and for domestic use. It also makes a range of eating utensils such as plates, bowls and cups as well as storage boxes of various sizes.

It has always purchased the plastic required for production from Howard Industries. Stephano has always been responsible for ordering the plastic granules and for paying the rent for the factory. When he orders some plastic granules, Howard Industries usually delivers within two or three working days and it then sends an invoice to SLD two or three days after that. Stephano has been dealing with Howard Industries for many years and he feels confident that he does not have to check the details of invoices because he trusts that its invoices will be correct. As soon as he receives an invoice he writes a cheque to pay for the plastic received.

The other costs, such as wages and electricity, have always been paid by Luciana.

Diego does not feel any need to concern himself with any of the costs of production, he concentrates on ensuring that orders are made and delivered to customers on time and that the products are of the highest quality. He is confident that Stephano and Luciana have all financial aspects of the business under control.

Luciana recently noticed that the latest bank statement for SLD showed that its bank balance was much lower than it had ever been before. They immediately checked to make sure that all payments that they had received had been paid into the account. They had. So why was the bank balance so low?

On investigation Stephano noticed that the price he was paying per kilo of plastic granules had increased by 10 per cent in the last three months as a result of the rising world price of oil. He knew that the rent for the factory had increased by $50 per month but he had not been aware of the increase in the price of plastic.

When Stephano mentioned his discovery to Luciana she told him that she had just noticed that, also due to rising world fuel costs, the last electricity bill was 8 per cent higher than expected.

Figure 5.3.1 ▲

1. Give two reasons why Stephano should have checked the invoices that were received from Howard Industries.
2. Discuss possible implications for SLD Plastics of not being aware of accurate cost information.

Types of costs

There are many different types of cost that a business needs to be aware of.

Fixed costs (FC)

Key term

Fixed cost: a cost that will not change with an increase or decrease in the level of output, e.g. rent.

Fixed costs are just what the term says, they are "fixed" and so will not change with the level of output produced. For example, the rent for a factory will have to be paid every month regardless of whether any production has taken place or not. If in one month the business produces 1000 units and the next month it produces 2000 and the month after that it only produces 400 units, the rent of say $500 per month will remain the same. It does not double just because output has doubled. Nor does it fall if output is reduced. The business will have agreed an amount of rent to be paid and that amount will remain unchanged for the duration of the rental agreement.

Salaries are also fixed costs because salaries must be paid to the employees regardless of how much work the employees do, i.e. it is usually a fixed amount per month.

Variable costs (VC)

Key term

Variable cost: a cost that will vary directly with the level of output, e.g. raw materials.

Variable costs, as the name suggests, do change or vary. Variable costs change with the level of output. For example, if a business produces plastic buckets, the amount of plastic used will depend on the number of buckets produced. If McDonald's sells twice as many burger meals this month as it sold last month, then it will use twice as many bread rolls, twice as many burgers, twice as many fries and twice as much salad trimmings and sauces. Therefore the variable costs associated with producing the buckets or the burger meals will depend on how many are made, i.e. these costs will vary according to the level of production of these products.

Wages that are agreed on "piece rate" are a variable cost because the employee will be paid according to how many units have been produced.

Marginal costs

Key term

Marginal cost: the additional cost of producing one extra unit of a product, e.g. the cost of the extra raw materials or labour used.

Marginal costs refer to the change in total cost of producing one extra item of a product or of providing a service to one extra person. For example, Chew & Co. makes 200 units of chuckles at a total cost of $340, but when it makes 201 chuckles its total costs are $348. The marginal (extra or additional) cost of making the one extra chuckle was $8.

Marginal costs are usually variable costs but there can be occasions when even a slight increase in production would require additional machinery to be purchased. In such circumstances marginal fixed costs would also be incurred. For example, a business manufactures hand-made tables and chairs and its usual output per week is ten units, with one unit consisting of a table and four chairs. One employee is responsible for making one complete unit (one table and four chairs) per week. The business decides that there is sufficient demand for it to

Getting it right

Remember that although direct costs and variable costs are often the same, sometimes they are not. Take the example of a teacher; their salary for delivering a course can be classed as a direct cost but their salary would be a fixed cost not a variable cost.

Key term

Direct costs: costs that can be linked directly to the production of an item, e.g. the raw material, labour cost or the cost of machinery.

Activities

1. Think of examples of fixed costs in your school or college.
2. Make a list of variable costs that you believe your school or college will incur.
3. Is the salary paid to a teacher a fixed or a variable cost? Explain the reason for your answer.
4. Identify possible examples of direct and indirect costs for a local business.

Key term

Indirect costs: a cost that cannot be directly linked to the production of a particular product, e.g. rent, insurance premiums or the wages of clerical staff.

increase output to 11 units per week. Additional wood will be used, additional glue and polish will also be used and an extra employee would be required. These are all additional (marginal) variable costs. The business has some cutting equipment and a machine for polishing the finished tables and chairs. The maximum number of tables and chairs that can be cut and polished with the current equipment is ten complete units per week. Therefore, if output is to be increased to 11 units each week then some additional cutting and polishing equipment will be needed. Purchasing the equipment is a fixed cost. In this case, an additional (marginal) fixed cost.

Direct costs

Direct costs are those that can be directly linked to an activity or the making of a product. Taking the earlier example of a business making plastic buckets, there will be a certain amount of plastic used in the manufacture of each bucket. Therefore, the cost of the plastic used in each bucket is a direct cost. If the buckets are packed and sold in multiples of 20, the cost of the packaging for each batch of 20 is also a direct cost. The business is likely to make a range of plastic products and similar costs can be linked to the making of the other products made by the business. Perhaps it also manufactures plastic bowls for washing dishes in, or plastic bowls and plates and plastic containers for storing food. It is likely that similar calculation of direct costs will be possible for each product. Direct costs are not necessarily variable costs. If there is a, for example, a quality inspector whose job is only concerned with the quality of the plastic buckets, the salary will be a fixed cost but it will also be a direct cost of making the buckets.

Indirect costs

Indirect costs are those costs that cannot be directly linked to the making of a product. An example of an indirect cost is that of a clerical assistant who prepares the invoices to be sent to customers. They prepare invoices for all products sold by the business and for all types of customers. In the case of the clerical assistant employed by SLD Plastics (the case study above), invoices would be sent to all of its industrial customers as well as to the retail customers who sell its domestic plastic items. The wage paid to the clerical assistant is an indirect cost because it cannot be linked directly to buckets, plates or bowls or any other item produced by SLD Plastics.

Case Study

Bribeck Medical Appliances (BMA)

Bribeck Medical Appliances (BMA) is a partnership that manufactures and sells a range of equipment such as wheelchairs, crutches, hoists to help people to move in and out of their bed or a bath. The equipment is all designed to help people to be able to live as active a life as possible even though they have a physical disability either temporary or permanent. At a recent meeting of the partners of BMA Adam

raised his concerns about the rising costs of running the business. Bhupesh challenged him by asking which costs exactly he was worried about. He said that the biggest expense was Olivia, a medical consultant, who worked with the customers to ensure that they each got the equipment that was best for them. Bhupesh said that he believed that it was the rising costs of their raw materials and labour costs that were the problem. The discussion continued for some time. They discussed whether the salaries paid to the clerical staff were a major contributor to the increase in costs. Another area for discussion was the fact that world fuel prices were rising and this was increasing the cost of electricity as well as the fuel for its delivery vehicles.

1 Classify each of the costs mentioned in the text.
2 Are there any other costs that have not been mentioned that you feel Bribeck Medical Appliances should look at?

Problems of allocating costs in given situations

Semi-variable costs

Although businesses need to be aware of the various costs that they might be incurring they also need to be aware that not all costs can be labelled as being distinctly one type of cost or another. For example, is electricity a fixed cost or a variable cost? If a business decides to manufacture more products then the amount of electricity used in production will increase. That element of the electricity cost can be seen to be variable. However, there is an element in the electricity bills in most countries that involves a basic fixed charge for supplying the electricity. This part of the electricity bill is a fixed cost. In this example the electricity bill is partly a fixed cost and partly a variable cost. Similarly with a telephone bill; part of the bill will be a "standing charge" for providing access to the service and the rest will be composed of charges for calls made. The term used for this is semi-variable cost.

Key term

Semi-variable cost: a business cost that will have a fixed cost element and a variable cost element.

Multi-product businesses

When businesses produce a range of products it can be difficult to determine how much of some costs have been incurred by the production of a specific product.

Using the example of SLD Plastics, it will be difficult to determine how much electricity was used to produce buckets and how much was used to produce plates. When it is not possible to be precise about the actual cost incurred, what some businesses do is to apportion the costs to groups of similar products. SLD Plastics might apportion costs to the production of the industrial plastic products and separately to the domestic plastic products. This is made easier when the business makes a clear distinction between the different categories of products for all the business activities. The business incurs costs for heating and lighting. These costs might be apportioned according to the amount of factory space each product group uses.

Getting it right

While the allocation of costs has a distinct meaning and is different to apportioning costs, use of the term "allocation" is likely to be taken as synonymous with "apportioning".

In accounting terminology "allocation" has a very specific meaning; it implies that a certain cost can be directly linked and therefore allocated to a specific product or cost centre. However, when that precise link cannot be made, the costs are then divided between various departments or cost centres. This is known as "apportionment".

Some of the problems associated with the allocation of costs are caused by the difficulties in classifying the various costs as outlined earlier.

Progress questions

1 Briefly explain two uses of cost information.
2 Explain, using examples, the difference between a fixed cost and a variable cost.
3 Explain one possible problem associated with allocating costs in a business.

Uses of cost information

Using cost information for decision-making

There are some decisions that a business might make for which cost information is essential.

Whether or not to produce a particular product

A business would need to be confident that it would be able to make a profit if it invested a lot of time and money into making and selling a particular product. In order to determine whether or not a product is likely to produce a profit the business would need to consider all of the costs involved. The total costs of producing the product would need to be calculated in order to make a decision. The total costs involve both the fixed costs and variable costs.

Key terms

Total costs: fixed costs plus variable costs. All of the costs involved in making a product or providing a service.
Average costs: the total costs of a product divided by the total output produced.

The business would also calculate the average costs of the product (fixed cost plus variable cost divided by output). The average cost of the product would need to be lower than the projected price that it would sell for. If the business calculates the average cost to be higher than any price that could be charged then the product should not be made.

Whether or not to accept a special order

Sometimes a business receives a request to supply products at a lower price than it would usually sell for. In such a situation the business must determine the extra costs that would be incurred by taking on that additional order. These would be the additional materials, labour, transport etc. that the additional order would require. The business would not necessarily have to consider the fixed costs in this situation because these will have already been covered by their existing orders.

This will be covered in more detail later in the chapter (see marginal costing on page 268; note that this is an A Level topic).

Can the business continue to trade?

A business would need to know details of its costs and revenues if a decision is being made about whether or not it can continue to trade.

If the business is having difficulty covering costs with the revenues received then a decision might be made to cease trading. However, if accurate cost data indicated that although high costs have been a serious issue for the business, the current trend is that some costs are starting to fall, then the business might still prove to be a viable venture. Of course, the reverse might also be true if the analysis of costs revealed an increasing trend.

Sometimes very detailed analysis of the costs of a business will be required if prudent decisions are to be taken.

The use of costs in pricing decisions

Costs are an essential element of the determination of the price of a product or service. In the short term the business needs to be able to price a product so that at least the variable costs of production are recovered. In the longer term the business also needs to cover the fixed costs. Most pricing decisions will therefore be based on the Average cost (FC + VC) ÷ Output.

Example

A business produces washing machines and has fixed costs of $240 000 per year. The variable costs for each washing machine are $80. The business produces 2500 washing machines each year.

What is the lowest price that can be charged for each washing machine that would allow the business to cover all of the costs?

$$\frac{\text{FC } \$240\,000 + \text{VC } \$200\,000\ (\$80 \times 2500)}{2500 \text{ (output)}} = \$176$$

The business would then need to decide how much profit it would like to make or needs to make. For example, if it decided that it wanted to make a $20 profit on each machine it would charge a price of $196 ($176 + $20). Any price above $176 would provide a profit for the business. However, there are many other factors to be considered when setting the price of a product.

Link

Price is one of the 4 Ps covered in AS Level Chapter 3.3b The marketing mix: price, promotion and place.

Using cost analysis to monitor and improve business performance

Businesses are often divided into sections or departments and these are often required to manage and be responsible for their own costs. These are known as cost centres. When a business is divided into different product divisions, each product division is often also required to prove that it is functioning profitably. This is known as a profit centre. The use of cost and profit centres is only suitable when the costs and profits can be clearly identified as belonging to a particular part of a business.

Key terms

Cost centre: part of a business for which costs can be clearly identified.
Profit centre: part of a business for which profit can be identified and calculated.

Link

See also A Level Chapter 2.3b Human resource management: further functions of HRM.

The creation of cost centres gives the senior management a performance indicator. They are able to judge the cost management performance of each cost centre. This is helpful when a business wants to determine which parts of the business are cost effective and which are not. It allows senior managers to identify the sections of

the business that need to exercise greater control over their costs. Controlling or reducing costs is often a key performance indicator for departmental managers.

Cost analysis might also be used if a fall in profit is experienced. The reasons for the fall might include a rise in costs. If this is found to be true then appropriate action can be taken.

Reviewing costs and a need to reduce them can sometimes lead to a change in the approach to the work being done. A change in the way in which various resources are used within a business can sometimes lead to a reduction in overall costs. For example, introducing teamwork might lead to faster production and a higher-quality product. This would reduce costs in terms of production costs and the costs of repairing or replacing faulty products.

Break-even analysis

Key term

Break even: the level of output at which total revenue = total costs.

Break-even analysis is a tool used to find the level of output at which the total revenue from a product is sufficient to cover the total costs of producing that product. Total costs include fixed costs and variable costs.

Break-even analysis can also be used to calculate the profit that will be made at a certain level of output. If a business is producing at a level of output that is higher than the break-even level of output then the business will be making a profit.

The break-even level of output can be determined by using a graph or by calculation.

The information that is required in order to find a break-even point is as follows.

Total revenue (TR)

In order to calculate the total revenue a business must have decided on a selling price. This will have been determined by the various costs involved in producing the product.

Variable costs (VC)

The variable costs can be given either as total variable costs (TVC) or variable costs per unit.

Fixed costs (FC)

Fixed costs need to be covered even if no production is taking place. As more and more products are made, the fixed costs per unit will fall because the total fixed costs will be spread over a larger number of units produced.

Example

Dephton Ltd makes small poultry units (a wooden building for keeping hens and other poultry in). It has fixed cost of $24 000 per year. The selling price of each poultry unit is $195 and the variable cost per unit is $95.

How many poultry units will Dephton Ltd have to produce in order to break even?

Key term

Contribution: the amount of revenue remaining after the deduction of variable costs. This can be put towards covering the fixed costs of the business.

Every time Dephton Ltd sells a poultry unit for $195, $95 will be taken to cover the variable costs such as the materials, labour and transport costs. That will leave it with $100 ($195 − $95). Is the $100 profit? No, because the $100 will need to be put towards covering the fixed costs of the business, i.e. the $100 will be a "contribution" that each poultry unit makes to fixed costs. So the question is, how many $100 will be needed before the fixed costs of $24 000 have been fully covered?

The break-even level of output can be determined by using the contribution method of calculation.

The contribution formula is:

$$\frac{\text{Fixed costs}}{\text{Contribution per unit (Selling price per unit} - \text{Variable costs per unit)}}$$

Getting it right

Unfortunately the term "contribution" is used ambiguously in this subject. In the context of break-even, contribution is price minus variable cost. In the context of contribution costing (see later in the A Level section of this chapter), contribution uses direct costs rather than variable costs.

The calculation for this is $\frac{24000}{100\,(195 - 95)} = 240$ units per year

The break-even level of output can also be found by using the following.

Break-even is where Total costs = Total revenue

Total costs = Fixed costs + Variable costs (Variable costs per unit × Quantity produced)

Total revenue = Price per unit × Quantity sold

We do not yet know the quantity, so we can call that Q. The other information for Dephton Ltd is given in the text. Put that information into the equation.

$TR = TC$

$195Q = 24000 + 95Q$

$195Q - 95Q = 24000$

$100Q = 24000$

$Q = \frac{24000}{100}$

$Q = 240$

Therefore 240 units must be produced and sold in order for the business to break even.

The answer can also be found by using a diagram which traces the relationship between costs, revenues and profit at various levels of output.

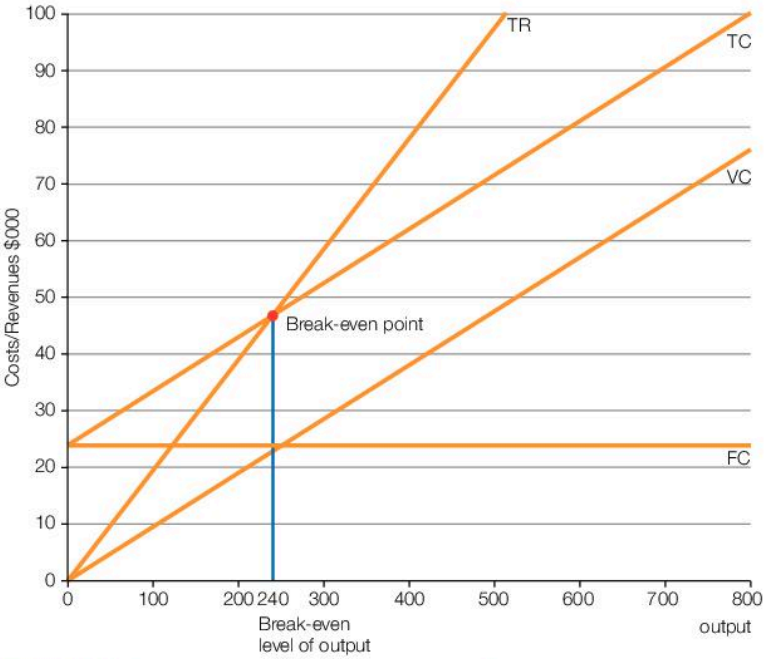


Figure 5.3.2 Break-even diagram for Dephton Ltd ▲

A break-even diagram allows the profit or loss at any given level of output to be identified. It also allows the effect of any changes to projected revenues and costs to be seen.

- For example, if the fixed costs of Dephton Ltd rose to $30 000, how many units would have to be produced to break even?
- Alternatively, if the variable costs of production rose by $5 per unit, what impact would that have on the break-even level of output?
- If a competitor entered the market and Dephton Ltd was forced to lower the price of its poultry units to $175, what effect might that have on its break-even level of output?

The margin of safety

Key term

Margin of safety: the difference between the break-even level of output and the actual output when actual output is higher than the break-even level.

The margin of safety is the amount of output produced that is above the break-even level of output. If a business produces 12 000 pairs of trainers per year and the level of output at which the business breaks even is 9000 pairs of trainers, the margin of safety is 3000 pairs of trainers. This means that the business will continue to make a profit if the output falls but by less than 3000 pairs of trainers per year. This can be reassuring for businesses during a recession when demand for their products might fall. They have an indication whether they will still be profitable at lower levels of production.

This will only be true if costs and revenue per unit remain unchanged.

We calculated that Dephton Ltd needed to produce 240 units in order to break even. If it produced and sold 400 units per year it would be making 160 units more than it needed to produce to break even. This will give the business some security such that if demand falls it will still be profitable if the demand stays higher than 240 units.

Getting it right

You need to know how to construct a break-even chart so that you are able to make changes to one that you are given. You must be able to interpret the information contained in any given break-even diagram. Remember, break even is the level of output, not the level of costs.

Key term

Contribution per unit: the amount from the sale of each product that can be used to cover fixed costs and to contribute to profit.

Progress questions

4 From Figure 5.3.2 how much profit will Dephton Ltd make if it is producing 400 units per year?

5 How much profit will it make if it only produces and sells 300 units each year?

The uses of break-even analysis

A business might use break-even analysis to:

- Calculate the level of output that would be required to give a desired amount of profit. This can be determined either by reading from a break-even diagram or by calculation. If the calculation method is used this is done by adding the desired profit to the fixed costs and dividing this by the contribution per unit.
- Break-even analysis allows a business to see the possible impact of a change in costs. If a supplier has given notice that its prices are to be increased, then its customers could use the new cost figures to calculate the new break-even level of output. The increase in costs might mean that they will be unable to cover their costs and therefore will have to either find a cheaper supplier or perhaps increase the price of their products.
- It can test the impact of an increase in price on its break-even point and on its profits. Any increase in price will also have to consider many other factors such as the price elasticity of demand (see page 178) and the amount of competition in the market.

The final two bullet points relate to changes whose effect might be assessed when a business is carrying out a "What if?" analysis.

The limitations of break-even analysis

- All output is assumed to be sold and it is assumed that the business does not hold any inventory. This is not always realistic. Market conditions can change, sometimes quite suddenly, and this can result in sales being lower than anticipated. If the business has bought in or produced lots of items it can be left with a significant proportion of these.
- The conclusions drawn from break-even analysis will depend on the accuracy of the information that was used to construct the diagram or calculate the break-even level of output. This is another example of the importance of having accurate cost information. If the information used is inaccurate then the conclusions drawn will also be inaccurate.
- The revenue and cost lines are assumed to be linear when in reality this is not always true. For example, the business might be given a discount for purchasing in bulk when its order passes a certain level. This would have the effect of reducing the variable costs above a certain level of output. The fixed costs might also change with levels

of output above a certain number. For example, using the current machinery a business might be able to produce 5000 units of a product, but if output was required to be higher than 5000 another machine would need to be bought. The fixed-cost line in the break-even chart would increase to a higher value at that point.

- Break-even analysis can only be used for one product. Therefore it would not be helpful to a multi-product business unless the production of each product was undertaken by an identifiable cost and profit centre.

Case Study

Sports Alive

Sports Alive produces football boots and football shirts and shorts. The football shirts and shorts are sold as one complete kit. The fixed costs for Sports Alive are $24 000 per annum which are to be allocated equally between the production of both items. The variable costs for the football boots are $10 per pair and the selling price is currently $15 per pair. The variable costs of producing the football kits are $8 and the selling price for a complete kit is $12.

Sports Alive is eager to encourage young people to get involved in sport at an early age and has therefore just announced that it will donate $1 from each pair of boots and each kit sold to local schools for the purchase of sports equipment.

1. Calculate the break-even level of output for the production of football boots before the $1 donation was announced.
2. Calculate the break-even level of output for the football kits after the announcement of the $1 per kit donation.

Progress questions

6. Define what is meant by the term "break-even".
7. Give the formula for calculating break-even using the contribution method.
8. Briefly explain two uses to a business of break-even analysis.
9. What is meant by the "margin of safety"?
10. Briefly explain two limitations of break-even analysis.

Methods of costing (A Level)

Businesses will take differing approaches to how they will calculate the cost of a particular product. A business might be divided up into sections with each of them being required to monitor and control their own costs as well as to function profitably, i.e. cost and profit centres.

When calculating costs it is essential that all costs are included. As well as the identifiable variable costs, businesses will also need to cover their fixed costs (overheads).

There are two main methods that businesses use to calculate the cost information required for decision-making: full costing and contribution costing.

Key term

Full costing: when all of the costs of a business are "absorbed" into the costs of the products made. The cost will include a portion of the fixed (indirect) costs of the business.

Full (absorption) costing

Full costing requires all of the costs of a business to be "absorbed" into the costs of the products made by the business. What costs need to be covered? The variable costs identifiable with a particular product or service together with identifiable indirect costs. However, the indirect costs that cannot be specifically allocated to one product or another also need to be covered. Therefore some method of apportioning (sharing out) those costs between the various products or departments must be found. Full costing is sometimes referred to as absorption costing, although, strictly, there are differences which do not concern us.

This method of costing is used when a business produces a range of products or services and needs to know what price it should charge for a specific product or service. In order to do this it needs to know the full cost that each product is required to cover.

The way in which indirect costs are apportioned can depend on which indirect cost is involved. The cost of heating or the rent of a business might be apportioned according to how much space each of the products used. The cost of the human resources department is more likely to be apportioned according to how many people are employed in each cost centre. However, whichever way it is done is arbitrary and open to discussion.

A business might decide to allocate all indirect costs based on the number of employees in each department. For example, a business that produces two products and has indirect costs of $100 000 might decide to apportion $50 000 to each product because they each use the same amount of space. However, the situation would be different if the number of employees involved in the production of each product was used. If product A has 20 employees and product B requires only five employees, then $80 000 would be apportioned to product A and $20 000 to product B (in the ratio of 4 : 1).

Once the full cost of a product has been calculated, the business can then decide what price can be charged that would cover all of the costs involved. Businesses will include a desired level of profit into this calculation. For example, if the cost of producing a bed sheet is $5 and the business requires a profit of 10 per cent, then the sheet would be priced at $5.50.

Limitations of full (absorption) costing

- Costs are allocated in an arbitrary way.
- It can prevent a business accepting an exceptional order that might have been considered if marginal costing were used.
- The method of apportioning costs to a department or product might be seen as unfair by some within the business.
- The rigid application of this method can prevent the use of penetration pricing.

Contribution costing (marginal costing)

Key term

Contribution costing: the calculation of the cost of producing an additional product. It looks at the direct cost of production rather than all of the costs.

Contribution costing is the calculation of the cost of producing an additional product. Any revenue gained above the marginal cost will be a contribution to the indirect costs if they have not already been covered by other products, and if they have been covered, to profits.

Contribution = Price − Direct cost per unit or sometimes
Total contribution = Total revenue − Total direct costs

In contribution costing the business is concerned with the total direct costs for a product or service. In this costing method indirect costs or overheads are not included, so the "full cost" of making a product is not covered. The key to this type of costing is does the product make a positive contribution to fixed costs or not? If a positive contribution is made then it is worth the business manufacturing the product or providing the service, provided other conditions are met.

For this syllabus contribution costing is only used in the following circumstances.

"One-off" special orders

A business has been asked to supply a batch of products at a price much lower than they would normally sell for. If the business was to use the absorption costing method, the order would be rejected because the total costs (FC + VC) of producing the order would not be covered by the price that the customer is willing to pay.

Example

Pingle Ltd makes footballs that sell to retailers for $15 each. The National Sports Association has approached Pingle Ltd to supply 1000 footballs but they are only willing to pay $10 per ball. The planned output per year is 25 000 units. Fixed costs per annum are $50 000.

Based on the planned level of output, the costs of production are as follows.

The direct labour cost is $6 per unit and the materials cost $3 per unit. Fixed costs are $2 per unit.

Should Pingle Ltd accept the order from the National Sports Association?

The full cost of production is $11 (6 + 3 + 2) meaning that it would make a loss of $1 per ball sold.

However, the fixed costs are already covered by the planned output.

Using contribution costing it is only the marginal cost of the order that needs to be considered. Therefore the costs of the extra order for 1000 footballs would be $9 (6 + 3) meaning that a contribution towards fixed costs and profits of $1 would be made per ball. This type of costing for an additional order can only work if the business has some spare capacity and if its current regular customers do not hear that it has been selling footballs at this lower price.

However, if the order would have required Pingle Ltd to purchase some additional equipment, then the cost of that equipment (a fixed cost) would have been included as part of the marginal (additional) cost of completing that order. This is because the cost of the additional equipment would be a direct cost and therefore would need to be taken into account when deciding whether to accept the order.

Progress question

11 Pingle Ltd also sells sports shirts to retailers at a price of $12. The planned annual output is 15000 shirts and the fixed costs are $30000. The cost of production for each shirt is: direct labour $5; materials $2. The National Sports Association approaches it to supply 500 shirts but at a price of only $8.

Explain whether or not the managers of Pingle Ltd should accept the order from the National Sports Association.

"Make or buy" decisions

Sometimes a business needs to make a decision whether it should continue to manufacture all of its products or whether it would be more profitable to buy them in from another business.

If the price that the business receives for the product is higher than the variable cost of its manufacture, then the business is getting a contribution to fixed costs. The contribution to fixed costs would be lost if it decided to stop production and buy them in from another manufacturer. This could mean that other products manufactured by the business would have to cover more of the fixed costs than previously.

Example

Trample manufactures chairs that it sells to retailers at a price of $60 per chair. Its planned output for the year is 2000 chairs. Fixed costs are $16000. The variable costs per chair are:

Direct labour $20; direct materials $14.

It has recently been approached by Eden Wood Products Ltd, a furniture manufacturer, who has offered to supply Trample with identical chairs but at a price of only $40. Should Trample stop manufacturing chairs and buy them from Eden Wood Products Ltd?

Using full (absorption) costing the chairs cost Trample $42 to manufacture, giving it a profit of $18 per chair.

If it orders from Eden Wood Products Ltd it would pay $40 per chair. If it continues to sell the chairs at $60 it now has a profit of $20 – or does it? It still has to cover its fixed costs. Therefore it has achieved a contribution to fixed costs of $20 per chair not a $20 profit.

Fixed costs are $16000, which is $8 per chair, and this still needs to be covered whether or not it manufactures the chairs. This means that the actual cost of each chair bought in would be $48 ($40 + $8).

It might still be worthwhile for Trample to buy in the chairs rather than make them if the production capacity could be used to produce another product that could make a greater contribution to fixed costs.

Should a business stop production of one of its products?

When the revenue from the sale of a product does not cover the full cost of production a business might make the decision to stop production of that item. However, when contribution costing is used a different decision might be taken.

Example

Haymar Ltd manufactures sports shirts, shorts and socks in team colours.

The fixed costs for the business are $30000 which are apportioned to the three items 50 per cent; 30 per cent and 20 per cent respectively.

The business produces 7500 shirts, 4500 pairs of shorts and 3000 pairs of socks per year.

The costs and revenues for the three products are as shown in Table 5.3.1.

Table 5.3.1 Costs and revenues ▼

	Shirts	Shorts	Socks
	$	$	$
Fixed costs	15000	9000	6000
Fixed cost per unit	2	2	2
Direct materials per unit	5	4	1
Direct labour per unit	8	6	3
Total cost per unit	15	12	6
Selling price	18	13	5
Profit/loss per unit	3	1	(1)

The shirts produce a total profit for Haymar Ltd of $22500, the shorts provide a total profit of $4500 but the socks produce a loss of ($3000). Should Haymar Ltd cease production of socks?

The answer is no. Although the socks are not providing a profit, they are providing a positive contribution to fixed costs of $1 per pair; giving a total contribution for the year of $3000. If the socks were no longer produced the $6000 of fixed costs would need to be covered by the remaining two products.

The shirts would need to cover extra fixed costs of $3750 (6000 × 50/80) and the shorts an extra $2250 ($6000 × 30/80). The $6000 fixed costs would be apportioned between shirts as 50 per cent of 80 per cent and shorts by calculating 30 per cent of the 80 per cent.

The figures would then be as shown in Figure 5.3.2.

Table 5.3.2 Costs and revenues for shirts and shorts ▼

	Shirts	Shorts
	$	$
Fixed costs	18 750.00	11 250.00
Fixed costs per unit	2.50	2.50
Direct materials per unit	5.00	4.00
Direct labour per unit	8.00	6.00
Total costs per unit	15.50	12.50
Selling price per unit	18.00	13.00
Contribution per unit	2.50	0.50

The total profit now gained from shirts is $18 750 (2.50 × 7500) and the total profit from shorts is $2250 (0.50 × 4500). The total profit for the business has reduced from $24 000 to $21 000.

Link

See also A Level Chapter 4.4 Capacity utilisation.

There are other possible reasons other than profitability why a business might continue to produce a loss-making product. In the case of the socks, it might be that when customers buy a sports shirt and shorts they prefer to buy the matching socks from the same producer. Therefore if the business stopped making socks they might find that demand for their shirts and shorts would fall.

The business would also be maximising the use of its production capacity both in terms of labour and equipment.

To decide between the production of two competing options

When there is insufficient production capacity to produce the range of products that has been made by the business a decision must be made about which product will no longer be produced.

Example

Trelics is an electronics business aiming to manufacture MP4 players and mobile telephones. In its first year of business it will only be able to manufacture one of these products.

The unit costs of manufacture are expected to be as shown in Table 5.3.3.

Table 5.3.3 Unit costs of manufacture ▼

	MP4 players	Mobile phones
Predicted production	25 000 units	10 000 units

Costs and revenues per unit are shown in Table 5.3.4. Advise the managers of Trelics which product should be manufactured.

Table 5.3.4 Costs and revenues per unit ▼

	$	$
Direct materials	8	10
Direct labour costs	3	4
Other variables costs	1	3
Fixed costs	20	50
Total costs	32	67
Selling price	60	90
Contribution per unit	28	23

MP4 players should be produced because this product provides a larger total contribution.

The total contribution for MP4 players is calculated as shown in Table 5.3.5.

Table 5.3.5 Total contribution of MP4 players ▼

	$	$
Sales revenue	(25 000 × 60)	1 500 000
Variable costs		
– materials	(25 000 × 8)	200 000
– labour	(25 000 × 3)	75 000
– other variable costs		25 000
		300 000
Total contribution		1 200 000

The total contribution of mobile phones is calculated as shown in Table 5.3.6.

Table 5.3.6 Total contribution of mobile phones ▼

	$	$
Sales revenue	(10 000 × $90)	900 000
Variable costs		
– materials	(10 000 × 10)	100 000
– labour	(10 000 × 4)	40 000
– other variable costs		30 000
		170 000
Total contribution		730 000

To check that the correct decision is made, you could use the following approach.

The total fixed costs are $1 million [(20 × 25 000) + (50 × 10 000)]. If only mobile phones were produced, the business would experience a loss of $270 000. However, if only MP4 players were produced, a profit of $20 000 would be made.

When entering a new market

Contribution costing can be used when a penetration price is to be charged on products when entering a new market. In the longer term the fixed costs must also be covered, but in the shorter term the business might only focus on covering all of the variable costs such as direct labour and materials. Once the product has become established in the new market, the price can be increased so that all costs will be covered in the long term.

Progress questions

12 Explain two situations when a business might choose to use contribution costing.
13 What is meant by the term "full costing"?
14 Explain one limitation to a business of using full costing.

Exam-style questions

1 Explain the difference between direct costs and variable costs. [3 marks]

2 a Explain how costs information might help the managers of a greetings card manufacturing business to determine the price to charge for the cards. [8 marks]

b Discuss the usefulness of cost information to the owners of a large business when measuring the performance of the various departments. [12 marks]

(A Level)

3 The following information relates to the production of "Quizzles", a children's toy. The business manufactures a range of educational toys, of which the Quizzle is one.

	$000
Sales revenue	220
Fixed costs	100
Direct labour	45
Direct materials	60
Salaries	25
Other overheads	8

a Advise the managers whether or not they should continue to produce Quizzles. Give clear reasons for the advice you give. [8 marks]

b Analyse possible ways in which the managers might reduce the costs of production of Quizzles. [8 marks]

Key concepts

AS **Change** can be developed by considering changing cost structures.

AS **Management** is required to use costs in monitoring and decisions.

A **Change** can be considered in the context of factors influencing costs.

A **Management** can be considered through the role of cost/profit centres and monitoring/controlling costs.

A **Strategy** can be involved in major decisions involving costs.

Progress check

You should now be able to:

AS explain why accurate cost data is important to a business

AS explain the difference between the various costs that a business might incur

AS analyse the importance of cost information to pricing decisions

AS discuss the relevance of cost information to monitoring performance

AS evaluate the impact of cost and/or revenue changes on the break-even level of output

A analyse and evaluate the usefulness of full and contribution costing in a range of circumstances

A solve business problems using cost information.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- AS the contents of an income statement and a statement of financial position
- AS liquidity and profitability ratios including acid test ratio, current ratio, gross profit margin and profit margin
- AS the usefulness of ratios and reasons for results obtained
- AS methods of improving ratios
- AS the comparison of ratios between businesses
- AS the limitations of accounting ratios
- AS the usefulness of ratios to various stakeholder groups
- AS the main users of accounts and the limitations of published accounts

5.4 Accounting fundamentals

Businesses need to keep a record of their financial transactions in order that they can determine whether or not the business is profitable. Financial records will allow a business to analyse what might be causing a loss of profitability.

The board of directors of a business that has shareholders needs to be able to demonstrate to them that it has managed the financial affairs of the business in a way that the shareholders approve of. If the shareholders are not satisfied with the way that a business is being managed, they can vote against the board of directors at the annual general meeting (AGM).

Businesses prepare three key documents: the income statement (formerly known as the profit and loss account), the statement of financial position (balance sheet) and the cash flow statement. (Cash flow statements are not examined in this syllabus.)

Income statement

An income statement is a record of the revenues and expenses of a business over a period of time, usually one year. For this reason it is headed "Income statement for the year ended dd/mm/yyyy". It is a statement of what has happened in the previous period of time. Therefore the figures are fact rather than a prediction. However, a forecasted income statement might be prepared as part of a business planning process.

It shows whether the business is making a profit or a loss. It distinguishes between the gross profit and the operating profit and also shows the way in which that profit or loss has been determined.

It consists of a trading account which shows the sales revenue of the business together with the cost of sales and the gross profit.

Getting it right

Accounting students should take care not to confuse "cash flow statements" and "cash flow forecasts". Cash flow statements are not covered by the Cambridge International AS and A Level Business syllabus.

Key terms

Income statement: a document that gives the revenues and costs for a business and the resulting profit or loss for a stated time period.
Statement of financial position: the financial document that lists all the assets and liabilities of a business on a specified date.
Gross profit: sales revenue minus the cost of sales.
Operating profit: gross profit minus expenses (operating costs). (Used to be known as net profit)
Trading account: the section of an income statement that records the sales revenue and cost of goods sold to arrive at the gross profit.
Sales revenue: the value of sales (price × quantity sold).
Cost of sales: the direct costs incurred in the generation of revenue. Cost of sales = Inventory + Purchases − Inventory remaining.

Example

Income statement for Empdale plc for the year ended 31 May 2014		
	$000	**$000**
Sales revenue		10000
Opening inventory	1500	
Purchases	4000	
	5500	
Closing inventory	(700)	
Cost of sales		(4800)
Gross profit		5200

"Cost of sales" is calculated, by adding opening inventory to purchases and subtracting closing inventory.

Once the gross profit has been calculated, other expenses that have been incurred need to be considered such as office expenses, wages, rent, heating and lighting. These must be listed and their total cost is subtracted from the gross profit to give the net profit (the profit net of all expenses).

Example

	$	**$**
Rent	1500	
Heat and light	700	
Wages	1800	
Office expenses	250	(4250)
Operating profit		950

That is still not quite the end of the profit story because the operating profit must now be divided between other commitments (other than business expenses). The profit at this stage is known as "net profit before interest and tax". Any interest due and any tax on profits due to the government are now deducted, leaving us with a profit figure that is known as "profit after tax". The shareholders of the business will also expect to receive a share of any profit made and therefore a dividend is usually paid to them. The size of the dividend paid will depend on the amount of profit after tax and any investment plans that the business might be considering. Any amount left after such payments have been made is retained in the business for future use and is known as retained earnings.

The section of the income statement that divides the profit after tax between the shareholders and retained profit is known as the appropriation account.

Activity

You might find it useful at this stage to get hold of an income statement for any business and take note of all of the elements contained in it. You should identify the different sections within the statement. Try changing one or two of the figures, e.g. increase the sales revenue by 10 per cent and then follow the calculation through to see what effect this has on gross profit and operating profit.

Key term

Retained earnings: the amount remaining in the business after all costs have been deducted from revenue and all interest and tax due has been paid. This is sometimes known as retained profit.

Example

	$
Net profit before interest and tax	950
Interest	(50)
Profit before tax	900
Tax at say 20%	(180)
	720
Dividends paid to shareholders	400
Retained earnings	320

The statement of financial position (balance sheet)

A statement of financial position (balance sheet) shows the net worth of a business and contains a list of the values of the business's assets and liabilities. The assets and liabilities can be either short term or long term and a distinction is made between these when the values are recorded. The values given in a balance sheet are those that are correct on one particular day, usually the last day in the business's financial year. Therefore the heading does not say "for the year ended" as in the income statement; it is headed "Statement of financial position at dd/mm/yyyy".

Key terms

Assets: what the business owns.
Liabilities: what the business owes to another business or individuals.
Non-current assets: assets owned by a business that will be used for more than one year, such as premises and machinery (previously known as fixed assets).
Current assets: cash or assets owned by a business that can be turned into cash in the near future.
Non-current liability: a debt of the business that will be repaid over a period longer than one year, such as long-term bank loans and mortgages (previously known as long-term liabilities).
Current liability: a debt of the business that is to be repaid within one year.

What values are recorded?

Non-current assets (fixed assets)

The value of any premises, equipment and vehicles that the business owns will be recorded. These are assets that the business would expect to use for more than one year and are known as non-current assets (fixed assets).

Current assets

The value of current assets (assets that are expected to be used up within one year) is also recorded. Current assets include inventory (stock), trade receivables (debtors, i. e. money owed to the business by its customers) and cash and cash equivalents (bank balances and cash held as notes and coins).

Non-current liabilities (long, term liabilities)

Businesses not only have assets, they also have liabilities (money that they owe to other businesses or individuals). Liabilities might include an outstanding mortgage or a long-term loan taken from a bank. These are expected to be repaid over a period longer than one year and therefore are classed as non-current liabilities (long-term liabilities).

Current liabilities

Any debt that is expected to be repaid within one year is classed as a current liability (short-term liability). These can include an overdraft owed to a bank and trade payables (payments due to creditors – money owed, for example to suppliers, by the business).

A statement of financial position also allows a calculation of the net assets owned by a business and the working capital figure.

Shareholders' equity

This is composed of all permanent share capital (ordinary shares and preferred shares) and all reserves.

Reserves are retained earnings. There are two types of reserve: revenue reserves are profits retained out of "normal" trading activities, capital reserves are profits retained from capital transactions and adjustments to the capital structure of the company.

The net assets figure of a business is calculated by deducting the value of total liabilities from the value of total assets.

Key term

Reserves: amounts set aside out of profits other than provisions for depreciation, bad debts and taxation. This amounts to an aggregation of all of the retained earnings.
Net assets: total assets minus total liabilities.

Link

See working capital in AS Level Chapter 5.2 Business finance and its sources and AS Level Chapter 5.5 Forecasting cash flows and managing working capital.

Activity

Get a statement of financial position for any business. Identify the various elements that are included in it. Again, you might try to change one or two of the figures and then work through the impact of the changes.
For example, calculate the impact of taking on a long-term bank loan to purchase additional vehicles.

Key term

Equity: the value of shareholders' fund in a business, i.e. ordinary shares and preference shares.

Example

Statement of financial position (balance sheet) for Empdale plc at 31 May 2014

	$000	$000
Non-current assets		
– premises	700	
– equipment	275	
– vehicles	185	
		1160
Current assets		
– inventory	15	
– trade receivables	9	
– cash and cash equivalents	12	
		36
Total assets		1196
Non-current liabilities		
– Long-term bank loan (repayable 2032)	(185)	
Current liabilities		
– overdraft	(8)	
– trade payables	(11)	
	(19)	
Total liabilities		(204)
Net assets		992
Equity		
– ordinary shares		500
– preferred shares		200
Reserves		292
		992

N.B. Total assets are found by adding together non-current assets and current assets.
Net assets are calculated by deducting total liabilities from total assets.

Ratios

Ratios are a means of extracting more information from the financial statements of a business. They enable stakeholders to further investigate the efficiency of the business in respect of the liquidity and profitability of the business. They allow for comparisons to be made with the performance of earlier years and with similar businesses. They can give us information about the "quality" of the figures given in the final accounts.

Liquidity ratios

The two ratios examined are the acid test ratio and the current ratio. Liquidity is a measure of a business's ability to pay its short-term debts. As mentioned in Chapter 5.2, it is essential that a business is able to meet any short-term financial obligations if it wants to continue to trade. The liquidity ratio will provide more information about the extent of the current assets of a business relative to its current liabilities.

Current ratio

This is calculated by taking the total of all current assets and comparing them to the total of current liabilities.

Example

PMB Ltd has the following current assets and liabilities:

Inventory $600; trade receivable $600; and cash and cash equivalents of $300. The business has an overdraft of $300 and trade payables of $300.

Add together the value of inventory, trade receivables, and cash and cash equivalents = $1500

The total of current liabilities = $600

A current ratio is expressed by:
Current assets : Current liabilities (CA : CL)

Or: $\frac{\text{Current assets}}{\text{Current liabilities}}$

Using the figures for PMB Ltd: CA : CL

1500 : 600

The figures are to be expressed in their lowest form possible. In this case both sides can be divided by 100 giving a ratio of 15 : 6; i.e. 15 divided by 6 = 2.5 therefore giving a final ratio of 2.5 : 1.

This means that for every $1 of current liabilities the business has $2.50 of current assets that can be used to cover that debt.

There is not an ideal current ratio figure that a business should aim to have; more important is the ability to cover any short-term debts. If a business gives credit to its customers then it is advisable for it to have a higher ratio than a business that sells on a cash only basis. The reason for this is that the business that sells on credit might not get paid as quickly as it would like to and therefore it can find itself in a position it they cannot pay its short-term debts. If trade receivables take a long time to pay, a business might aim for a current ratio of 3 : 1 whereas as business that sells on a cash only basis might find that 1 : 1 is acceptable.

Key terms

Acid test ratio: the relationship between current assets less inventory and current liabilities.
Current assets – inventory: current liabilities.
Current ratio: the relationship between current assets and current liabilities.
Liquidity ratios: ratios designed to measure the ability of a business to meet its short-term liabilities.
Trade payables: money owed by a business to its suppliers for products purchased on credit.
Trade receivables: money owed to a business from credit sales to its customers.

Getting it right

The precise layout of financial statements varies from country to country and between textbooks. There are many styles of presentation that contain exactly the same information. If possible you should follow the layout that is given to you, but be aware that other formats are acceptable.

Link

The difference between cash and profit is discussed in AS Level Chapter 5.5 Forecasting cash flows and managing working capital.

Progress questions

A business has the following current assets: inventory of $4000, trade receivables of $4000 and cash and cash equivalents of $2000. The current liabilities for the business are: overdraft $3000 and trade payables of $2000.

1 Calculate the current ratio for the business.
2 Explain whether or not this ratio is acceptable for the business.
3 What impact would a reduction of stock have on the ratio?

Acid test ratio

The acid test ratio recognises that inventory might not be sold and therefore might not be available in a cash form to enable the business to meet its short-term liabilities. It might be old and is perhaps no longer in demand. If this is true then it is unlikely that the inventory will be turned into cash. The acid test ratio ignores the value of inventory and includes the more liquid assets of trade receivables and cash and cash equivalents.

Take the example of PMB Ltd again.

The total of current assets would be $900 (Trade receivables + Cash and Cash equivalents).

The current liabilities remain the same $600 (Overdraft + Trade payables)

The formula for the acid test ratio is:

Acid test ratio = Current assets (minus inventory) : Current liabilities

$$\text{Or: } \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

$$900:600 = \frac{900}{600}$$

Acid test ratio = 1.5 : 1

This means that for every $1 of short-term debt that the business has, it has $1.50 to cover it. This business might be sufficiently liquid but it would rely on its trade receivables paying in a timely manner. If any debtor delayed payment for a long time PMB could find itself unable to meet its short-term financial obligations.

Progress questions

Prambly Limited has current assets of: inventory $3000; trade receivables $5000; and cash and cash equivalents $1000. It has current liabilities of: overdraft $3000 and trade payables $2000.

4 Calculate the current ratio for Prambly Limited.
5 Calculate the acid test ratio for Prambly Limited.
6 Explain why the acid test ratio might be judged to be a more useful measure of liquidity than the current ratio.

Profitability ratios

It can be difficult to determine whether or not a profit figure is good or satisfactory for a business. Is a profit of $1000 better than a profit of $50 000? The answer to this question will depend on several factors such as whether the figure refers to the gross profit or the operating profit. How much did the business have to spend in order to generate that profit? If the $1000 profit had been achieved on sales of $2000, that would be a better return than the $50 000 if that amount of profit had been achieved from $2 000 000 of sales. The quality of the profit also depends on what the profit figure was in previous years. If the figure was higher in previous years then the current profit figure might not be satisfactory. A business might also compare its profit to that of similar businesses in the same industry.

Key terms

Profitability ratios: a means of measuring different types of profit in relation to sales revenue.
Gross profit margin: the relationship between the gross profit and the sales revenue of a business.
Profit margin: the relationship between the operating profit and the sales revenue of a business.

Calculating a profitability ratio will give more information than a statement of a profit figure.

Two profitability ratios that are assessed are the gross profit margin and the profit margin.

These are calculated as follows.

Gross profit margin

This shows the relationship between the gross profit of the business and the sales revenue (revenue) that generated the profit. Gross profit margin is expressed as a percentage.

The formula used for the calculation of gross profit margin is:

$$\frac{\text{Gross profit}}{\text{Sales revenue}} \times 100$$

If Delinge Ltd generated sales revenue of $20 000 and a gross profit of $5000 the calculation would be as follows:

$$\text{Gross profit margin} = \frac{5000}{20\,000} \times 100 = 25\%$$

This means that for every $1 of sales revenue the business earns a gross profit of $0.25.

The analysis of this result will include whether it is higher or lower than previous years. If the same business had consistently generated profits of 40 per cent or more in previous years then this year the business has not been as successful. The reasons for the change in gross profit margin must then be investigated. Has the cost of sales risen? Has sales revenue fallen? Is it a combination of both of these? What action can be taken to improve the situation for the future?

Progress question

7 A business has sales revenue of $40 000 and a gross profit of $15 000. Calculate the gross profit margin for the business.

Profit margin (sometimes known as net profit margin)

This shows the relationship between the operating profit and the sales revenue. Just like the gross profit margin this ratio is also expressed as a percentage.

The formula for the calculation of the profit margin is:

$$\frac{\text{Operating profit}}{\text{Sales revenue}} \times 100$$

If Delinge Ltd had sales revenue of $20 000 and an operating profit of $2000 the profit margin would be:

$$\frac{2000}{20\,000} \times 100 = 10\%$$

This result means that for every $1 of sales revenue the business earns a profit margin of $0.10 after all overheads have been covered.

Just as with the gross profit margin you must now question whether the result of 10 per cent is good or not. What was the profit margin last year or the year before that?

Progress question

8 A business has a sales revenue of $90 000 and an operating profit of $15 000. Calculate the profit margin for the business.

Analysis of gross profit margin and profit margin

When both of these ratios have been calculated further analysis can take place. The relationship between the two ratios will provide further information to stakeholders. The profit margin will illustrate how efficient the business is at controlling its expenses. For example, if a business had a gross profit margin of 50 per cent and a profit margin of 5 per cent, this might indicate that the business has lost control of its overhead expenses. However, it might also indicate that this is a business that naturally incurs a high level of overheads in order to generate sales.

A better indication is to look at the relationship between these two ratios over a period of time by looking back at previous years' accounts.

Example

In this example the business is improving its profit margin, which shows that it is getting better at controlling its expenses. The business is managing to generate more sales from lower expenses or overheads and is retaining a larger proportion of sales revenue as profit in 2014 than it was in 2012 and 2013.

Table 5.4.1 Profit margin ▼

	2012	2013	2014
Gross profit margin	40%	45%	48%
Profit margin	20%	22%	25%

If the profit margin was falling rather than increasing, this would indicate that expenses were rising at a greater rate than sales revenue. In this situation a business would need to examine its expenses and find the reason for the increase in overheads. There might be a valid reason. For example, the business might have increased its spending on advertising in the hope of generating more sales revenue in the future. An increase in advertising does not always have an immediate impact on sales revenue and therefore the spending might result in higher sales in the next financial period rather than the current one.

Ways in which businesses might try to improve ratio results

Businesses want to present the best possible picture of their performance to anyone reading and analysing their financial statements.

One way to improve liquidity ratios is to reduce costs by finding cheaper suppliers. However, this might have quality implications. A way to improve profitability ratios is to increase the selling price, but this can be limited by the extent to which customers would be willing to purchase at a higher price.

Other means of improving ratios could be as follows.

To cut costs in general

An improvement in ratio results might occur because the business has been striving to improve its overall performance. For example, there might have been a stronger focus on the management of costs as a result of which the profitability of the business would improve. Therefore, in this case, both the liquidity and profitability ratios are likely to show some improvement. Liquidity ratios would improve because of a smaller amount of cash or money from a bank account being spent on expenses or because fewer resources were being bought on short-term credit. Such action would preserve the level of current assets and prevent the raising of current liabilities.

To postpone spending

If a business was planning to purchase a non-current asset using money in the bank, this could be postponed in order to present a better liquidity ratio to stakeholders. Had the purchase gone ahead the value of the new non-current asset would be listed in the non-current asset section of the statement of financial position and the bank balances element of current assets would be reduced by the cost of the new asset. This reduction in the bank balance would reduce the current assets value and result in a weaker current ratio. Postponement of the purchase would delay this result until after the completion of the statement of financial position.

This also would help to improve the working capital position of the business.

Progress questions

9 Zeta Limited has a gross profit margin of 48 per cent and a profit margin of 21 per cent.

Explain the reasons for the difference between these two ratios.

10 The following information is for Jamello plc.

	$000 (2014)	$000 (2013)
Sales revenue	1600	1500
Cost of products sold	400	380
Overheads	320	550

a Calculate the profit margin for 2014.

b The profit margin for 2013 was 38 per cent. Explain the difference in the profit margins for 2013 and 2014.

Uses of ratio analysis

Financial accounts and ratios are used by various stakeholders.

To get financial support

A bank manager might want to consider the liquidity ratios of a business if the business has approached the bank for a loan or an overdraft. The bank manager would need to know that the business has the ability to make the repayments on the loan. If the previous income statement revealed that the business had a very low liquidity ratio then the bank might consider the loan to be too risky. The bank manager might also look at the profit margin because this would give an indication about how well the business is controlling and managing its current expenses.

Shareholders would want to see that their investment is going to be worthwhile. They would want to see that the business is being managed effectively and that it will yield them a return on the money that they spend on shares.

Figure 5.4.1 Shareholders will scrutinise ratios carefully ▶

> **Link**
>
> See also AS Level Chapter 5.2. Business finance and its sources.

To judge performance from one year to another

A business does not just look at the financial records for one year. A comparison will be made to determine whether the business is performing better or worse than it did in previous years. The shareholders might look at the final accounts to judge the impact of an investment project on the overall profitability of the business.

To compare the performance of a business with others in the same industry

A business might wish to look at the accounts of similar businesses to judge their performance relative to others in the same industry. They might see that other businesses in the industry are achieving a profit margin of 20 per cent or more. If the business in question is consistently realising a profit margin of less than 15 per cent this might indicate that it is not as efficient in controlling its expenses. It might need to look more closely at the expenses incurred and see if there are any inefficiencies that are causing costs to be higher than necessary.

Alternatively it might be that it is not the overheads that are the problem. It could be that the business is selling its products too cheaply and is therefore not receiving the amount in sales revenue that it should.

Limitations of using ratios

- Ratios are based on past information, and future performance might be very different.
- Information in published accounts may lack some detail that might change the interpretation of a ratio.
- It is a quantitative technique and other qualitative factors might also need to be considered.
- Ratios are a measure of good or poor business performance, but they do not give any information about the causes or possible solutions to any problems that they might indicate.
- Comparisons between businesses can be misleading because different businesses can use differing accounting techniques that could change the result of a ratio calculation. This would make any comparison of limited use because the comparison would not be one of like with like.
- The published accounts are an overview and could disguise an inefficient department or branch within a business.
- The statement of financial position (balance sheet) records the value of assets and liabilities on a particular day, but those values might vary substantially throughout the year.
- It can be difficult to compare the ratios of businesses that are very different in size. For example, a large business is likely to be able to buy materials in bulk and therefore to be given a discount by suppliers. Therefore any comparison between the costs of different businesses might lead to the conclusion that the large business is better at controlling costs when in reality they are getting cheaper supplies by virtue of their size, not their ability to control costs.

Getting it right

When you suggest ways in which a business might improve its profitability or liquidity remember to consider the impact that your recommendations can have. For example, will increasing prices really result in an increase in profit? Consider the possible reaction of customers to the increase in price.

Progress questions

11 Explain two uses of ratios.
12 Explain two limitations of using ratios.

Link

See also AS Level Chapter 1.5 Stakeholders in a business.

Main users of accounts

The owners of a business

The accounts of a business will be of use to many different stakeholders. The users of the accounts of a business will depend on the structure of the business. A sole trader or a partnership is not required to publish its accounts; they will be prepared for the purpose of calculating the amount of tax due to be paid and for the internal use of the business owners. They might want to compare one year of accounts with another so that they can judge whether the business is improving its performance over time.

In the case of a private limited company and a public limited company (plc) the owners of the business are the shareholders and they will be required to provide their shareholders with a copy of the accounts of the business. The shareholders will want to see whether or not the business made a profit and therefore whether or not they will be receiving any dividends. They will be able to see whether the managers are running the business in an efficient manner, for example by controlling the costs of the business compared to the revenue generated.

Lenders of finance

If a business approached a bank or other financial institution or an individual to ask for a loan, it is very likely that the potential lender would ask to see the final accounts of the business. This will allow them to judge whether or not the business is in a position to make the repayments on any loan that it might be given. They can also judge if the business is improving its financial position over time by comparing a few years' accounts to see if there is a positive or a negative trend in revenues and costs.

A potential lender would need to know that a business is efficient in getting paid for products or services provided to customers. A bank would be very concerned about lending money to a business that showed a large profit but failed to actually get the cash in from its customers. This could indicate that the business might be unable to meet the required repayments for the loan.

The government tax office

The business will be required to pay tax on profits made, therefore the tax authorities might ask to see a set of accounts to decide what amount of tax is due.

The government might also be considering giving a grant to a business and therefore might want to judge the potential for growth of the business if it was to be given some money to invest.

Customers

Customers of a business might want to know that the business is strong and will survive into the future especially if they are about to purchase a high-cost item from the business. They will want the reassurance that, if they need to buy parts for the product in the future, the business will still be in existence and therefore able to supply them.

Local community

People living close to the business might want some reassurance that there will still be employment in the area and whether or not more employees might be required in the future.

The managers of the business

The managers of a business are likely to use the income statement and the statement of financial position (balance sheet) to assess the performance of the business. They might want to compare the performance with that of other businesses in the industry to see if they

are performing better or worse than the industry average. They might be able to see that other businesses are more successful at controlling their costs, which might lead managers to search for cheaper suppliers or to resist a call to pay higher wages to their employees.

Employees

Employees are likely to want to see how profitable a business is or how large a proportion of business expenses are accounted for by wages and salaries. If employees have not had an increase in pay for some time and they can see that the profitability of the business has increased significantly over the same period, they might put pressure on the business for higher pay. Similarly, if the financial statements show that the profitability of the business is decreasing then the employees might decide not to ask for pay increases. The same could apply to employees considering demanding better working conditions or facilities.

Suppliers

Suppliers would need to know that a business is in a position to be able to pay for any products or services supplied to it. They would therefore use the accounts to judge the liquidity of the business.

The limitations of using published accounts

- They are based on historical data and therefore cannot be an accurate predictor of what might happen in the future. Published accounts are used to identify trends, for example trends in sales revenue and costs, but there cannot be a guarantee that the trend will continue; there might be a recession or economic growth, both of which could alter the future trend in the figures.
- The financial information is purely quantitative information and does not give any details on the qualitative aspects of the business. For example, how effective are the managers within the business? Are the workforce motivated or are the managers having difficulty getting their employees to work to the required standard?
- The accounts might have been "window-dressed", which means that they might have been produced to present a more positive set of figures. For example, if a business sells off some of its assets it can appear to have increased its liquidity when compared to earlier years, but the increase would be a one-off and might not be a true reflection of the longer-term liquidity position of the business.
- The published accounts present the financial details of a whole business and do not give any information about the performance of individual sections within it. It might be that one department has outstanding performance whilst others are inefficient, but their inefficiency will be hidden if the overall financial results for the business are satisfactory.

Key terms

Window dressing: changes made in the accounts of a business in order to present a more favourable picture to the users of the accounts, e.g. assets such as "goodwill" are overstated to make the business look better than it is.

Progress questions

13 Explain how two stakeholders might find an income statement and a statement of financial position useful.

14 Explain two limitations of using published accounts.

Exam-style questions

1 The following information is available for Trumbelt, a private limited company:

	2013	2014
	$000	$000
Current assets		
– inventory	8	12
– trade receivables	4	4
Cash and cash equivalents	20	0
Current liabilities		
– trade payables	16	20
– overdraft	0	12

a Calculate the current ratio for 2013 and 2014. [4 marks]

b Explain the possible reasons for the difference in the two current ratios. [4 marks]

2 **a** Explain what is meant by the term "acid test ratio". [2 marks]

b Explain why profitability ratios are important when assessing the performance of a business. [3 marks]

3 Discuss the usefulness of published accounts to two stakeholders of a business. [12 marks]

Key concepts

AS **Change** can be developed though considering the impact of changes on the accounts of a business.

AS **Management** is seen through considering management accounting and the use of ratio analysis to improve performance.

AS **Creating value** can arise from the use of accounts to improve business performance thereby improving value to customers.

AS **Strategy** is involved in major decisions involved in improving financial performance.

Progress check

You should now be able to:

AS use and make amendments to the contents of an income statement and a statement of financial position

AS calculate liquidity and profitability ratios and discuss the significance to a business of the results of ratio calculations

AS discuss the limitations of ratio analysis, the difficulty of making comparisons between businesses and the ways in which businesses might seek to improve them

AS analyse and evaluate the usefulness of published accounts to different stakeholder groups.

AS evaluate the usefulness and the limitations of published accounts.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **AS** the purposes of cash flow forecasts
- **AS** the difference between cash and profits
- **AS** the need for a business to hold cash
- **AS** construction, amendment, interpretation and uses of cash flow forecasts
- **AS** methods of improving cash flow in a business
- **AS** improving cash flow forecasts in a given situation

5.5 Forecasting cash flows and managing working capital

It is important to remember that a cash flow forecast is just that: a forecast; a prediction. It is an estimation. It is not a statement of what has already happened but rather of what can reasonably be expected to happen in the future.

Case Study

Midi Computers

Jan runs a shop selling computers. The shop has done very well since it was set up two years ago. Jan has sold computers for home use. The profits have been good as he has been able to put a mark-up of 50 per cent on the price the computer manufacturers charge him. Jan buys the computers for an average of $200 and he is able to sell them for an average of $300. With overheads averaging only $20 per computer that means a profit of around $80 per computer.

On the advice of a friend, Jan has recently started selling computers to business customers in Jan's town. He finds the business customers more demanding – they are much more skilled in negotiating lower prices and rather than paying cash for the computers they expect two months credit.

Average prices for business customers are $250 so he should be making a profit of about $30 per computer.

However, Jan is very disappointed. Instead of the business's bank balance going up, he has an overdraft. "You want to get some credit from your suppliers" said Rose, one of Jan's business friends.

1 Why do you think Jan can make a profit on each computer and yet find himself with an overdraft?
2 How might getting more credit from suppliers help Jan reduce his overdraft?

The purposes of cash flow forecasts

What is the difference between cash and profit and working capital?

An important fact that needs to be stated at the outset is that cash and profit are not the same things! Cash is a means available to pay for the things that a business or individual might want to buy. Profit is the difference between sales revenue and costs. However, products might have been sold on credit terms and so the money might still be owed to the business. Some customers might never pay their debts and therefore the "profit" on those items will never come into the business. Profit is not available to spend, e.g. cash can be used to buy coffee from the canteen but profit cannot.

Imagine that you have bought a painting for $50 and then someone admired it so much that they offered to buy it from you for $200. You have made a profit of $150! The purchaser says that he will pay you for the painting next week. You still have a profit but you do not have any cash. You go to the shops to buy some new clothes. What are you going to use to pay for the clothes? You cannot pay for them with your profit from the painting because you have not been paid yet.

Key terms

Cash: money in the form of notes and coins or other methods of immediate payment such as cheques. It also includes payments by credit and debit cards as the payments are received quickly.
Profit: the difference between revenues and costs. In cash flow terms it is measured when the transaction takes place as opposed to when payment is received.

Key term

Transaction: the activity of a buyer and seller agreeing to exchange a product/service for money either in the form of cash or credit.

Getting it right

Do not confuse a cash flow forecast with a cash flow statement. A cash flow forecast is a prediction. A cash flow statement is a statement of fact; what has already been recorded. Cash flow statements are not covered by the Cambridge International AS and A Level Business syllabus.

Key term

Insolvent: when a business is unable to meet its short-term financial obligations.

The profit was made at the time the transaction took place, but the cash was not available until payment had been made. The profit in all cases is calculated based on the agreed transaction *whether or not money has changed hands.*

Why is it so important for a business to hold cash?

Cash gives a business the ability to pay for everyday items such as wages and pay suppliers for raw materials or other products or services provided.

- If a business does not pay its suppliers there is a good chance that the suppliers will refuse to supply the business in the future. The business would then be unable to function.
- If a business was unable to pay the employees' wages the employees would look for work elsewhere. If a business was in financial difficulty it has been known for employees to allow the payment of their wages to be delayed, but this can only happen in the short term. Employees need their wages to be paid so that they can pay for things that they need such as food and other basic needs.

Sufficient cash must be available to a business to enable it to meet short-term financial obligations.

A business might be very profitable, but if it cannot meet its short-term debts it can be declared insolvent and will cease to exist.

However, there is also a danger with holding too much cash. There is an opportunity cost (see page 14) because the money could have been used in the business to increase sales or improve efficiency. Alternatively, money could have been placed in a bank account which would have paid some interest; this opportunity would have been be lost. Some cash may be held in bank accounts, but the other cash, notes and coins might be stolen. There is a trade-off between holding too much cash and having insufficient cash in a business.

Figure 5.5.1 The possible result of poor cash flow management – closure ▲

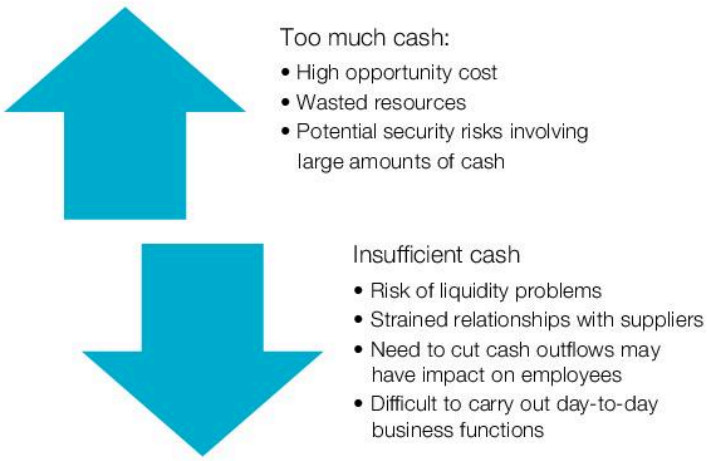


Figure 5.5.2 The trade-off between holding too much or too little cash ▲

Key term

Cash flow: the cash going into and out of a business.

It is very important that a business carefully monitors the level of cash in the business. This is achieved by using a cash flow forecast.

Figure 5.5.3 Example of a cash flow forecast ▼

	A	B	C	D	E	F	G	H	I	J	K	L	M	N
1	**Cash flow forecast for XYZ Chemicals**													
2		**Jan**	**Feb**	**March**	**April**	**May**	**June**	**July**	**August**	**Sept**	**Oct**	**Nov**	**Dec**	
3	Opening balance	20	20	30	–50	–30	0	30	70	105	65	35	–5	
4														
5	**Inflows:**													
6	Cash sales	50	60	70	80	90	100	110	110	90	70	60	50	
7	Payments from previous credit sales	10	15	20	25	30	35	40	45	35	20	15	10	
8	Bank loan													
9														
10	**Outflows**													
11	Lease	10												
12	Rent	10	10	10	10	10	10	10	10	10	10	10	10	
13	Materials (payments to creditors)	25	35	45	55	65	75	85	90	90	90	90	90	
14	Labour	10	15	10	15	10	15	10	15	10	15	10	15	
15	Other operating costs	5	5	5	5	5	5	5	5	5	5	5	5	
16	New machinery			100						50				
17														
18	**Closing balance**	20	30	–50	–30	0	30	70	105	65	35	–5	–65	
19														

Getting it right

A high proportion of businesses fail in their first year. Most business failures, particularly of new businesses are caused by cash flow problems. Businesses get "easy" credit from suppliers but then find there is insufficient cash inflow to pay the suppliers at the right time. So cash may be more important than profit at times.

Cash flow has different uses in business.

- **The cash flow statement**, previously known as funds flow statement, is a historical record of all of the cash inflows and outflows for a particular period of time. It forms part of the financial statements of limited companies. However, this particular accounting statement is *not* part of this syllabus either at AS or A Level and will not be discussed in this chapter.
- **Cash flow forecast.** Businesses need to know for planning purposes how the inflows and outflows of cash are likely to relate to one another in the future. This is particularly important to ensure that there is sufficient finance available for day-to-day operations. In situations where outflows are greater than inflows the business will need to make financial arrangements.

Case Study

Large increase in the failure of small businesses in Australia

In early 2012, the number of small business failures jumped almost 50 per cent compared with 2011. Australia became as high risk for small business failure as Europe following the Eurozone crisis. Even though interest rates were their lowest for many years, reducing debt costs for businesses, there was a large amount of uncertainty in the business world. Lack of confidence was keeping customers away. The global slowdown also meant customers had less money to spend. Customers were finding it more difficult to borrow because of the tightening of credit. While business overheads remained high, and were difficult to reduce for new, small businesses, pressures on cash flows increased.

As pressures on cash flow increased, financial analysts in Australia blamed poor management of cash flows for business failures. Small businesses do not have the large cash reserves that protect big companies.

1 What are the pressures that are reducing cash inflows?
2 Why is it difficult to reduce cash outflows?
3 Why is careful cash flow planning important for small businesses?

Key term

Trade credit: when products can be purchased and payment for them is not required immediately. For example, 30 or 60 days might be allowed before payment must be made.

Many new businesses fail due to a poor cash flow and not because the business is not profitable. New businesses often find that their suppliers require them to pay for products or services as soon as they receive them and it can be many months before any trade credit will be given to the business. However, the customer of the new business might expect to pay for the products or services at a later date because all of the other businesses that they deal with allow them to purchase on credit terms. The new business would be unlikely to gain business if they too did not allow credit to their customers. The problem is that the business is paying money out immediately but is then waiting for payment for products from sales. This creates a potential cash flow problem; money flowing out but no money flowing in.

Progress questions

1 What is meant by the term "cash flow forecast"?
2 Briefly explain the difference between cash and profit.
3 Explain one reason why cash flow is important to a business.

Uses of cash flow forecasts

Why would a business use a cash flow forecast?

The cash flow forecast is the modelling or projection of a business's future cash inflows and outflows over a specific future timeframe. The timeframe will depend on the use to which the forecast is to be put.

To predict times when there might be a shortage of cash in the business

For example, the business could identify when large payments might need to be made for raw materials and could then make sure that the cash is available to pay for them. Many payments that a business makes will be made on a regular basis, such as wages, yet others might occur only quarterly, half-yearly or annually such as electricity bills, insurance premiums or rent. These periodic payments can sometimes be forgotten, particularly by new businesses, then the payment of these items can cause a shortfall in the cash held in the business. A cash flow forecast would include all payments predicted to be made over a period of time and the business can be prepared for any less regular payments that must be made. Action can be taken to make sure that any possible shortfall in the cash available to the business is covered.

To plan for foreseeable variations in cash flow

Some businesses experience seasonal variations in the cash flowing into and out of the business. A business that is based on the tourist industry, such as a hotel, would expect to receive high inflows of cash during the tourist season. However, during the time of year when the tourists are not visiting there will still be costs to the business. The business will still need to pay for electricity and water and if the business premises have been bought using a mortgage then regular mortgage payments

will still need to be made. A cash flow forecast will help the business to plan for the months when less cash is coming into the business.

To set targets

Targets within the business might have to be adjusted. For example, if a shortfall of cash is forecast in a particular month then the cash sales target for the previous month might be raised in order to increase the inflow of cash into the business. A cash flow forecast can determine some of the actions within a business. Some activities might be delayed if they would cause a negative net cash flow. For example, a planned purchase of a new vehicle can be postponed if the cash forecast indicates that this would cause a liquidity problem.

Key term

Liquidity problem: when there is a possibility that a business will be unable to pay its short-term debts because there are insufficient liquid funds.

To show to a potential lender

It is usual for the business to be asked to provide a cash flow forecast when applying for a loan. This allows the potential lender to see if the business will be able to repay the loan. The lender will assess if the monthly repayments will be possible given the predicted cash inflows and outflows of the business.

To undertake "What if?" analysis

A cash flow forecast can be used to assess the possible implications of changes to sales and costs. For example, it could show the potential impact of undertaking cost-saving measures, or having an advertising campaign to try to increase sales, or the consequences of changing credit terms either regarding trade receivables/debtors or trade payables/creditors.

Key terms

Trade receivables/debtor: a customer that owes money to a business for credit purchases. They have agreed to pay at a later date.

Trade payables/creditor: a business, usually a supplier, which is owed money for credit purchases, to be paid at a later date.

Constructing a cash flow forecast

There are three stages to constructing cash flow forecasts:

1 Decide on time span and time period (often the time span will be 12 months, the time period will be one month).

2 Identify all of the cash inflows. These are likely to be:

- **a** cash injections such as owner's capital
- **b** receipt from bank of agreed bank loan
- **c** customers' cash purchases
- **d** repayments of purchases bought on credit.

3 Identify all of the cash outflows. These are likely to be cash payments for:

- **a** leases and other costs associated with the property the business uses
- **b** payments for utilities – telephone, energy, water
- **c** labour – employees' wages, taxes and financial benefits
- **d** raw materials and other purchases from suppliers, although these are likely to be bought on credit
- **e** creditors to pay for previous purchases
- **f** new equipment and other capital investments.

Link

See also A Level Chapter 5.8 Analysis of published accounts.

A cash flow forecast can be very difficult for a new business to prepare because the business will not have any financial history on which to base its predictions. An established business can look back at what has happened before and can then build this in to a reasonably accurate forecasted cash flow for the future. It is important that a cash flow forecast is as realistic as possible. New businesses can sometimes be too optimistic about how successful they expect the business to be. Creating a "best", a "worst" and a "most likely" scenario is often a useful exercise for a new business when preparing cash flow forecasts before the business begins trading.

Example

Bellevue Hair Salon has several regular customers and can estimate, quite accurately, the cash inflow from customers each month.

The only cash inflow is from customers paying to have their hair styled.

The cash outflows are more numerous. There are two stylists who are paid each week. The shop is rented and the rent is paid monthly. Supplies of hair products are purchased every two months. Insurance premiums for the business are paid quarterly.

Cash inflows: Payments from customers.

Cash outflows: Wages; rent; payments to suppliers; insurance premiums.

The following simple format is often used to produce a cash flow forecast.

Cash inflows	**$**
Income from customers	500
Total inflow	500
Cash outflows	
Rent	200
Wages	150
Total outflow	350
Net cash flow	150

Key term

Net cash flow: cash inflow minus cash outflow. This can be either a positive or a negative figure.

It simply lists:

- All cash inflows and shows a total for them
- All cash outflows and a total of outflows.

Then it subtracts the total cash outflows from the total of cash inflows to give a figure for the net cash flow.

Example

In this example the business has $150 more coming into the business than flowing out of the business. The difference between the cash inflow and the cash outflow is known as the net cash flow. This can be either positive or negative. In this instance Bellevue Hair Salon has a positive net cash flow.

Getting it right

Net cash flow in this context can easily be confused with net cash flow forecast in investment appraisal (A Level Chapter 5.8 Analysis of published accounts).

Although we are focusing on cash flow forecasts in a business situation, businesses are doing the same calculations that many individuals and households do frequently. In a household there is usually a need to list

Activities

1 Draw up your own cash flow forecast. You can include any money that you might earn either at home or from a part-time job. You should also include any planned expenses such as a brother or sister's birthday present.
2 In small groups draw up a cash flow forecast for an average household.

all of the income that can be expected and all of the bills that need to be paid. The householder will then look at the closing balance to see if they need to draw on their savings or take out a loan or an overdraft. This will depend on whether or not they expect the shortfall in cash to be a short-term or a long-term situation.

Businesses are doing exactly the same thing.

However, the example above was only for one month of trading and there are other payments that need to be made such as the payments to suppliers every two months and the payment of insurance premiums every three months. The cash flow forecast will look different for those months. This is illustrated in the following example where the business also starts the period, at the beginning of May, with a cash amount of $50.

	May	June	July
	$	$	$
Cash inflows			
Income from customers	500	500	500
Total cash inflow	500	500	500
Cash outflows			
Rent	200	200	200
Wages	150	150	150
Supplies		50	
Insurance premium			50
Total cash outflow	350	400	400
Net cash flow	150	100	100
Opening balance	50	200	300
Closing balance	200	300	400

Even with the extra outflows in months 2 and 3 Bellevue Hair Salon still has a positive cash flow. The business is not going to be in a position where it cannot cover the necessary cash outflows.

If the calculation began without any figure being given for cash held at the start of the process then the balance to carry forward (closing balance) from the first month would be the same as the net cash flow.

The closing balance for month 1 is added to the net cash flow for month 2 to give a closing balance for month 2 and so on through all the months of the cash flow forecast.

What if there was a change to the cash inflows and outflows?

The cash inflows and outflows of a business can change, in which case the cash flow forecast might need to be adjusted. For example, Bellevue knows that in June a new salon is due to open in the same neighbourhood and therefore it is possible that Bellevue might experience a decrease in customers, causing its cash inflow to fall. The owner of Bellevue is also aware that a rent increase will come into effect

in June. The owner knows the importance of cash flow and therefore needs to build these changing factors into a cash flow forecast.

If the income from customers fell to $350 and the landlord is increasing the rent to $300, what impact would that have on the cash flow forecast?

	May	June	July
	$	$	$
Cash inflows			
Income from customer	500	350	350
Total cash inflow (a)	500	350	350
Cash outflows			
Rent	200	300	300
Wages	150	150	150
Supplies		50	
Insurance premium			50
Total cash outflow (b)	350	500	500
Net Cash Flow			
(a – b)	150	(150)	(150)
Opening balance	50	200	50
Closing balance	200	50	(100)

The figures in brackets ( ) indicate a negative amount.

The decrease in income from customers and the increase in rent have resulted in Bellevue Hair Salon having a predicted negative cash flow in July.

The owner of the hair salon will have to take action to ensure that the negative closing balance in July does not affect its ability to pay its suppliers or employees' wages. It is circumstances like this that can cause a business to ask for an overdraft facility on its bank account to cover the likely short-term shortfall. The owner might decide that they would prefer to plan to put some more of their own money into the business if the predicted negative cash flow was expected to last for a longer time.

If the shortfall is predicted to be only for a short period or perhaps due to seasonal factors then other action might not need to be taken. However, in this example, if the new salon continues to take customers away from Bellevue then the owner of Bellevue will have to take action. Perhaps it can reduce its prices, but this might reduce the income from customers even further if customers are not attracted back to Bellevue. The situation will certainly have to be closely monitored and action taken if necessary.

In the case of a hair salon the customers could possibly all pay in cash. However, the cash flow situation can be further complicated when a business has credit customers. The business will need to build the delay in payment into the cash flow forecast.

Progress questions

4 Explain two uses of a cash flow forecast.
5 Explain what is meant by a "liquidity problem".
6 Why might a business experience problems forecasting cash flows?

Interpretation of cash flow forecasts

From a cash flow forecast it is necessary to check for the following possibilities:

- Are there times of the year when a cash shortfall is forecast?
- If there are, how long is it predicted to last?
- What is the largest cash shortfall?
- What causes the cash shortfalls?
- In which months does the business have a cash surplus?
- How large do the surpluses become?

Knowing the answer to these questions can suggest strategies to deal with cash shortfalls. For example, should the business:

- Borrow to cover shortfall periods? This might increase the cash surpluses.
- Attempt to reduce cash outflows? This may only exacerbate the cash surpluses.
- Attempt to increase sales to increase cash inflows? This might work if it is done in the low sales months.
- Borrow to cover capital investment. This may work if the surplus is used to repay the debt later on.
- Do nothing. This may work in the short term but if the shortfall is predicted to be worsening then action must be taken.
- Reschedule spending commitments. How critical are they to the business's operations?

The answers may also lead to suggestions of strategies to deal with cash surpluses. However, the cash flow forecasts are based on forecasts and the answers to these questions are totally dependent on the assumptions made for these forecasts. This means that the forecasts are only as good as the assumptions. This leads to the most important use of the forecasts: the "What if?" analysis.

By varying the assumptions the cash flow will show how sensitive the key outcomes (cash shortfalls and cash surpluses) are to the assumptions made. This means that informed decisions can be made with some regard to risks and uncertainties.

Getting it right

You must be prepared to draw up a cash flow forecast or to calculate missing figures from a given forecast. You might be asked to make adjustments to a given cash flow forecast from given changes that are expected to occur. You should also be prepared to interpret a given cash flow forecast.

Amendment of cash flow in the light of changed circumstances

Because cash flow forecasts refer to the future, and the future is unknown, they can only be constructed based on assumptions about the future. These assumptions are likely to change with time. "What if?" analysis explores the impact of changing assumptions. Cash flows can easily be adjusted for different assumptions particularly if the cash flow has been set up as a spreadsheet.

Typical assumptions that can be changed include:

- Different value of sales
- Different credit terms offered to customers
- Different credit terms from suppliers
- Changes in prices (own product/services)
- Wage changes
- Changes in other input costs
- New loan
- New capital spending.

Assessing the impact of such changes means modifying the appropriate numbers in the cash flow forecast remembering that a change in the closing balance changes the opening balance for the next time period.

Example

S & J Limited is a small engineering business manufacturing components for small domestic appliances.

Their cash flow forecast for the first four months of the year is as follows.

	January	February	March	April
	$000	$000	$000	$000
Cash inflows				
Cash receipts	275	300	325	425
Payments from debtors	150	125	75	?
Total cash inflows	425	425	400	600
Cash outflows				
Rent	250	250	250	250
Wages	150	150	150	150
Suppliers	100	125	150	150
Total cash outflows	500	525	550	550
Net cash flow	(75)	(100)	?	50
Opening balance	125	50	(50)	(200)
Closing balance	50	(50)	(200)	?

Getting it right

Remember, cash flow forecasts are predictions. They are based on assumptions. Forecasts cannot be "right" or "wrong"; however, they can be realistic or unrealistic, based on good assumptions or poor assumptions.

Key terms

Closing balance: the amount of cash held in a business at the end of a period of trading.
Opening balance: the amount of cash held in a businesss at the start of a period of trading.

Getting it right

You should be prepared to comment on trends shown in a cash flow forecast and to decide whether they are improving or worsening.

Progress question

7 Fill in the missing figures in the cash flow forecast for S & J Limited.

Methods of improving cash flow

There are times when a business must take action to improve its cash flow position.

Key terms

Cash inflow: cash flowing into a business from sales or loans.
Cash outflow: cash flowing from a business, e.g. to pay rent or to pay suppliers.

It must take a close look at the relationship between cash inflows and cash outflows.

Can it increase cash inflows? If cash inflows are the cause of the problem because of delays in receiving them, can it speed up cash inflows?

Can the business reduce the outflows of cash? Can cheaper suppliers be found? Can longer credit terms be arranged with suppliers?

Reduce credit period given to customers (trade receivables/debtors)

Debtors can be asked to settle their debts more quickly. Perhaps in the past a 60-day credit period might have been given to established customers of the business. The credit period could be reduced to 30 days, therefore making sure that the business does not have to wait as long to get payments in.

However, this might result in some customers taking their business to another organisation especially if other businesses in the same industry are allowing 60 days credit to their customers. Most businesses want to get money paid to them as quickly as possible while wanting to delay the time when they pay for products for as long as possible. Businesses need to find a balance that is acceptable to their customers and their suppliers.

If a very big customer refuses to accept the shorter credit period, the business will have to consider very carefully whether or not it can afford to lose the business of that customer.

Many businesses offer discounts for earlier payment of outstanding debts, but this will have the effect of reducing the actual amount received by the business. The business will have to decide if it is better to receive a slightly smaller payment quicker or to wait for a longer period of time to receive the full amount of the invoice.

For example, a business supplying oil for domestic heating could consider offering a discount of 2p per litre if payment for fuel is made before the 15th day of the month following the date of the invoice.

The discount would be likely to have the effect of reducing the time that the majority of customers take to pay for their fuel.

Reduce costs

It might be possible to reduce the cost of materials essential to the business. This can be achieved by finding a cheaper supplier or perhaps

by renegotiating the prices paid to the current suppliers. If a supplier fears that they will lose a customer they can often be willing to charge a lower price.

Example

Suzie and Ahmed run Lakeside, a small hotel. They offer bed, breakfast and an evening meal to their guests. They purchase frozen meat, vegetables and pastries from MPJ Limited, a local supplier. After several increases in the price of those products over the past three years, Suzie and Ahmed decided that they could no longer afford to use their current supplier. The increased cost of food ingredients was having a negative effect on their cash flow situation. When a representative from MPJ Limited telephoned for the weekly order Suzie told him that they were considering buying from a cheaper supplier. MPJ Limited rang back within ten minutes to offer them a 10 per cent discount on their orders.

Cash flow improved!

Activity

Can you think of any reason why MPJ did not offer a 10 per cent discount to Suzie and Ahmed until they said they were about to buy from another supplier?

Increase the price of products or services sold

It might be possible for a business to increase the prices that it charges to its customers. However, this will depend on whether or not there are a lot of competitors because, if there are, their customers might start to buy from the competition. This would reduce the cash inflows even more. It can also depend on just what the product is. For example, in some countries the price of some products is regulated by the government, in which case an increase in price would not be an available option. For example, in Malaysia, for many years the government controlled the price of chicken because this was an important food source for the population.

Increase sales

This might seem a little unconventional as a means to improving cash flow because there are likely to be some cash outflows associated with this action. It might be necessary to purchase more items to sell, which would mean cash outflow! It might require an increase in advertising to encourage more sales, which would mean cash outflow! However, if the time between these actions and the time when the money is received for the extra products sold is short, the result will be an overall increase in net cash flow.

There are also occasions when inventory (stock) has been in storage for such a long period of time that all hope of ever selling it is almost gone. The inventory will have already been paid for. The money has gone. Even if the products cost $10 each to purchase it might be worth the business selling them off at $1 in order to get rid of them and to get some cash flowing into the business. While these "old" items are held in stock they are incurring storage costs and have already caused a cash outflow without any following inflow.

Getting it right

Beware of simply saying that an increase in sales would increase cash inflow because if that is to happen, the sales must be for cash not on credit.

Extend credit periods to creditors (suppliers)

This is the reverse of the situation described when looking to reduce the credit period given to customers. If a business is paying for any products that it purchases within 30 days but their customers are paying them,

on average, after 60 days, one solution to any cash flow problems is to extend the time that is taken to pay suppliers to 60 days. In this way the money is flowing out on the same time scale as money is flowing in and this might therefore prevent any cash flow issues.

There are two ways in which the credit payment can be extended: by agreement with the supplier or by just delaying payments.

Extending the time taken to pay suppliers might create a cash flow problem for the supplier and therefore they would not agree to any extension of credit terms. If the credit period is extended, not by agreement but simply by delaying payment, the supplier might begin to worry that the purchasing business is unable to pay for the products received. In some circumstances this might result in the supplier refusing to supply any products in the future. This might depend on how big the customer is that is delaying payment.

Debt factoring

Key term

Debt factoring: when a debt factoring business will pay a sum of money to another business for customers' debts. The business selling the debt receives the cash payment. The debt factor receives the payments from customers. The debt factor pays less than the value of the debts to be collected.

When products or services are sold on credit an invoice will be issued to the purchaser. If a business (business A) wishes to improve its cash flow position, it might need invoices to be settled quickly. Cash flow can be improved by selling invoices to a debt factoring business (business B). The debt factor will pay for the invoices: usually approximately 80 per cent of the invoices' value. This gives the original business A the inflow of cash that it needs to improve cash flow. The factoring business will keep the remainder of the money recovered. The remainder of the value of the invoice is kept by the debt factor (business B) because that is its revenue for the service given to business A. For example, Business A sells invoices to the value of $1000 to Business B. Business A receives $800 for the invoices. The remaining $200 will be retained by Business B; that is its payment for recovering the debt.

There are problems associated with debt factoring:

- Only part of the invoiced value is received
- Debtors might not like having their debt sold on to another business
- Customers might not want to deal again with the business that sold their debt.

Progress question

Antonio and James run a small business where they hand make men's clothes. They have many very loyal customers who are allowed on buy on credit.

8 Explain why it might not be appropriate for them to seek to improve their cash flow by selling off invoices to a debt factor.

Longer-term methods of improving cash flow

Other possible solutions that may not work in the very short term involve the business's fixed assets – those assets such as building and machinery that are expected to work for the business for a period longer than a year.

Link

See sources of finance in AS Level Chapter 5.1 Business finance and its sources.

Sale and leaseback

The option might be taken to sell some assets to a lease company and then to lease them back so that they can still be used within the business.

The sale of the asset will bring an inflow of funds into the business, but the fact that it will then be leased from the leasing company means that there will also be regular cash outflows in terms of lease payments. An immediate cash inflow has been achieved, but a cash outflow is also created that will continue for the length of the lease.

If a business is experiencing a short-term cash flow problem the sale of assets might be an appropriate solution. Businesses must be certain that the regular payments to the leasing company will not create a cash flow problem for the future.

Leasing

If a business needs to purchase some new equipment but does not want to have a large cash outflow to purchase it, leasing might be the answer. When equipment is leased it means that it remains the property of the leasing company but that another business can pay to use the equipment for an agreed length of time. This will require a commitment to regular payments; usually monthly or quarterly. The equipment being leased will never become the property of the business using it unless they have an agreement to purchase at the end of the lease period.

This can be a useful way of managing cash flow when a new product is being developed as the cash outflows will be high in the early stages because while the development process in being undertaken there are outflows without any inflows. Leasing reduces the outflows in the early stages.

Sale of assets

In some cases the business may have unused, or underused assets. These could be sold provided that they are not so essential that their loss will mean the business cannot continue to function. Such action is often extreme but may be necessary if the business's survival is threatened.

Hire purchase

This can work in the same way as leasing. A business can acquire equipment without needing to pay the full cost of the equipment at the time of the acquisition. In the case of hire purchase, a business would be required to pay a deposit to the hire purchase company and would then repay the remainder of the cost plus interest over an agreed period. Regular payments would be required. As with leasing, the need to have a cash outflow for the full cost of equipment is avoided, but there will be regular outflows thereafter due to the regular payments that are required. At the end of the hire purchase agreement the equipment becomes the property of the purchasing business.

As with leasing, this helps to spread the cost of equipment over a longer period of time.

Table 5.5.1 Methods of improving cash flow ▼

Method	Possible advantages	Possible disadvantages
Increasing sales	Potentially easy way to improve cash inflows	May only be achieved by reducing prices, which might not have the desired effect on cash income Also costs might increase, reducing net inflows
Reduce credit terms to customers	Immediate impact on cash flows	Can only be done once How will customers react?
Debt factoring	Quick injection of cash	Debt factoring comes at a cost which will have an eventual impact on profits. Could be a signal to stakeholders of liquidity problems. Can only be done once
Sale of assets	Could be significant cash inflows	Is it likely any assets are not needed? How quickly could they be sold? Quick sales will lead to low prices Can only be done once
Sale and leaseback	Could be significant cash inflows	Who would buy? Would control of asset be lost? Loss of future collateral for a loan Lease costs would reduce future years' profits Can only be done once
Use an overdraft facility	Quick, simple	Usually expensive way of borrowing money Bank can withdraw overdraft facility, hastening a liquidity problem Intended to be only for the very short term
Cut spending by finding cheaper raw materials	May help increase profits	May lead to lower levels of quality Could upset relationships with existing suppliers
Cut spending on overheads	It may be possible to identify inefficiencies	Will there be long-term consequences? For example, cutting advertising spend will have little effect in the short term but can effect longer-term sales, and hence cash flow
Lease capital equipment rather than buy it	There will be no large cash outflow, but a longer sequence of small cash outflows Leased equipment can be more easily updated than bought equipment	Leasing costs will be higher than purchase in the long term, affecting future profits Less control over the asset
Delay payment to suppliers	Immediate impact on cash flow	Would supplier agree? May have a detrimental effect on suppliers' cash flow, which could affect relationship with supplier
Delay purchase of capital equipment and other capital spending	Delays cash outflows	How important is the equipment? May delay expansion and hence future profits Impact on supplier who might maintain existing equipment

Key: Methods in blue have an impact on cash inflows
Methods in red have an impact on cash outflows

Key term

Overtrading: when a business expands at such a fast rate that it lacks the finance to support the higher rate of business activity.

Overtrading can best be managed by slowing down the rate of expansion. An overdraft may be needed to help cash flow in the short term.

Progress questions

9 Explain two ways of improving cash flow within a business.
10 Explain two disadvantages to a business of selling its outstanding invoices to a debt factoring business.
11 Explain why reducing the credit period for debtors might not be of benefit to a business.

Recognising methods of improving cash flow/working capital

Working capital

Related to the concept of cash, profit and cash flow is the concept of working capital. Managing cash flow and managing working capital are closely related.

> **Link**
> Working capital was introduced in AS Level Chapter 5.1 Business finance and its sources.

Cash flow describes the *flows* of cash in and out of a business.

Cash describes the *stock* of money in the business.

Working capital extends the idea of the stock of money to include other aspects of a business's finances that could be easily converted into cash if there was an urgent need. For example:

- Stocks of finished products could be sold and converted into cash
- Customers who have not paid yet (known as trade receivables/debtors) could be required to pay sooner than usual, bringing cash into the business
- Suppliers who provide credit (trade payables/creditors) could be asked if the business's credit terms could be extended – delaying payments out of the business.

These "near cash" items form working capital – the amount of money (capital) in a business needed to cover the day-to-day operations of the business.

> **Link**
> For more on how working capital is measured, see AS Level Chapter 5.1 and 5.2 Business finance and its sources.

So working capital is the stock of money and near money in a business. As described in AS Level Chapter 5.1, it is the money needed for the day-to-day operation of the business.

A business may face liquidation if there is a shortage of cash. However, it can prevent liquidation if it can turn some of its working capital into cash quickly.

So cash flow problems can also be helped by proper management of working capital:

- Controlling the level of stocks
- Effective credit control to ensure debtors are paying
- Negotiating appropriate credit terms with suppliers.

If cash is needed in an emergency, then this can be achieved by:

- Gaining cash from debtors:
  - giving customers shorter credit periods
  - not giving credit to new customers
  - ensuring debtors do pay, and pay on time using discounts for prompt payment
  - selling customers' debt to debt factors.

- Releasing cash from stocks
- Holding smaller levels of buffer stock
- Using just-in-time methods of stock control
- Increased stock monitoring, e.g. using computerized information management systems
- Reducing cash paid to creditors:
  - renegotiating credit terms
- Seeking cheaper sources of supply.

In order to decide which method of improving cash flow or of improving working capital is going to work in a given situation it is essential to identify the causes of the problem(s).

Once these have been identified, and the circumstances of the business and the constraints on it identified, then an appropriate method can be chosen.

Universal solutions to the problems are unlikely but the following ideas might provide guidance:

- If the problem is related to falling sales then a marketing approach might be considered or some other method to improve cash inflows.
- If the problem is related to falling payments from customers (increasing significance of debtors) then increased credit control or the employment of debt factors may be solutions.
- If the problem is a short-term one, an overdraft may be appropriate. However, if it is a longer-term problem it can be unwise to solve a cash problem through further borrowing. Perhaps leasing assets or some other asset-related solution might be appropriate.
- If the problem is cash outflow related then reducing costs, or negotiating different credit terms with suppliers, may help.

Getting it right

When faced with a cash flow or liquidity problem make sure you analyse methods of reducing the problem that are consistent with the evidence that you have about the business and its problems.

Case Study

Carrefour's profit in France falls 40 per cent in 2011

Carrefour, the French supermarket chain, and the second-largest retailer in the world, saw shares fall dramatically in early 2012 as poor profit results were announced.

In 2011, faced with increasing costs of the products it sells in France, Carrefour increased its prices. However, other French supermarket chains did not follow. Carrefour then lost customers and market share. Subsequent to the resulting falling profit figures Carrefour reversed its pricing policy and reduced prices. Probably because of falling economic activity caused by the Eurozone crisis, Carrefour has been unable to recover sales as many customers have failed to return to the shop.

Carrefour's response to falling profits has been to: abandon a merger with a Brazilian supermarket chain, postpone major shop refurbishments and introduce redundancies throughout the workforce.

1 What do you think Carrefour hoped to achieve by increasing prices?
2 What do you think Carrefour hoped to achieve by reducing prices?
3 Why do you think neither policy achieved the desired effect of increasing profits?
4 What impact is Carrefour's response to falling profits likely to have on cash flows and profits?

Exam-style questions

1 Explain the potential benefits to a business of using cash flow forecasts. [5 marks]

2 a Explain the difficulty that a new business might have when preparing a cash flow forecast. [8 marks]

b Discuss how a retail business might try to improve its cash flow. [12 marks]

Condor Copper (CC)

CC is a private limited company. CC has discovered copper in a remote region of your country. CC plans to develop a copper mine which will involve a large investment in infrastructure and machinery. CC has produced the following cash flow forecast for the project.

CC's cash flow forecasts ($m)

Year	2013	2014	2015	2016	2017
Opening balance	−100	−60	−70	−50	130
Sales of copper	0	0	40	200	400
Development costs	160	10			
Operating costs	0	0	20	20	20
Closing balance	−60	−70	−50	130	X

3 Using the information in this table calculate the closing balance for 2017. [2 marks]

4 Evaluate the usefulness to CC of this cash flow forecast. [10 marks]

Bargain Basement (BB) Limited

Bargain Basement (BB) Limited is a business with several large retail outlets in many large towns selling household products and basic foods at very low prices. Two months ago the decision was taken to expand the range of items being sold to include plants and some small furniture items. It is hoped that the expanded range of products will bring many new customers to the shops of BB. The changes being made are not as a result of any feedback from customers but are because the managers of some shops feel that the extra items will boost overall sales. The management recognise that they will need to spend money to purchase the new items before they are able to put them on sale. They are worried that this will have a negative effect on the cash flow situation.

The management of Bargain Basement (BB) Limited has prepared a cash flow forecast for the next three months. The new range of products will go on sale for the first time in June.

	April	May	June
	$000	$000	$000
Cash inflows			
Sales	23	22	25
Total cash inflow	23	22	25
Cash outflows			
Rent	5	5	5
Wages	4	4	4
Purchases	12	20	21
Total cash outflow	21	29	30
Net cash flow	2	(7)	(5)
Opening balance	7	9	2
Closing balance	9	2	(3)

5 BB has increased its purchase of items in May ready for the launch of the new products in June. If BB took the decision to reduce the purchases made in May to $16000 what would be the effect on the closing balance in June? [3 marks]

6 Explain why it was useful for BB to have produced this cash flow forecast before launching its new range of products. [4 marks]

Key concepts

AS **Change** can be developed though the impact of changing factors on cash flow.

AS **Management** is involved in implementing methods to improve cash flow.

AS **Strategy** requires strategic decisions to improve cash flow.

Progress check

You should now be able to:

AS comment on the importance of cash to a business and analyse the possible consequences of holding insufficient cash

AS construct and amend cash flow forecasts from given information

AS discuss the possible methods of improving cash flow and the appropriateness of each method to different situations.

You should be able to relate these to a range of businesses in different situations.

1 Business and its environment

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- A how the state might intervene to help businesses
- A how the state might intervene to constrain businesses
- A how the state might deal with market failure
- A the key macro-economic objectives of governments
- A the impact of macro-economic objectives on business activity
- A how a government might place a different emphasis on macro-economic objectives from time to time
- A the policy instruments used to achieve macro-economic objectives
- A how changes in macro-economic performance and policies may affect businesses behaviour

1.6a External influences on business activity: economic constraints and enablers

Introduction

This chapter and A Level Chapter 1.6b are concerned with factors outside of a business's control that influence the way the business behaves.

Factors include:

- The role of the state through laws and the management of the economy
- Changes in technology
- Changes in social attitudes
- Population changes
- The environment.

This chapter will focus on the way the state has an impact on businesses through the way it manages the economy of a country. A Level Chapter 1.6b will focus on the other constraints and enablers: legislation, technology, social, demographic and environmental changes.

How the state might intervene to help businesses

There will always be arguments about the extent to which the state should be involved in businesses' activities. There are those who argue that business (and individuals) should be allowed to get on with their activities without any government involvement. There are those who seek more involvement by the government.

There is, however, agreement in most countries that a thriving business sector is essential to the well-being of a country and its people.

Businesses provide:

- Employment for people and communities
- Economic wealth and growth which enables schools, hospitals, defence and other essential services to be provided
- The products and services people need and want
- Innovation.

Because countries and governments regard a thriving business sector as so important for the development of a country, the government will provide incentives to help businesses grow and flourish. The extent of the support depends on the country involved but typically support includes:

- Taxation systems that encourage businesses to start up
- Taxation systems that favour investment
- Information and other services, particularly to help businesses to start up and to export

- Grants and other forms of subsidies to help businesses that provide essential services, or where new ideas need support early on
- Favourable treatment when governments want to encourage investment in particular regions of the country
- Financial support for employing young people or the unemployed
- Awarding contracts to local businesses.

How the state might intervene to constrain businesses

Governments recognise that although businesses are generally beneficial to a community and country, left to themselves businesses might not have full regard for the consequences of their action on people in general – businesses are no different from individuals in this respect.

Therefore, in the same way as there are rules and regulations governing our individual lives (what side of the road we drive on, what behaviour we regard as illegal, what age we can leave school etc.) there need to be laws and regulations to govern businesses. A business may find its activities constrained if:

- Products and/or services provided by the business are, in some sense, regarded as harmful (e.g. tobacco products) or unsafe (e.g. electrical products that can give an electric shock)
- It has processes that may damage the environment
- It does not treat its employees fairly
- It has become too powerful and exploits people
- It is involved in unfair practices such as using bribery to get contracts, or agreeing with other businesses to fix prices
- Markets are not competitive or fail
- It does not meet internationally agreed standards.

These issues are dealt with more fully in A Level Chapter 1.6b.

The greatest influence of the government on business activity results from its role in managing the economy. In this chapter we shall focus on that external influence on business.

Link

For additional external influences see A Level Chapter 1.6b External influences on business activity: additional external constraints and enablers.

Progress questions

1. Give three reasons for government to constrain the activities of a mining business.
2. Why is it not a good idea to allow education to be limited to only those who can afford it?
3. Explain why a failing in the harvest of a key source of food (e.g. wheat, maize or rice) might require intervention from the government.

How the state might deal with market failure

Many people believe that the role of the government should be as small as possible, with governments leaving important decisions to markets – that is, the interaction between buyers and sellers. So, for example, it is better for the price of a car to be determined by the market than by bureaucrats working for the government.

Sometimes, however, this market approach to businesses does not produce what is in the best interests of society in general. For instance:

- Bad weather can lead to poor harvests and food shortages. Markets would lead to very high prices and possibly to poor people starving.
- A market in education would lead to education being available only to those who can afford it.
- People would prefer to spend their earnings on products and services for themselves rather than defence, national security, legal systems and police forces.
- It is very difficult to decide who should pay for things such as street lighting, parks, roads, railways, hospitals and other medical services.

In these and other cases, it is very difficult to see how privately owned businesses would be able to provide these products/services to an acceptable standard *and* make a profit. In many countries the state decides that it is responsible for ensuring that those services that businesses do not provide are provided. The state can provide the services directly (e.g. the army, navy and air force) or it can pay for businesses to provide them.

Case Study

The 2007–8 credit crunch

In 2007, banks around the world were facing major problems with several banks failing and many banks needing to be rescued by governments. The problem arose from banks failing to take a proper account of risk, and money was lent to people and businesses who could not afford to repay. This happened for several reasons:

- House prices had risen continuously for many years, and banks expected this to continue
- Regulations governing banks were relaxed
- Low interest rates encouraged wide-scale borrowing
- Innovation led to banking products that were not fully tested
- There was intense competition between banks
- A highly integrated banking system means that problems in one bank lead to problems elsewhere, even spreading to other countries (known as "contagion").

To a large extent the banking system relies on confidence and when customers are confident they leave their money deposited with banks. In 2007 that confidence was shattered following falls in house prices in the US. With stories of large-scale high-risk lending, more money was withdrawn from banks by savers than the banks could cope with. Bad debt, worldwide, amounted to some $1 trillion. Because of the global nature of the banking industry, the problems spread around the world with many banks getting into difficulty. Governments around the world had to rescue banks in some instances by taking them into public ownership (nationalisation). In the UK, for example, the UK government nationalised Royal Bank of Scotland and Lloyds, while in America the US government took control of Citigroup and AIG amongst others. If these banks had failed, the effect on the world's financial systems would have been catastrophic.

1 Why are banks an important part of the economy?
2 Why should a problem in the US have an effect on banks in the other countries?
3 Why did the market in loans fail?
4 Why did governments nationalise some banks?
5 What evidence is there that banks need regulation by the government?

Markets provide the interaction between buyers and sellers of products and services. Sometimes markets fail, or are less efficient than they could be. Although markets are usually the most efficient way of making rational buying and selling decisions, i.e. allocating resources, markets do not always react in rational ways. Consider the following possibilities:

- Let us suppose that this year, because of the weather, farmers have produced too much sugar and not enough wheat. The result is that the price of sugar falls and the price of wheat rises. Seeing this, farmers decide to plant more wheat (to get the higher price) and less sugar (because the price has fallen). The result is that, next year, there is a shortage of sugar (and higher prices) and too much wheat (lower prices).
- Let us suppose that international banks want to move many of their operations to, say, Hong Kong. The banks might offer high wages and bonus packages, and may attract people away from essential services such as education and health. Although shortages may be only short term, they would create problems.
- A media magnate owning several TV stations takes over a large national newspaper. This means that one owner has control of most of the newspapers and TV channels in a country. This gives him or her huge power and influence.
- A supermarket chain has grown so large that it now accounts for 40 per cent of food sales in the country. This puts it in a very powerful position in relation to both suppliers and customers.
- The state-owned electricity supplier is the only supplier in a country (a monopoly). It has no competition and prices for electricity are significantly higher than in competitor countries so customers might then be exploited.
- There are rumours that company A is about to announce disastrous losses. Shares in company A fall on the stock market. Because the share price falls, the rumour becomes more believable and more people sell their shares. And so on … The share price falls way beyond what is justified. Eventually astute speculators see a bargain, buy the shares and the price goes back up again!
- The threat of a strike by petrol tanker drivers leads to panic buying of petrol and, hence, causes shortages.
- The owners of a wind farm price the electricity produced as low as possible to be competitive. Now that the turbines are coming to the end of their useful life the business fails as it cannot afford the costs of dismantling the old turbines.
- A plastic bag manufacturer has found a cheaper way of making plastic bags. However, one of the raw materials is a harmful chemical that is difficult to dispose of safely. Local councils are having to pay the extra costs of the special treatment needed to deal with used bags effectively.
- In the credit crunch in 2007–8 a number of banks over extended their borrowing and were faced with failure, threatening savings and investments and the stability of banking systems around the world.

Getting it right

The important aspect of market failure is the impact that failure has on businesses and how businesses might respond rather than the causes of failure.

Key term

Market failure: a situation in which the usual interaction of buyers and sellers does not lead to a stable equilibrium price. It is recognised by excesses or shortages and/or unstable prices.

These are all examples in which markets are not working in the interests of everyone (the country, customers, investors, businesses). This is known as market failure. Whilst markets usually work well, sometimes they lead to:

- Unjustifiable or exceptionally large fluctuations in prices or supply
- Overreactions to situations
- Undue economic power and influence for a few
- Distortions in the allocation of resources
- The wrong people paying for pollution and other environmental problems caused by business
- Unforeseen consequences that have a very wide impact.

Link

Privatisation is covered in AS Level Chapter 1.2 Business structure.

The extent to which governments get involved varies from country to country and depends on who is in power at any given time. Some governments will only intervene as a matter of last resort, while others want to take early action.

Table 1.6.1 gives some idea of how governments might respond and what the impact might be.

Table 1.6.1 Market failure – possible government responses and their impacts ▼

Market failure	Possible solution	Likely consequences
• Wildly fluctuating or extreme commodity prices	• Governments sometimes enter the market to stabilise them by buying or selling as appropriate. They may also set quotas	• Businesses and consumers can plan more effectively. Inflationary pressures may be reduced
• Wildly fluctuating or extreme share prices	• Governments generally leave these markets alone	• Speculation may increase
• Skills shortages	• Governments provide training opportunities, grants for employers/employees, targets, tax incentives	• Skills shortages may be solved but not in the short term
• Commodity shortages	• Government may attempt to resolve shortages • Resolve strike threat • Seek more supplies from overseas • Act to calm markets	• Business and consumers may be reassured
• Environmental impacts (external costs)	• Introduce a system whereby polluter pays • Introduce tougher environmental laws	• Cost may be passed on to consumer
• Excessive business power	• Legislation and regulation of monopolies	• Restrictions on takeovers and mergers • More choice for consumers
• Inefficiencies in public sector businesses	• Privatisation	• Employees may see major changes/ redundancies • Consumers may see lower prices, better services
• Extreme market failure	• Business taken back into State ownership	• Existing shareholders may lose a lot of their investment but many customers will be protected. Confidence is maintained in the system
• Inefficiencies in private sector organisations	• Relax government controls and regulations, introduce more competition	• Often welcomed by businesses that feel less constrained. Businesses are not very good at regulating themselves and there may be unintended consequences

Activity

Find out what banks in your country were affected by the credit crunch. What help and support did the government provide?

Progress questions

4 Give two examples of how markets might fail.
5 How might fluctuating commodity prices affect a supermarket business?
6 Give two reasons why more competition could benefit customers.
7 Give three consequences of market failure.

The key macro-economic objectives of governments

Key term

Macro-economic: relating to the economy of a country as a whole rather than smaller individual parts.

Most people are agreed that governments are expected to manage the economic conditions of their country to achieve the key economic objectives expected by the "stakeholders" (see AS Level Chapter 1.5) in the country. When these objectives involve managing the country as a *whole* (rather than specific sectors or areas) they are known as macro-economic objectives. Different governments place different emphasis on the various key economic objectives.

In addition to macro-economic objectives, governments seek to create the right conditions for businesses to flourish and for consumers to be protected. These types of economic management issues are covered in A Level Chapter 1.6b.

Managing the macro-economy is very difficult, as we shall see later in the chapter. Outcomes of actions are often unpredictable and there are many uncertainties in the global economic world. However, what is certain is that macro-economic conditions and the way governments react to them through economic policies have a significant impact on business behaviour and on a business's stakeholders.

The key macro-economic objectives that relate to the key economic problems are:

- Low unemployment/high employment
- Low inflation
- Economic growth – suitable and sustainable
- Low levels of poverty – a fair distribution of income and wealth
- Long-term balance between imports and exports (current balance)
- A stable exchange rate.

Key terms

Unemployment: the situation that occurs when some members of the population who want to work cannot find jobs.
Inflation: a situation in which there is a sustained general increase in prices in a country over a period of time.
Economic growth: a situation in which a country's wealth, measured in real terms (i.e. adjusted for inflation), is growing through economic activity. Measured by GDP (see below) adjusted for inflation.
Poverty: a situation in which some people in a country are unable to fulfill their basic needs.
Current balance: the difference between the value of a country's exports and its imports.
Imports: products and services bought from other countries.
Exports: products and services sold in other countries.
Exchange rate: the price of one currency in terms of another.

Case Study

Tata Steel, 2011

In the last three months of 2011 weak demand for steel hit profits for Tata Steel, India's largest steel maker. The economic recession in Europe meant that demand for steel had fallen, leading to lower prices. Much of Tata's steel-making capacity is in Europe. European macro-economic policies continued to be focused more on reducing government borrowing rather than stimulating growth so Tata was not expecting demand to recover in

the near future. Although European interest rates have been forced down by governments this is unlikely to stimulate demand for steel for quite a long time.

Steel prices have fallen, but there still remains modest inflation in Europe. This means that Tata's costs of inputs, in particular wages, have not fallen. In addition the price of coal has remained reasonably strong in world markets.

Steel makers such as Tata would rather see governments focusing more on growth. Government spending on large infrastructure projects such as roads would help stimulate the European economies as well as creating demand for steel.

Tata responded to the downturn in the European steel market by:

- Cutting costs wherever possible including significant numbers of steelwork closures and redundancies
- Securing new and cheaper supplies for raw materials
- Tuning itself more effectively to customer requirements
- Moving to higher value-added steel products.

1 Identify three possible ways in which the European governments could have responded to the recession.
2 Identify three key factors influencing Tata's performance.
3 Discuss how Tata's response could make the effects of the recession less severe on Tata.

Figure 1.6.1 ▲

Understanding macro-economic objectives

Let us examine the key economic problems individually:

- **Unemployment** is a waste of the human resources of a country. It means that talent is wasted and some people are idle rather than productive. Not only is it expensive – it represents a real cost (both to society and the individual) and opportunity costs (lost opportunities for creating wealth, lost tax revenues to the government and so on). So governments should seek to reduce this waste.
- **Inflation** means that the value of money in a country decreases, usually as a result of increasing prices. This means that one unit of a currency, say $1, will be worth less after inflation than it was before because prices have gone up. Inflation causes uncertainty and disruption; it makes it difficult to negotiate contracts and

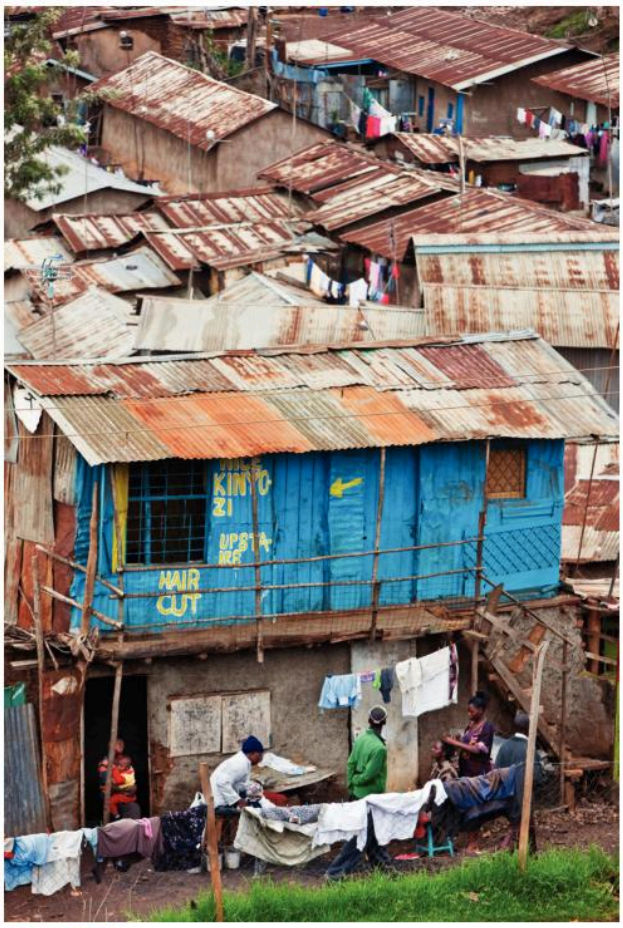


Figure 1.6.2 Tackling poverty is seen as a priority by many governments ▲

may lead to inefficiency through hoarding. So governments will seek to reduce the impact of price increases. However, it may mean that the real value of a debt falls and the money value of business assets increases.

- **A lack of growth** means that the country is failing to get richer. It becomes more difficult for the country to afford schools, hospitals, roads and the other things it needs to succeed. So governments will seek to help create wealth. However, governments also have to be mindful of the fact that uncontrolled economic growth can lead to environmental problems and extremes of wealth distribution.
- **Poverty**, particularly extreme poverty, is regarded in most societies as undesirable. It is generally accepted that those who are well off should provide economically for those who struggle to survive (through illness, unemployment, natural disasters and so on). So governments will go some way towards redistributing wealth.
- **A trade imbalance** usually means the value of a country's imports is much greater than the value of its exports. This can mean flows of money out of the country, reducing the nation's wealth. Other countries will get concerned at trade imbalances and there may be a fall in foreign companies investing in the country. So governments will seek to encourage exports. There can also be problems when the trade imbalance is reversed (i.e. a sustained surplus of exports over imports).
- An unstable **exchange rate** makes it very difficult for businesses to trade. It is difficult to plan, and import prices will be unpredictable. So governments will aim to stabilise a country's currency.

Progress questions

8 Explain why high unemployment would be a bad thing for your country.
9 Give one advantage and one disadvantage of economic growth in your country.
10 Explain why an unstable exchange rate makes it difficult for a business exporting raw materials such as crude oil.
11 Are there any groups of people who might benefit from inflation? Explain your answer.

Link

See AS Level Chapter 1.5 Stakeholders in a business for more on stakeholder objectives.

Conflicting macro-economic objectives

Life for governments would be easy if all of these objectives could be achieved simultaneously. However, in the same way as stakeholder objectives can conflict (see AS Level Chapter 1.5), the government's macro-economic objectives might conflict. The study of macro-economics

is very complex, but it is useful to get some understanding of how the bits can fit together.

Just consider the situation in which the government had ensured that everyone in the country who wanted a job had a job – zero unemployment.

Where could the human resources come from to help the country grow? The only way employers could do the recruitment needed to create more products and services would be through higher wages. That would add to the business's costs and either reduce profits or increase prices. That could lead to inflation or reduced growth and so on.

The art of good economic management by government is to balance the objectives in such a way that the outcome benefits the country as a whole (see Figure 1.6.3).

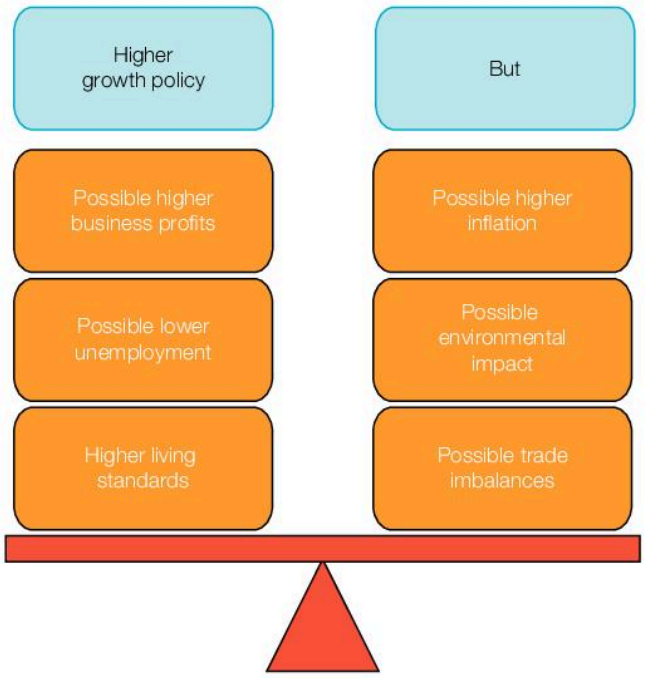


Figure 1.6.3 Balancing growth with other macro-economic objectives ▶

Progress questions

12 Why might reducing unemployment lead to higher inflation?
13 Why might it be difficult for a government to get rid of poverty *and* achieve a high rate of growth?
14 Why might changing interest rates have an impact on exchange rates?

How macro-economic objectives/developments can have an impact on business activity

Macro-economic developments affect businesses as well as countries. In addition, the actions that governments take to solve macro-economic problems will have an impact on businesses as well as, hopefully, solving the problems themselves.

To begin with we will study the *direct* impact of the *problems* on businesses before turning to the impact that the *solutions* have (see page 319 later in this chapter).

Table 1.6.2 outlines the key economic problems and the direct impact that they have on businesses.

Table 1.6.2 How macroeconomic factors have an impact on businesses ▼

High unemployment (low unemployment likely to be the reverse of these)	• Easier to recruit • Less upward pressure on wages • Employees will fear losing jobs so may be more compliant • Might have to make employees redundant if demand for business's products falls • Customers: could be less demand for a business's products/services because the unemployed will have less to spend. Businesses may have to reduce output because of falling demand, may lead to redundancies • Some customers will switch to cheaper good/services so businesses providing these will benefit, e.g. low-cost supermarkets
High inflation (deflation or low inflation likely to be the reverse of these)	• Employees may demand higher wages • Business will face higher costs of raw materials/services etc. • Customers become more aware of price as an issue and will shop around more for a good deal • Frequent changes to price lists – major problem in, for example, a supermarket or shop • Customers likely to switch from luxuries to essentials • Hoarding in anticipation of future price increases – increased demand to begin with, reduced longer-term demand (both from customers and other businesses) • Increased uncertainty on prices and likely future prices • Greater uncertainty in investment decisions • Likely higher costs of borrowing (see page 243) • Monetary value of assets will increase • Greater scope for speculators to buy now, sell later at a higher price
Low growth or recession	• Fewer opportunities for the business to expand • Reduced consumer spending • Possible reduced input costs as demand has fallen • Uncertainty about the future • Loss of competitiveness with businesses from countries that have high growth rates • May look to overseas (growing) markets rather than home markets • Unlikely to upgrade to new technology without growth stimulus

Exchange rate problems	• Rising exchange rates (appreciating):
	  • more difficult to export as prices will rise in the importing country
	  • easier to import raw materials etc. as currency buys more of overseas products/services
	  • more difficult to compete against imported products/services
	  • increased uncertainty about future price movements
	  • difficulty planning
	• Depreciating exchange rates have the opposite effect to appreciating rates

Key terms

Deflation: a fall in the average level of prices of products and services in a country.
Recession: a sustained period (usually six months or more) of declining GDP.

Progress questions

15 How could a manufacturer of cars be affected by a recession?
16 How would exchange rate problems affect the competitiveness of a local computer manufacturer compared with foreign competitors?
17 Why might a bread producer be relatively unaffected by high unemployment?
18 In what situations might a fast-food business be able to offer lower wages to new employees?

Key term

GDP: gross domestic product, the prosperity of a country measured by the total value of products and services produced in that country in a year. "Real" GDP has been adjusted for inflation.

How a government might place a different emphasis on macro-economic objectives from time to time

Objectives for governments change over time and between countries. Table 1.6.3 shows key economic indicators for a range of countries for the years 2006, 2008 and 2011.

Table 1.6.3 Key indicators for selected countries, 2006, 2008, 2011 ▼

	Unemployment (% of work force)			Inflation (% per year)			Growth (GDP % per year)		
	2006	2008	2011	2006	2008	2011	2006	2008	2011
Argentina	10.1	7.8	7.2	10.9	8.6	22.0	8.5	6.8	8.0
China	4.1	4.1	6.5	1.5	5.9	5.4	12.7	9.6	9.5
India	4.4	8.0	9.8	6.1	8.4	6.8	9.3	4.9	7.8
Indonesia	10.3	8.4	6.7	13.1	9.8	5.7	5.5	6.0	6.4
Japan	4.1	4.0	4.8	0.2	1.4	0.4	2.0	−1.2	−0.5
Mauritius	9.7	7.2	7.8	8.9	9.7	6.7	3.9	5.5	4.2
New Zealand	3.9	4.2	6.5	3.2	3.9	4.5	0.8	−1.5	2.0
Pakistan	6.1	5.0	5.7	7.9	20.3	13.9	6.2	1.6	2.4
Spain	8.5	11.3	22.9	3.5	4.1	3.1	4.0	0.9	0.8
United States	4.6	5.8	9.1	3.2	3.8	3.0	2.7	−0.1	1.5
Zimbabwe	v. high	v. high	v. high	1096	24 411	5.6	−3.3	−17.7	6.0

Source: The World Factbook and the World Bank

Table 1.6.3 compares some historical macro-economic measures over a five-year timescale. This is not an easy period to understand as there was great turmoil in the world economies resulting from the banking crisis of 2007 onwards, the credit crunch. Governments, mainly in the US and Europe, had to spend billions of dollars rescuing banks that had taken very high risks. This led to recession in many countries. However, it is possible to see countries that are benefiting from high growth rates but also seeing higher inflation rates (e.g. China). There are other countries that show the clear impact of the economic turmoil and recession, e.g. the USA. Japan is the only country showing low inflation.

From the 1950s many governments saw low unemployment as the key objective. However, periods of very high inflation together with high unemployment in the 1970s forced governments to reconsider their priorities. Inflation became the key target in the 1970s and onwards. Low inflation remained the main priority until the credit crunch in 2007–8 forced governments to think again. The severe recession in the USA and Europe has led to far greater discussion of the importance of growth.

Activities

1. In groups discuss what you think were the key issues facing the above countries in 2006.
2. Are these the same issues as in 2011?
3. What would your key economic priority have been in 2011 for each country?
4. What examples of conflicting developments can you see in the data?
5. Collect similar data for your own country (if not listed here). What does it tell you?

Key terms

Fiscal policies: actions by governments relating to changes in government revenues (taxes etc.) and spending.
Monetary policies: actions by governments relating to the supply of money in an economy and interest rates.
Exchange rate policies: actions by governments designed to influence the exchange rates of a country relative to others.

Activity

Identify examples of fiscal policies your country is adopting. Also identify specifically the policies it is using to manage the supply of money.

Getting it right

Changes in the economy and in the way governments handle these changes may sometimes seem insignificant. However, they may have a major impact on business confidence. In addition, a series of seemingly insignificant changes can end up having a large impact on businesses. Whether or not a business flourishes depends as much on how it responds to a change as the change itself.

Key term

Seasonal unemployment: unemployment as result of the usual seasonal pattern of some industries, e.g. tourism.

Policy instruments to achieve macro-economic objectives

Governments have three main sets of economic instruments (often known as "tools") for managing the macro-economy: fiscal policies, monetary policies and exchange rate policies.

Table 1.6.4 Macro-economy policy instruments ▼

Fiscal policies	Monetary policies	Exchange rate policies

• Change levels of government spending:
  • On services such as health, education, defence
  • On grants such as support for small businesses
  • On payments to individuals such as pensions, social benefits
	• Change interest rates:
	  • To affect the cost of borrowing
	  • To change the amount of money available in an economy
	• Change the amount of money in circulation by:
	  • Selling government debt (e.g. quantitative easing)
	  • Changing the amount of secure reserves banks have to hold
	  • Changing controls on credit
		• Changing interest rates impact on exchange rates through currency inflows/outflows
		• Changing the amount of money in circulation has a similar impact

• Change levels of taxation:
  • On individuals such as income tax
  • On sales such as Value Added Tax
  • On businesses such as corporation taxes
	• Restrict borrowing/lending of banks and other institutions	• Governments can make decisions about linking exchange rates, e.g. European countries and the €. Other countries "tie" their currency to stronger currencies. Governments can "talk" exchange rates up or down through their public relations

Usually governments will choose a balance between the three instruments available. Some governments also use "supply side policies" that aim to improve the competitiveness of businesses such as developing free markets, privatisation, increasing competition and freeing up labour markets.

Choice of economic management tool

The choice of tool depends largely on the causes and nature of the economic problem (which is likely to change over time as the economic cycle changes) and how other countries are reacting to changing international economic conditions.

Unemployment

Unemployment falls into several categories.

Seasonal unemployment is often seen in industries such as tourism and agriculture. Large numbers of employees are needed at peak times but they are not needed for the rest of the season. This is a problem which the government would not usually get involved in.

Figure 1.6.4 Looking for work ▲

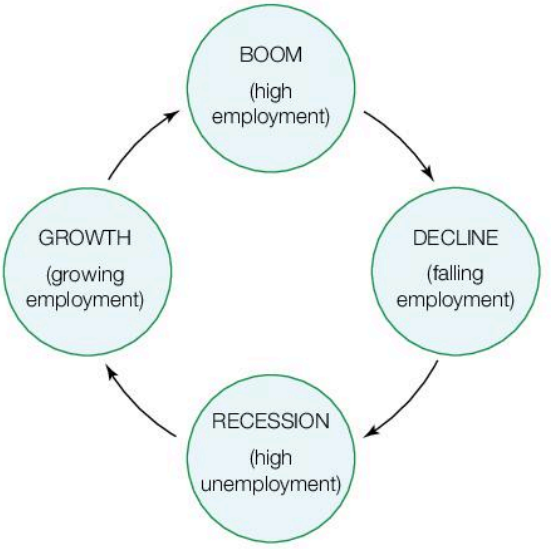


Figure 1.6.5 Cyclical unemployment ▲

Key terms

Business cycle: the observed pattern of "swings" in many economies ranging from "boom" years when the economy is vibrant to "bust" years when the economy is under-performing and possibly in recession.
Cyclical unemployment: unemployment caused as a result of the economy changing to a low point of the business cycle.
Structural unemployment: unemployment caused by permanent changes to the structure of an economy with some sectors/industries growing and others in decline.

Getting it right

Rising unemployment may be a bad thing for society as a whole and for individuals, and businesses may see falling demand for their products/services, but it may also provide an opportunity for businesses to reduce employment costs. But would this be regarded as unethical?

Unemployment follows the business cycles that many economies experience over a period of years, and this is known as cyclical unemployment. Governments may choose to try and smooth out the fluctuations in economic activity by trying to reduce the effects of the cycle or stimulating growth when there is a cyclical downturn.

Structural unemployment is unemployment created by the changing nature of economies. This may be due to:

- Fundamental changes to the nature of economies. Highly developed western economies now tend to have very few heavy manufacturing businesses (e.g. steelmaking or shipbuilding). Developing economies often see falls in employment in agriculture as agricultural businesses become larger through land purchases and so become more able to use capital-intensive equipment.
- Changes in tastes and fashions making some products/services no longer required, e.g. video cassettes.
- Improvements in technology with machines replacing employees.

In order to help reduce problems caused by structural unemployment, governments may provide:

- Incentives for new industries and businesses to move into the affected area.
- Opportunities for the unemployed to retrain by means of supplying training grants or setting up training courses. These will provide skills for the new industries/businesses.
- Stimuli for the local economy through taxation and government spending initiatives.

Governments may try to provide employees with the opportunity to gain skills in the new industries. Governments may also try to encourage new industries to develop, to replace the old ones. Governments may also try to create more demand in parts of the economy not in decline.

Inflation

There are four main causes of inflation.

Key terms

Cost push: inflation caused by increasing input costs.
Demand pull: inflation caused by excess demand for products and services.
Money supply: the amount of money (cash, cheques, credit circulating in an economy). Governments can change the amount of money in circulation.

Cost push inflation is when the economy (and therefore business) faces increasing costs. These cost increases may be due to:

- Employees and unions seeking higher wages – perhaps because they see their own costs going up, or because there are skills shortages
- Increasing taxes on spending (e.g. VAT set by governments)
- Imports (including raw materials) costing more, perhaps because worldwide shortages have pushed prices upwards, or perhaps because the exchange rate has fallen (depreciated), making imports more expensive
- Other shortages from within the country.

Demand pull inflation is when consumers and businesses want to buy more raw materials or finished products/services than is currently being produced. This may be due to consumer expectations about the future, government spending rising too rapidly, or products and services being exported rather than sold locally.

Money supply inflation is when governments, via the banking system, increase the amount of money in circulation faster than the economy is able to supply products and services.

The fourth cause of inflation relates to expectations. Sometimes because people expect that there is going to be inflation, these expectations cause it to happen, e.g. items are bought in anticipation of price rises, employees demand large pay rises to protect against price increases.

Getting it right

Inflation may lead to an increase in a business's costs but it might also present an opportunity for a business to increase its prices. It may also mean its burden of debt is not so great. It is important to assess the causes of inflation before discussing how a business might respond.

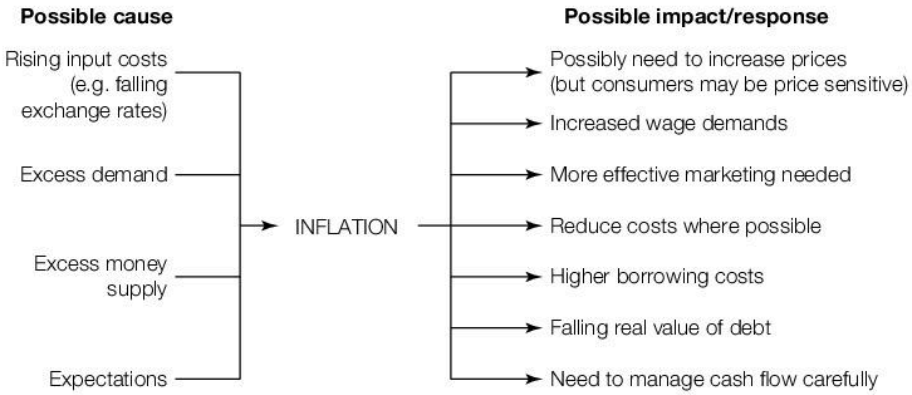


Figure 1.6.6 Inflation: possible causes, impacts and responses ▲

Lack of growth

Failure of an economy to grow can be due to a number of causes:

- An economic shock such as the credit crunch has made consumers wary of spending their money, businesses wary of investing and banks wary of lending

Getting it right

It is important to recognise that growth is an instinctive objective for individuals, businesses and economies. Without growth there will not be the benefits of growth! However, it is also important to remember that growth might come at a cost. Would a town be happy if a new factory meant a lot of new pollution? All stakeholders should be considered.

- A country has failed to respond to changes taking place and has productive capacity no longer needed (e.g. too many steelworks in Europe)
- Other countries having become a lot more competitive
- The downward stages of the business cycle (see page 320)
- Demographic factors (population changes) such as an ageing population, which requires more of the nation's wealth to be spent on the non-productive elderly population with falling tax receipts to pay for them
- Supply-side factors such as a workforce without skills, business failure to invest in technology, employees who are not prepared or able to move to new industries
- Unexpected events such as natural disasters.

Exchange rate problems

A country can experience exchange rate problems if the currency is too high, or rising (exchange rate appreciation), or too low, or falling (exchange rate depreciation) when compared with exchange rates of countries it trades with. There can also be problems if exchange rates fluctuate a great deal. These problems could be caused by:

- An imbalance between imports and exports
- Economic policies of other countries
- Too much reliance on one particular industry or group of industries
- Interest rates set too high/too low affecting flows of money into and out of the country
- Speculation – speculators are guessing which way a currency will move, and can influence movements through their buying and selling, thereby making the problem worse
- Belonging to a fixed rate currency mechanism, or some other arrangement such as the euro in which the rate is no longer consistent with the economic state of the country (e.g. Greece around 2010)
- Fluctuating rates which cause uncertainty and difficulty planning.

Key terms

Exchange rate appreciation: a rise in the value of the currency in one country (let us say "A") against the currency in another country (let us say "B"). It will make imports from B to A cheaper while exports from A to B will be more expensive.
Exchange rate depreciation: a fall in the value of the currency in one country compared with the currency in another country. The effect is the opposite of an appreciation.

It is important to work out how a change in exchange rate has an impact on a business.

A strong currency means:

- Exports from local businesses become more expensive in overseas countries
- Local businesses exporting will find it more difficult to compete
- Local businesses may have to reduce prices
- Imports will be cheaper

- Local businesses will have to compete with cheaper imports
- Local businesses may be able to buy cheaper imported raw materials and components.

A weak currency means:

- Exports from local businesses become cheaper in overseas countries
- Local businesses will find exporting easier and it will be easier to compete
- Local businesses could increase overseas prices
- Imports will be more expensive
- Local businesses will be able to compete better with imports and could increase prices
- Local businesses will pay more for imported raw materials and components.

Getting it right

It is very easy to think "strong currency – good; weak currency – bad". It is important to think through what impact a given significant currency change would have on a business – there will be winners and losers. It is also important to have regard to the *size* of the change. Remember to think through the impact; many students get it the wrong way round.

Activities

Discuss how the following businesses in your country might respond to a significantly falling exchange rate:

- A clothes manufacturer that imports raw materials and sells in a strongly competitive market in your country
- A mining company that exports most of its products
- A multinational soft-drinks business
- A firm of solicitors.

Case Study

China monetary policy decision, 2012

In 2012, the Chinese Central Bank cut the reserve ratio (the proportion of bank deposits that cannot be re-lent) to 20.5 per cent. By reducing the ratio banks could lend more. This was done to stimulate the economy following the publication of weak economic data. A year earlier, in 2011, the Central Bank took the opposite action of increasing the reserve ratio to try to slow down property speculation. Because there was less money to lend, house prices fell dramatically. This was important because the property sector accounted for 13 per cent of GDP in China at that time.

In 2012, there was further evidence of economic downturn in China. Europe's recession had a major impact on the Chinese economy. China's exports fell, imports fell by 22.5 per cent. Power generation and infrastructure investment both fell. The chairman of a leading bank said, "This fall was alarming; electricity consumption had fallen faster than the decline in the Great Recession". However, despite these downward pressures on the Chinese economy, inflation jumped to 4.5 per cent in January 2012.

Analysts think that the earlier monetary policy of easing credit in response to the worldwide credit crunch of 2008 may have led to an overreaction, with borrowing by people and businesses that possibly widened inequality between rich and poor. Then the authorities faced the delicate task of preventing recession.

With conflicting economic signals, the Central Bank's room for manoeuvre was limited. The economy had reached the point at which the trade-off between rising prices and growth became more difficult to balance.

1 Explain the meaning of the terms:
   a Recession
   b GDP
   c Monetary policy.
2 What examples are there of conflicting economic objectives facing the Chinese government?
3 Why would the Chinese government expect reducing the reserve ratio to increase house prices?
4 What evidence is there that the Chinese government has changed its economic objectives? Why might it have done this?
5 Evaluate the external macroeconomic pressures on China.

Progress questions

19 Why might a falling exchange rate be of benefit to a country that focuses on manufacturing?

20 Using numerical examples explain the difference between a depreciation of a currency and an appreciation of a currency for your country.

21 Give two examples of how fiscal and monetary policies differ.

22 Explain why a strong currency may not be of benefit to a country.

How changes in macro-economic performance and policies may affect business behaviour

To choose the available macro-economic instruments to solve a given problem is beyond the scope of this chapter and is, indeed, a task that stretches both governments and economists to the limit! However, it is important for businesses to understand how the various macro-economic tools have an impact on businesses.

Some actions of governments have a direct impact on businesses (e.g. an increase in corporation tax has a direct impact on business profits) while others (such as increase in income tax) have an indirect impact through a business's customers. Businesses are wise to study government economic policies, to think through their likely impact on their business and their customers and to prepare strategic responses to any changes in policy.

Table 1.6.5 Government policies: impacts and responses ▼

Type of policy	Policy	Impact on business	Example of a business's response
Fiscal	Increase direct taxes on individuals	• Customers have less to spend and will cut back on some non-essentials	• Depends on nature of product and its income elasticity (see AS Level Chapter 3.3b). • Increased marketing effort • Reduced prices • New products • Look to new markets, e.g. exports
	Increase taxes on sales (expenditure taxes)	• Prices to customers increase so sales may decrease especially if product/service is non-essential	• Not pass increases on to customers – lower profits • Try to reduce costs
	Increase taxes on companies (e.g. corporation tax)	• Reduced profits	• Invest less • Accept lower profits • Try to reduce costs • Invest more so less profit is taxed • Relocate to a lower-tax country
	Reduce government spending	• Direct impact on businesses that provide products/services to the government • Indirect impact through reduced spending by government employees who have been made redundant	• Look for new markets • Try to export more • Produce new/products/services that are less reliant on the government • Find new customers in overseas governments
Monetary	Increase interest rates/Decrease money supply	• Direct impact through increased cost of loans, and more expensive to borrow • Indirect impact through customers having less to spend, and more difficult for them to borrow	• Depends on company gearing (see A Level Chapter 5.8) • Try to reduce costs elsewhere in the business • Cut back on borrowing • Increase marketing • Reduce prices • Repay loans where possible • Increase credit charges to customers • Become innovative with finances and products • Rationalise the business

Activities

Identify a large and important business in your country. List the major stakeholders in that business. Prepare a presentation that shows how the key stakeholders might be affected by:

- An increase in interest rates
- Rising unemployment in your country
- Reduced government spending on roads, hospitals and education
- An increase in a sales tax (e.g. VAT).

Getting it right

Macro-economic conditions and policies are likely to affect a range of stakeholders in a business. When considering the impact that a change in the macro-economy will have on a business it is important to consider *all* stakeholders (see AS Level Chapter 1.5). Once that has been done you can look at how the business could respond.

Of course, businesses could respond to government policies using other strategic developments such as diversification, rationalisation, mergers/takeovers and innovation with the aim of staying ahead of competitors and markets. And circumstances can change very quickly. For example, there could be a major natural disaster, a war, a change of government and so on.

Case Study

How to beat a recession

Many restaurants, particularly in the US and Europe, suffered falling sales and profits in 2008–2010 as a result of the recession. Customers spend less on eating out and switch to cheaper alternatives during times of economic hardship. Against this trend, McDonald's – the worldwide fast-food franchise – managed to thrive during the recession.

Partly this success was due to McDonald's usually being at the lower end of the price range for fast food. It reinforced this position with "a recession-friendly menu" and value-for-money pricing. McDonald's also saw the recession as an appropriate time to introduce new products such as "premium" coffee and other drinks likely to attract the younger customer. Internet access in its outlets has also been made widely available.

McDonald's, in contrast with many of its competitors, has increased its advertising by taking advantage of low TV advertising rates. McDonald's has also had an aggressive "cost-cutting" programme throughout its operations. Much of this has been achieved through careful analysis of the huge amount of customer data available to it.

1 Analyse the impact that changes to the marketing mix have had on McDonald's ability to thrive during a recession.
2 Why might McDonald's want to attract the younger customer?
3 What sort of costs could McDonald's cut?
4 How might data analysis have helped McDonald's?

Exam-style questions

Maypole Computers (MC) produces tablet computers. MC is highly geared – it relies a lot on borrowing for expansion. MC operates in three different countries: A, B and C. Currently MC has its production facilities in country A, a developed economy. Market growth in tablets has been impressive for several years and MC has been able to maintain its market share in all three countries. The three different countries have been affected differently by recent economic conditions. Following changes to the global economy, MC has suffered falling sales in both country A and B.

The markets in countries A and B are highly competitive. Country C is an emerging economy (that is, it is developing rapidly from a relatively low level) and so competition is less intense at the moment.

MC has some major marketing and operational decisions to make and is considering some key economic data on the three countries.

	Country A	Country B	Country C
Annual GDP growth rate	0.5	3.0	7.0
Inflation 2013	5	3	10
Interest rate	5	10	3
Unemployment	5	10	1
Exchange rate movement:	strengthening	fluctuating	weakening
Economic prospects	continued low growth	uncertain growth	continued strong growth

1 Explain the terms:
   - **a** inflation [3 marks]
   - **b** recession [3 marks]
   - **c** deflation [3 marks]

2 Discuss how the economic conditions in country A could affect MC's operations in that country. [20 marks]

3 MC has its manufacturing operations in country C. Discuss the likely impact on MC of a weakening exchange rate in country C. [12 marks]

4 How might Maypole respond to the high unemployment rate in country B? [8 marks]

5 Evaluate the factors that Maypole would consider in deciding whether to relocate its operations to either country A or country B. [20 marks]

Key concepts

- A **Change** can be seen through the impact of changing economic factors and changing economic policies.
- A **Management** can be developed through consideration of the management of change in response to external economic factors.
- A **Customer focus** can be investigated through the impact of economic change on customers and how customers respond to changing economic/business circumstances.
- A **Strategy** can be viewed through strategic response that businesses make to changing economic circumstances.

Progress check

You should now be able to:

- A explain how and why the state could intervene in business activity
- A analyse why state intervention could help or constrain businesses
- A understand the role of the state in dealing with market failure
- A explain the key macro-economic objectives of governments
- A discuss why macro-economic objectives can change over time
- A explain the policy instruments used to achieve macro-economic objectives
- A evaluate the impact that changes in macro-economic policy have on businesses.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **A** how governments use the law to regulate business behaviour including market failure
- **A** how businesses might respond to those laws
- **A** how business responds to social, technological and demographic changes
- **A** the role that environmental issues play in business behaviour

1.6b External influences on business activity: additional external constraints and enablers

How the government and the law might seek to control business behaviour

In A Level Chapter 1.6a we saw the extent to which governments influence businesses through their involvement in managing the economy. This chapter looks at other ways in which governments have an impact on businesses through:

- Policies to improve efficiency and competition
- Laws
- International agreements.

Governments may seek to influence business activities in a variety of other situations:

- They may want to encourage small businesses through favourable taxation rates and other kinds of support such as advice
- They may want to encourage investment in particular industries regarded as strategically important for the economy, e.g. biotechnology
- They may want to discourage certain activities/industries (e.g. smoking and the tobacco industry) by imposing higher taxes (usually known as "duties") on related products
- They may want to support industries that are going through a difficult period by increasing relevant government spending (e.g. the construction industry could be supported through a road-building programme).

The legal framework for businesses

As well as fiscal responses to situations facing businesses, governments will often resort to legislation (creating laws). In many countries these involve laws relating to:

- Protection of employees
- Protection of customers
- Ensuring competition
- Controlling developments (e.g. building factories)
- Monitoring and controlling incorporated businesses
- Laws arising from international agreements
- Environmental protection.

Astute businesses will often go well beyond the minimum requirements of the law, making high standards of business behaviour part of their Corporate Social Responsibility (CSR).

Getting it right

It is not necessary to have a detailed understanding of specific laws. What is important is the impact of the existence of such laws on businesses and how they may respond. However, it would be interesting for you to have outline knowledge of relevant laws in your own country.

Link

See AS Level Chapter 1.4 Business objectives for more on CSR.

Laws relating to employment protection

In most countries, there is recognition by both politicians and the people of the country that the workforce is a very valuable resource for the country. As with all resources, care should be taken to ensure that the resource is as productive as it can be and that waste is minimised. As a result, many governments will intervene in employment issues to try to ensure that labour is as productive as it can be.

This means that in most countries there are laws relating to some (or all) of the following:

- Laws to prevent discrimination against particular groups of people based on their characteristics (e.g. age, gender, religion, disabilities and so on)
- Laws to prevent employees being dismissed unfairly
- Laws setting the minimum wage that can be paid
- Laws ensuring that employees can belong to a trades union
- Laws protecting the health and safety of employees at work (NB these are often combined with laws protecting customers – see below).
- Laws governing employment contracts.

The impact of these on businesses can be both positive and negative:

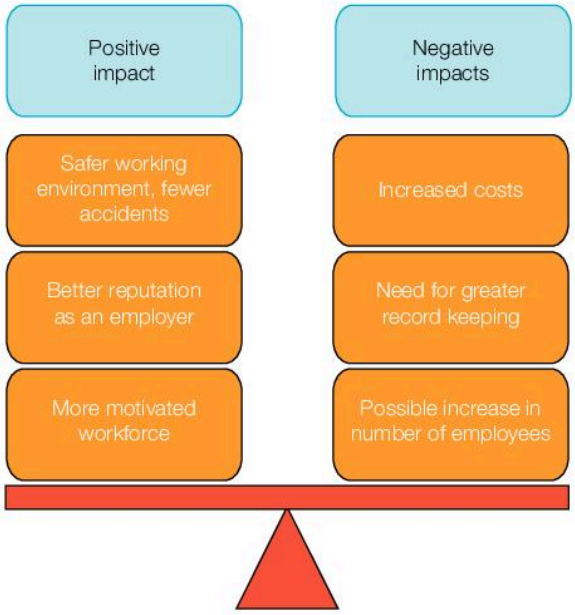


Figure 1.6.7 Positive and negative impacts of employment legislation ▲

Link

Employment legislation is also covered in AS Level Chapter 2.3a Human resource management.

Key terms

Minimum wage: the lowest wage which employees are entitled to by law.
Health and safety: laws governing activities designed to ensure that there are no threats to the health and safety of the population.

Progress questions

1 How can a building business benefit from health and safety laws?
2 Why might a minimum wage increase the costs of a clothes making business?
3 Give three examples of situations that you would regard as unfair dismissal.

Case Study

The need for employment protection

Every day 6300 people die worldwide as a result of occupational accidents or work-related diseases – that is more than 2.3 million deaths per year. Over 337 million accidents occur on the job annually; many of these result in extended absences from work.

The human cost is vast and the economic burden of poor occupational safety and health practices is estimated at 4 per cent of global GDP each year.

Hundreds of millions of people suffer from discrimination in the world of work. This not only violates a most basic human right, it has wider social and economic consequences. Discrimination stifles opportunities, wasting the human talent needed for economic progress, and it accentuates social tensions and inequalities.

Based on information from the International Labour Organization

1 Why do you think so many people die as a result of accidents at work?
2 Why is discrimination at work a bad thing?
3 How can governments prevent discrimination at work?
4 What economic grounds are there for governments to improve health and safety at work?

Getting it right

Consumer protection laws vary from country to country. It is not necessary for you to know the details of the laws – it is more important for you to be able to analyse how the existence of laws can have an impact on business behaviour. An outline understanding of laws in your own country would help.

Link

See AS Level Chapter 3.1 What is marketing? for more on marketing.

Laws relating to consumer protection

Governments recognise that often consumers (customers) are relatively powerless when it comes to disputes with large businesses. Often selling methods and advertising create a great deal of pressure on the customer who may not understand all the details of the product that they are buying (this is particularly true for electronic products). Governments around the world are increasingly using laws relating to consumer protection. Most countries provide basic protection for consumers which may include:

- Laws ensuring that products and services are safe, have no defects and can do what is intended of them (most countries have consumer protection acts).
- Laws that prevent misleading descriptions of products and services (many countries have legislation preventing misleading advertising).
- Laws governing weights and measures (to ensure customers are sold the right quantities).
- Laws governing food hygiene and food preparation.
- Laws and regulations covering advertising standards. For example, many countries have laws governing how products are described. Advertising in the media, especially television, is often monitored and controlled by law (e.g. where advertising is directed at children). Many countries have their own organisations setting advertising standards.

While in the short term these laws and regulations may lead to increases in costs and change the way a business operates, the benefits often outweigh these costs. Businesses will want, for example, to avoid disputes with customers in courts, particularly where health or safety issues are involved. These are usually very expensive both in money terms and loss of reputation.

Laws relating to competition

Most governments now regard competition as being generally beneficial to the economy and to the general well-being of the country. Government

policies in many countries have been designed to make businesses more efficient through increased competition. This benefits the customer through lower prices, the businesses through greater innovation resulting from competition and the country through greater ability to compete with overseas businesses.

A variety of laws may be put in place, for example:

- Competition laws restricting the power of monopolies, scrutinising mergers and takeovers with the power to prevent them
- Fair trading laws that limit unfair practices such as price-fixing agreements, predatory pricing, producers exerting too much power over retailers.

Activities

1. Find out how someone opening a bank account in your country will be affected by consumer protection legislation.
2. Find out what protection there is if you buy electrical products such as a television.
3. Find out what restrictions there are on advertising in magazines.

Other laws affecting businesses

Governments, both local and national, often have laws and regulations governing other aspects of business activity. They have laws concerning building and operating businesses in order to protect the environment and sometimes as part of regional policies. There may be regulations governing where businesses can be located, and restricting the kind of facilities that can be built. There may be a need to restrict the movement of lorries, trucks and other vehicles, or operating of machinery at particular times of the day or night as part of health and safety of the community as opposed to that of the workforce. All of these are constraints on business behaviour.

How international agreements might have an impact on businesses

The world is becoming increasingly interrelated with international agreements on trade (WTO, GATT), the environment (Kyoto, Copenhagen), employment (EU, ILO employment agreements), International Accounting Standards and so on.

Each of these has an impact on business behaviour, possibly increasing costs, sometimes limiting activity, but always providing opportunities for global trading and operations. Compliance with international agreements – which are not always enforced by law – may well be essential to businesses planning to operate in international markets.

Examples of international agreements include agreements on:

- Carbon emissions which have required businesses to become more energy efficient.
- Trade which have opened up trading opportunities in more countries for many businesses.
- Accounting standards which have required changes in how accounts are produced and published.
- Labour (employee) issues which have usually led to a change in legislation, with an impact on businesses in the relevant countries. The ILO has produced agreements to minimise the adverse effects of globalisation on workforces through a statement of principle.

Getting it right

Remember, although the law is often seen as a constraint, working within the law can be of benefit by protecting businesses and their customers. It could, for example, prevent disastrous consequences for businesses that might otherwise be careless and can be a starting point for an effective Corporate Social Responsibility (CSR) policy.

- International trade via the World Trade Organization, that govern many aspects of international trading, including rules governing trading businesses, and opening up competition opportunities in a wide range of countries. Agreements have also created a climate for overseas investment opportunities. For example, the WTO prevents businesses selling products at prices designed to destroy competition in poorer countries or selling "unsafe" products that they could not sell in their own markets.

The impact of and issues associated with the community and CSR

Many businesses are becoming increasingly aware that social changes are having an impact on business decisions. In many countries people are becoming more aware of and demanding on issues such as:

- Damage to the environment
- The role of women in society
- The perception that people at the top are "greedy"
- Changing demographics (see below)
- Loss of local identity in an increasingly global business world
- Other issues related to globalisation such as the loss of local employment and local businesses
- Increased social divisions brought about by education opportunities for some but not others
- Lack of IT skills that deny some people access to markets and information
- Recognition that debt burdens hold some countries back to the benefit of others
- Poverty and the unequal distribution of income between countries
- Changing roles of ethnic minorities.

Businesses may well want to consider some of these developments in their decisions. For example, a business may decide that it wants to raise the profile of women at the top levels of the business by promoting more women to senior jobs. It may decide to produce products for poorer countries or introduce discriminatory pricing – some pharmaceutical companies make drugs for Aids and malaria available at lower prices for developing countries.

Responding to these issues may be a genuine attempt at developing Corporate Social Responsibility (see AS Level Chapter 1.4), it may be an attempt to respond to pressure groups or other stakeholders (see AS Level Chapter 1.5) or it may be seen as a marketing opportunity (see AS Level Chapter 3.1).

Often businesses will include social auditing as part of their CSR programme. This means that the business will need to identify how it intends to meet its social obligations. Social auditing extends the idea

Activities

1 Identify which social issues are of concern in your country.
2 Are there other issues that you want to add to the list?

Link

See AS Level Chapter 1.4 Business objectives for more on CSR.
AS Level Chapter 1.5 Stakeholders in a business covers stakeholders.
AS Level Chapter 3.1 What is marketing? will provide more information on marketing.

Key term

Social auditing: this involves a business formally reviewing and accounting for the impact on society of its operations. It can include its impact on the environment, its effect on the local community, its attitude to such things as human rights and its attitude to stakeholders including employees.

of accounting to non-financial aspects of a business, and deals with social matters that are not necessarily measured in financial terms. So, for example, the accounts will detail not only things like profit and loss, but also the extent to which its equal opportunities policies are working, improvements in health and safety, and so on.

Businesses will also need to modify accounting practices in order to be able to produce accounting and environmental audits. Commenting on the social aspects of business performance through these audits may mean the business needs to be able to record health and safety data, the costs and benefits of schemes to benefit employees, customer perceptions on the extent to which the business is seen as ethical, ways in which the business contributes to the community, and data relating to pollution and waste and recycling activities, energy use etc. Each of these require careful collection and interpretation of the data as for many businesses this will be a new activity for which there are no agreed standards.

Some societies are getting increasingly concerned about making sure that incentives for the award of contracts can be ethically justified, so businesses are increasingly making efforts to make sure such payments are transparent in their accounts.

Case Study

Traidcraft

Traidcraft is a British-based public limited company dedicated to fighting poverty through trade. It is a trading company owned by around 5300 shareholders who have invested their capital in order to deliver a social impact rather than gain a financial return. Traidcraft's vision statement is "a world freed from the scandal of poverty, where trade is just and people and communities can flourish" while its mission statement is "to fight poverty through trade, pioneering and promoting approaches to trade that help poor people in the developing world transform their lives".

Each year in its Annual Report Traidcraft measures its performance against ten targets. These include:

- The number of producers (from poor countries) who benefit from being paid "fair" prices for their products
- Reduction in Traidcraft's carbon footprint
- Staff survey rating
- Spending on charitable activities
- Supplier satisfaction

Increasing sales is not one of its targets.

Source adapted from Traidcraft Annual Report

1 Why might publishing achievements relating to Traidcraft's targets be a type of social accounting?
2 Traidcraft sells its branded products to final customers. Why might sales not be one of its ten targets?
3 Why might shareholders be pleased to see increased spending on charitable activities rather than higher dividends?
4 To what extent might meeting these targets improve profits for Traidcraft?

Progress questions

4 How might a large, profitable business respond to news reports about excessive pay at the top of large businesses?
5 Why should a retail business take account of social changes?
6 How could a software company help people without IT skills get access to e-commerce?

Link

CAD, CAM, ERP and mass customisation are covered in AS Level Chapter 4.1 The nature of operations and AS Level Chapter 4.2 Operations planning.

Problems of introducing technological change

Technology brings considerable potential benefits to a business.

Figure 1.6.8 Potential benefits of technological change to business functions ▲

Key term

Technological change: change brought about through the use of new technology such as computers, robots, the Internet etc.

In the same way, failure to adopt technology can lead to a business falling behind its competitors.

However, the introduction of technology needs very careful management to get the most benefit while limiting the problems that can happen.

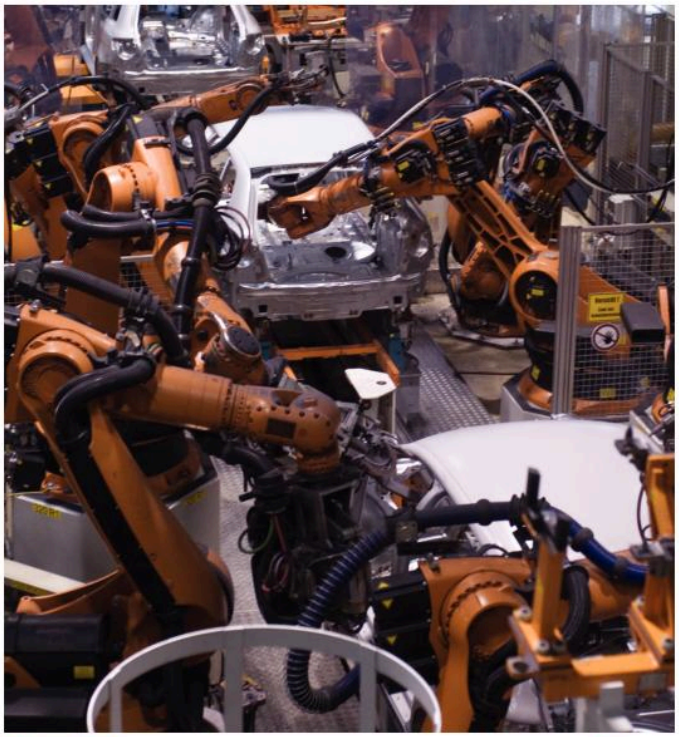


Figure 1.6.9 Robots are used to assemble cars in this factory ▲

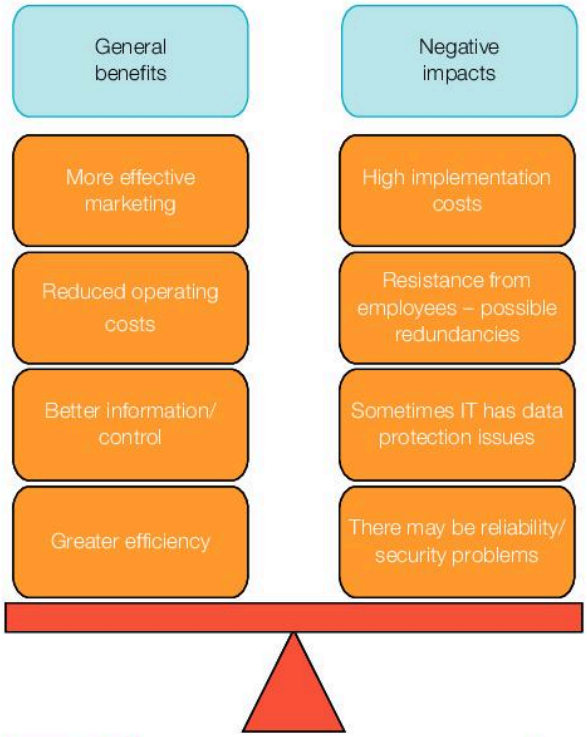


Figure 1.6.10 Impacts of introducing new technology ▲

Getting it right

Employees often see the introduction of new technology as a threat. It can be a benefit if it ensures growth and survival of the business. It can provide opportunities for more interesting and less arduous work. In some instances, e.g. in the banking sector, it increases employment.

Link

See A Level Chapter 2.5 Business communication for the use of IT in marketing.

Link

The connections between different businesses were explored in AS Level Chapter 1.1 Enterprise.

Successful implementation of new technology will involve:

- Careful analysis of the benefits of the technology
- Careful choice of the best systems
- Involvement of management staff wherever possible
- Extensive planning of all activities and resources involved including training
- Review and update of systems, procedures and training.

The use and impacts of technological developments are discussed more fully in the relevant chapters:

- CAD, CAM, mass customisation see Chapter 4.2
- Communication see A Level Chapter 2.5
- Use of IT in marketing see A Level Chapter 3.4.

How businesses are constrained by and rely on other businesses

As we have seen throughout this book, the business world is complex. Businesses not only have business relationships with the final consumer but they also have business relationships with other businesses either as a supplier of raw materials or components (e.g. a timber company will be a supplier for a furniture making business) or as a business that supplies to other businesses.

It follows, therefore, that not only does any individual business rely on other businesses, its activities are going to be strongly influenced by other businesses:

- The supplier may only be able to supply a limited quantity at a given price
- The supplier may be facing difficulties
- The supplier will have some influence over the price the customer pays
- The customer will have particular demands in terms of price, quantity and quality
- The financier may place restrictions on the amount and use of finance.

It is important to remember that no business can operate in isolation of other businesses.

How a business might react to a given demographic change

Key term

Demographic change: changes in the human population in terms of age, gender, ethnicity etc.

Demography refers to the way the population is made up and changing in terms of age, gender and other features that distinguish people, such as ethnicity and education. It is influenced by birth rates, death rates, migration and social change.

Demographic change can be an important factor in business decisions.

The demography of a country is important to businesses because it can help determine the best way to target products and marketing. It also has impacts on manpower planning and other workforce issues.

There is a wide variety of demographic development around the world. For example, in Japan in 1950 there were 9.3 people under 20 for every person over 65. By 2025 this ratio is forecast to be 0.59 people under 20 for every person older than 65. In contrast, in Libya nearly half of the population was under 25 in 2011.

We need to recognise that people of different ages have differing demands for products and services.

Young people typically buy:	Older people typically buy:
• Music • Electronics including mobile phones and services • Fashion clothes • Entertainment	• Holidays and travel • Properties with facilities for the elderly • Health products • Investments

Clearly these population differences have an impact on marketing strategies of businesses.

However, there are also implications for the workforce. For example, a young population is likely to provide a workforce that is:

- Lower cost
- More flexible
- Likely to change jobs more frequently
- Able to move easily to different locations
- More innovative
- More up to date
- More demanding in terms of maternity leave, facilities
- More skilled in some aspects, e.g. IT.

On the other hand an older workforce is likely to be:

- More loyal
- Less likely to move
- More experienced
- More hard-working.

Demographic changes will, as a consequence, have major implications for workforce planning decisions (see page 103 in Chapter 2.3):

- A younger workforce may need more training but would create demand for different products and services.
- A multicultural workforce may have different demands for facilities and may expect different working patterns. There may be increased

Link

Workforce planning is discussed in AS Level Chapter 2.3a Human resource management (HRM).

demand for ethnic products creating new fashions and tastes. Immigrants might accept lower wages which could create friction with existing employees.

- More women in the workforce may lead to increased demands for flexible working and maternity leave. It will mean greater disposable income for many families, which will increase the demand for some products/services.
- An ageing population will put strains on a business's pension plans, requiring larger contributions from younger employees. Governments may have to put taxes up to pay pensions, which may reduce demand for products and services.
- A rapidly growing population produces growth opportunities.

Activities

1 What is happening to the demography of your country?
2 Which businesses are most likely to benefit from the biggest demographic changes in your country?
3 Which businesses are most likely to suffer from the biggest demographic changes? How might they respond in your country?

Progress questions

7 How might a changing ethnic mix in your country affect a food manufacturer?
8 How might the changing role of women in society affect the design of cars?
9 Why might a fast-food business prefer to employ younger people?
10 Why might a retailer selling garden products prefer to employ older people?
11 How might an ageing population affect the entertainment industry?

How environmental issues might influence business behaviour

Businesses can have an impact on the environment in a number of ways. Factories can cause pollution; primary industries such as mining, agriculture and forestry can adversely affect the appearance of the countryside, businesses can create waste.

Many businesses proudly announce their environmental credentials in response to growing concerns about the protection of our physical environment. Reasons for this include:

- A genuine concern on the part of the business and its employees for the environment
- A recognition that the appearance of environmental concern may give a business a marketing benefit
- As part of a public relations drive
- In order to comply with the law and regulations
- A desire to avoid fines, taxes or other costs
- In response to demands from stakeholders, particularly customers and pressure groups
- To meet internationally agreed targets, e.g. on carbon emissions
- In response to social/environmental audits (as part of a CSR programme).

Key term

Pressure groups: organisations such as Friends of the Earth that have been set up to highlight and sometimes oppose developments that may cause changes to the environment.

How a business responds to a given environmental situation will depend on a careful balance between costs and benefits, some of which are very difficult to measure/assess, and some of which are impossible to put a value on.

Figure 1.6.11 The Botocan Dam in the Philippines is an example of a source of renewable energy ▲

Activities

Find out what "carbon trading" means. Find out what your country's policy is towards carbon trading. Has it signed up to any targets? If so, are there mechanisms for carbon trading?

Case Study

Malaysia and climate change

Plans to construct a 300 megawatt power station fuelled by coal in Malaysia has been cancelled. According to a news report, the environment minister for the Malaysian state of Sabah has rejected the plan for the coal plant, citing worries that environmental impacts would be too great. This victory comes after months of work on the part of Malaysian environmental groups and international climate organisations attempting to stop the coal plant's construction.

Malaysia has committed to cut its "carbon intensity" – or carbon emissions released per unit of energy generated – by 40 per cent by the year 2020. It is unclear exactly how the country plans to achieve this goal, particularly if it increases its reliance on coal for energy. Because coal is one of the dirtiest of all fossil fuels and among the biggest causes of climate change, heavy reliance on coal makes it very difficult for a country to reduce emissions. If the proposed Sabah coal plant is not built, it will increase the likelihood that Malaysia can achieve its climate goals.

Malaysia's potential for renewable energy generation is substantial. Its equatorial location is superb for solar energy, and its extensive tropical forests can supply large quantities of biomass. Hydropower already plays a significant part in the nation's energy mix, particularly on the island of Borneo, and hydropower from streams and rivers has boosted the electricity supply in rural areas.

Adapted from www.justmeans.com/blogs/good-news-on-climate-change-from-malaysia, Good News on Climate Change from Malaysia, Blog Entry by Nick Engelfried in Environment and Climate Change August 19, 2010

1. Why might the Malaysian government have committed to lower carbon emissions?
2. What was the role of pressure groups in the decision?
3. Explain why the Malaysian government has an influence on the decision.
4. What could be the impact of the decision on Malaysian business?
5. What could the power generators use as alternatives to coal?
6. If the plant is not built there might be a shortage of electricity at times in Malaysia. What might be the impact on businesses in Malaysia?

Progress questions

12. In what ways might a shoe manufacturer have an impact on the environment?
13. You buy a new MP3 player. In what ways might you have had an environmental impact?

Exam-style question

Sibco is a bus company with a fleet of 125 minibuses. Sibco has grown very rapidly and is now so big that it is thinking of taking over the national bus company which, itself, used to be a monopoly. Sibco has recently come in for criticism by pressure groups and in the national media. It is rumoured that to pay for the takeover Sibco is going to increase the prices that it charges for school bus contracts – "They'll have to pay more as they've got no alternative" said John the managing director of Sibco. "They've got to get the kids to school and no one else will do it!" Newspapers are also talking about the fact that the minibuses are not maintained properly, that they make a lot of dirty exhaust fumes, and that safety is not the priority it should be.

The operations department of Sibco is concerned that government policies to reduce inflation and unemployment may have an impact on Sibco's costs.

1 Evaluate the extent to which governments should try to control the operations of businesses such as Sibco. [20 marks]

Key concepts

- **Change** can be seen as a result of changing political, social, technological, demographic and environmental influences on business.
- **Management** can be seen through how managers respond to the changing environment.
- **Customers** can be viewed from the perspective of the influence of various changes on customer behaviour.
- **Innovation** can be seen through the impact of technology on businesses, customers and business decisions. It can also be seen through innovative responses to changes in the external environment.
- **Creating value** can be developed through technological and environmental improvements in products and services.
- **Strategy** can be developed through business policy changes in response to changes in the external environment.

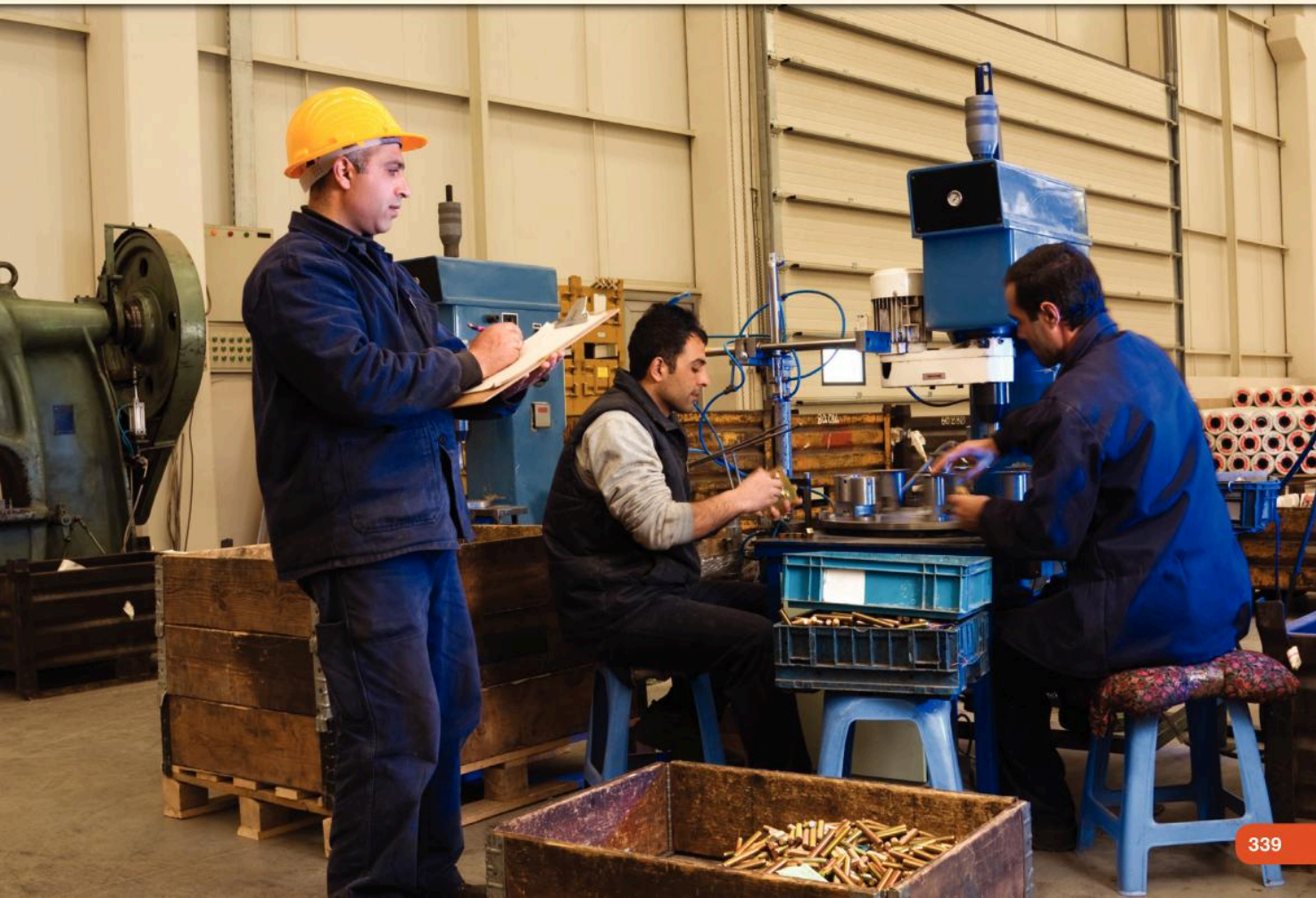
Progress check

You should now be able to:

- discuss how governments use the law to regulate business behaviour
- analyse the role that international agreements have on business behaviour
- discuss the issues associated with CSR
- discuss why businesses need to consider the needs of the community including pressure groups
- discuss the problems for business of introducing technological change and the Internet
- analyse how a business could respond to demographic change and the importance of such changes on businesses
- discuss how environmental issues influence business behaviour.

You should be able to relate these to a range of businesses in different situations.

2 People in organisations



This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- A "hard" and "soft" approaches to HRM
- A the role of HRM in the measurement of employee performance
- A the implementation and usefulness of management by objectives
- A the need for and the broad content of labour legislation
- A the benefits of co-operation between management and the workforce
- A the importance of workforce planning
- A the role of trade unions and negotiation in HRM

Key terms

Hard HRM: an approach in which employees are viewed as resources to be used by a business in its pursuit of its objectives. The training and development of staff is likely to be for increased efficiency only rather than for the individual development of staff.

Soft HRM: the treatment of employees as individuals usually with an awareness of the individual development and/or needs of each employee.

Temporary contract: a contract usually specifying a short-term period of employment, e.g. nine months, or until the completion of a project or order.

2.3b Human resource management: further functions of HRM

Approaches to HRM

"Hard" and "soft" approaches to HRM

The approach to HRM used varies between businesses and can vary within a business depending on the circumstances facing it.

"Hard" HRM

Approaches to HRM are often judged as being either "hard" or "soft". The hard approach to HRM (hard HRM) involves a business viewing its employees as a resource to be used to achieve its objectives just like the machinery, vehicles and premises. Employees will be recruited, trained, redeployed or dismissed according to the needs of the business. Employees are likely to be closely monitored to ensure that their performance is going to enable the business to meet its targets. Improved performance will be encouraged and training might be given, but it is not for the direct benefit of the employee but rather to improve the business outcomes.

"Soft" HRM

The soft approach to HRM (soft HRM) takes a more "humanistic" approach to the management of employees. Employees are treated as individuals rather than just a body of workers who are there to ensure that the business achieves its goals. An organisation following a soft approach to HRM will still monitor its employees, perhaps by using staff appraisal, but it will use the appraisal system to identify any training needs that will benefit the employee. The attitude in this approach is that a motivated employee will be more productive and loyal to the business. The result might be a reduced level of absenteeism and labour turnover. The views of the employees matter to management in this form of HRM and employees are often consulted about any changes to reward systems that might be used by the business. If employees believe the reward system is fair, they are more likely to work hard to obtain those rewards.

HRM and flexibility

There are times when a business needs to have as much flexibility as possible regarding the size of the workforce, so the approach to HRM would then need to focus on flexibility too.

For example, during a recession many businesses might prefer to employ workers on temporary contracts rather than full-time permanent contracts, giving the business the opportunity to reduce its workforce, if necessary, without incurring redundancy costs.

Some businesses employ workers on a zero hours contract which means although the employees are expected to be available for work, they will only be paid for the hours that they are actually required to work. If, for example, a shirt manufacturer employs staff on a zero hours contract

then the employees will only be paid for the hours they are actually producing shirts. If one order for shirts is met at 11 a.m. and the next order cannot be started until 4 p.m. then the business will not pay the employees for five hours during which they were not required to work. Workers employed in a restaurant will be expected to be available for work, but if there are not many customers and the employees are not required to wait on tables or to cook then they will not be paid. However, if later on the restaurant becomes busy then they will be expected to work and will be paid for that time only.

Similarly some businesses prefer to employ workers on part-time contracts rather than full-time contracts. This can be because the part-time employees might be willing to be flexible about which hours they work thus allowing the business to use them at the time that is most beneficial to the business. Full-time employees will attend work for the required number of hours each day and will have to be paid regardless of whether there is work for them to do or not.

Advantages of temporary or flexible contracts

Temporary contracts can be used when the business does not have a need for additional permanent staff but does need extra employees at a particular time. One example of this can be when a business has seasonal demand which can require different numbers of employees at various times of the year. Flexible contracts can be used to allow a business and/or its employees to vary the number of hours worked. Variations might be based on guaranteed minimum hours of employment which can be averaged out weekly, monthly, quarterly or annually depending on the contractual agreement between employer and the employee.

- In the case of temporary contracts, the relationship between the business and the employee can be ended more easily than if the employee was employed on a permanent basis. The employee understands that the contract might only be for a short time.
- The business does not need to pay any redundancy pay to the employee if the work they are employed to do is no longer required.
- In the case of flexible contracts, the hours worked can be increased or decreased by the business depending on how many hours of work they need from each employee.
- When part-time contracts are issued rather than full-time contracts, the business has the opportunity to ask part-time employees to vary the number of hours worked and to work the required hours at different times of the week. It might be easier to get a part-time employee to work some extra hours if the business situation requires it.
- The main advantage to a business is that of financial saving. Zero hours contracts only require payment to workers for the hours they actually work; temporary contracts enable a business to end the contract as soon as the employee is no longer required. Part-time contracts allow a business to reduce its wage bill by employing workers for a limited number of hours each week but perhaps giving them the opportunity to ask such employees to work extra hours if needed.

Key terms

Permanent contract: a contract of employment that does not specify a time period or have a termination date.
Zero hours contract: a contract of employment where the employee does not have any guaranteed hours of work. The employee will only be paid for the hours they are actually required to work, which might be zero in any given time period.

Link

See also AS Level Chapter 2.2 Motivation where financial rewards are discussed.

Key terms

Part-time contract: a contract of employment for a specified number of hours that is less than the number of hours worked by full-time employees.
Full-time contract: a contract for a permanent job.
Flexible contracts: these allow the hours and days of work to be varied by agreement between employers and employees according to the needs of the business and/or the individual employee. These can include an agreement to allow flexible working hours within agreed parameters.

Disadvantages of temporary or flexible contracts

- Employees on a temporary contract, a flexible contract or a part-time contract might not feel as much loyalty towards the business as those employed on a permanent full-time contract.
- Employees do not have any security of employment and therefore income. This might lead them to look for employment elsewhere if more permanent employment can be found.

Case Study

Delicaroma

Delicaroma is a chain of coffee shops that prides itself on using the best ingredients and providing an outstanding service to its customers. However, a recent article in a national newspaper has accused the business of exploiting its employees through the use of zero hours employment contracts. The article claims to have interviewed one of the employees of Delicaroma and states that employees are expected to be available for work from 7 a.m. until 10 p.m. for six days a week but that they are not guaranteed any hours of work at all. The contract also prevents them from taking any work with another business. The result of this is that the employees are contractually bound to Delicaroma but might not be able to earn enough money to support themselves and their families.

Recently there has also been an increase in the number of customer complaints in several of the branches of Delicaroma.

1 Briefly explain any advantages that Delicaroma might gain from the use of zero hours contracts.
2 Suggest an employment contract that might be more beneficial to the employees of Delicaroma.
3 Explain why a change in the contract of employment might lead to higher levels of customer service.

Activities

1 Research some job advertisements in newspapers and/or online and identify any examples of temporary and flexible contracts.
2 Make a note of the type of business in each case and try to think of any reason why that particular type of contract might be appropriate for that business/industry.

Progress questions

1 Distinguish between "hard" and "soft" approaches to HRM.
2 Give one advantage to a business of employing employees on a zero hours contract.
3 Outline one advantage to an employee of having a part-time contract rather than a full-time contract.

Key term

Staff appraisal: a process of measuring the performance of an employee against predetermined targets or desired outcomes.

The measurement of employee performance (staff appraisal)

The HRM department is a vital part in the process for measuring the performance of employees. It might have developed and introduced the systems for staff appraisal and would usually be involved in recording and keeping the records of any appraisals undertaken.

The appraisal system should be outlined to new members of staff during their induction training. They should be told what form the appraisal will take and how frequently it will take place. Some businesses use an appraisal system that requires annual assessment of employees whereas others carry our appraisals on a quarterly or half-yearly basis.

Link

See the section on training in AS Level Chapter 2.3a Human resource management.

Figure 2.3.3 A supervisor observes an employee as part of an appraisal ▲

What form can appraisal take?

- Appraisal can take the form of regular, planned interviews with employees when they will be given the opportunity to discuss their work and the extent to which they have reached any preset targets.
- Employees can also be appraised through observation. This is commonly used in production line settings where a supervisor or manager will watch the way in which an individual does their work, possibly also taking note of the time taken to complete their work. It is also frequently used in education where a teacher or instructor will be observed giving a lesson to see how effectively information is passed on to the students.
- The rate of work of employees can be measured in a production setting by calculating the productivity rate (output per time period).

The benefits of staff appraisal

- During appraisal interviews or observations, training needs (or perhaps equipment needs) can often be identified. For example, an employee might not be meeting targets due to the age of the equipment that they are using. Failure to meet targets can sometimes be caused by the inability of old equipment to function at the speed required to enable some targets to be met. The appraisal system would highlight this need and hopefully the need for better equipment could be satisfied in order to allow the employee to perform at the desired level and be able to meet future targets.
- Staff development issues can become evident during the appraisal process. The discussion with the employee might reveal that the employee has an ambition to progress to a higher level within the organisation. If the person is thought to be suitable then appropriate training can perhaps be arranged to enable the employee to apply for higher-level posts. If the appraisal system did not exist and if the discussion had not taken place the HRM department could be unaware of an employee's desire to progress within the business.
- It can allow pay levels to be adjusted. For example, if an employee was judged to be consistently meeting and exceeding targets, it may be appropriate for them to be paid more.
- It can confirm the extent to which employees are meeting targets and therefore can be used to determine the level of any bonus payments that may be due to the employee. Bonuses linked to performance are likely to motivate employees to achieve higher levels of performance thus benefitting the business as well as themselves.

Progress questions

4 Give two benefits to a business of staff appraisal.
5 Explain two ways in which staff might be appraised in a manufacturing business.

Possible causes and consequences of poor employee performance

Possible causes

Link
See also AS Level Chapter 2.2 Motivation.

Poor employee performance is often linked to low levels of motivation although the specific cause is often difficult to identify. It can also be difficult to remedy because employees are not all motivated by the same things; some might be highly motivated by financial gain while others are more influenced by job satisfaction.

Link
See AS Level Chapter 2.1 Management and leadership.

It can also be caused by a lack of effective leadership or management, which can result in employees underperforming because they are unaware of what is required of them. This can result in targets and objectives not being attained.

Possible consequences

A high labour turnover might be a consequence of poor employee performance if the lack of performance has been due to the employees being dissatisfied with their job. This can significantly increase the recruitment and training costs of the organisation.

Poor performance might also lead to disciplinary action being required and if the employee believes that the disciplinary action was unjustified a grievance procedure might be invoked by an employee.

Disciplinary procedures

Key term
Dismissal: terminating a contract of employment because the employee has not fulfilled the conditions of the contract in some way.

It is the responsibility of the HR department to implement the business's disciplinary procedure. This can occur in the event of an employee being in breach of their employment contract or having committed an act that justifies disciplinary action or even dismissal.

The disciplinary procedures can be included in employment contracts, but this is not compulsory in most countries. If the procedures are not outlined in the contract of employment then employees must be made aware of where that information is kept and how to access it.

Why is it important for a business to have disciplinary procedures in place?

Key terms
Unfair dismissal: when the employment of an employee is terminated without just cause.
Breach of contract: when the terms of an employment contract are not met. This can be either by an employer or an employee.

- To avoid any claims of wrongful or unfair dismissal. If an employee is dismissed without appropriate procedures being followed they might argue that they should not have been dismissed.
- To inform employees of the process that they and the employer must follow in the case of any failure to follow the rules of their employment.
- To comply with employment legislation if details are given in the employment contract. If details of the disciplinary procedures are outlined in the contract of employment and they are not followed when disciplinary action is taken, the employee can deem that the employer is in breach of contract. This can result in the employer having to pay compensation to the employee who was a victim of unfair dismissal for example.

What information does an employee need to know?

- What rules and regulations they must follow.
- Who they report to in the case of disciplinary action being taken or who they should appeal to if a decision is taken that they do not agree with.
- What steps will be followed during the procedure and as a result of disciplinary action being taken. For example the number of verbal and written warnings that will be given before dismissal becomes a possibility.
- What kind of behaviour can result in immediate dismissal from the employment.

What kind of behaviour might lead to disciplinary action being taken?

- Persistent lateness or absenteeism. Employers can reasonably expect their employees to attend for work each day as required and to arrive punctually. The need for punctuality and regular attendance at work is often an implied contract term and although not stated explicitly can be the subject of disciplinary action.
- A persistent failure to meet targets for work completed. This could be interpreted as an inability to complete the work required in a particular job. It might mean that the employee is not trying to work fast enough or accurately enough or perhaps is not capable of working faster or more accurately. The employer would need to determine whether or not the employee might require further training rather than taking disciplinary action against them.
- Unacceptable behaviour. This can include acting in a way that might cause damage to property or injury to fellow employees. It also applies to an employee who acts in a way that humiliates another employee by making inappropriate comments such as sexual comments or by unjustifiably criticising their appearance or their work.
- Theft of products or property from the business.

Grievance procedures

Grievances are sometimes caused by disciplinary action being taken against an employee. Sometimes an employee can feel that they have been unfairly treated either by their line manager(s) or by fellow employees. In such cases the employee might wish to pursue a grievance either informally or formally through the official channels available to them within the business.

Employers should record details of their grievance procedure and must also make the details available to employees. Details can be included in an employee handbook that will be given to all employees when they start working for the business or they can be included in the contract of employment. Businesses are not obliged to include details of their

grievance procedure in employment contracts but they are required to ensure that employees know of the existence of such procedures and where the details can be found.

If an employee feels that they have a valid grievance, it is often advisable for them to speak to the person or persons involved on an informal basis first. Sometimes the reason for the grievance might be seen as unreasonable once a thorough explanation of action has been given to the employee. If this does not have a satisfactory outcome then they need to know who to speak to so that some formal procedures can begin.

If a formal procedure is to be pursued then it is likely that a meeting will be arranged between the employee and the manager or other involved parties to determine the facts of the grievance. Sometimes issues can be resolved at this early stage by each party recognising the facts and reaching some form of compromise.

If the issue cannot be resolved at an initial meeting, the manager(s) will investigate all of the facts before making a decision about any action that might need to be taken.

Details of how to appeal against any decision should be made clear to the employee along with who they need to contact to dispute the decision.

The rules affecting grievance procedures can vary from one country to another.

Activity

Find out what the usual disciplinary and grievance procedures are in your country. If these are not specified by law try to find out and briefly outline what procedures are followed by any business whose information you can get access to.

Management by objectives (MBO)

Implementation and usefulness

Key term

Management by objectives: a tool for managing a business by negotiating and setting objectives at all levels of the business so that all managers and employees know and understand what is expected of them.

The setting of individual targets or goals would be discussed in the appraisal interview. Management by objectives is inevitably linked to staff appraisal.

The approach to setting objectives varies from one business to another and could be influenced by whether the business uses a hard or soft approach in its management of employees. The decision about such objectives can be agreed by reaching a consensus between the employee and the person conducting the appraisal. Alternatively, businesses that are predominantly target driven will impose the targets that they require to be met. In target-driven businesses departmental targets will be imposed by senior managers. The individual departmental managers will then inform each person within their department what they are required to achieve in order to ensure that the department meets its collective target.

Link

See also objectives in AS Level Chapter 1.4 Business objectives.

The targets agreed should be realistic and achievable if they are to motivate the employee. Targets that are felt to be unachievable are likely to demotivate an employee because they believe that they cannot be met no matter how hard they try. Peter Drucker applied the acronym SMART to MBO.

- Specific
- Measurable

- Achievable
- Realistic
- Time related.

The "A" was taken to be "agreed" rather than "achievable" as is commonly used in a marketing context when targets are being set either at a corporate or a functional level.

One of the original underlying principles was that the targets were agreed between an employee and their line manager. This is to give the employee an increased feeling of involvement and ownership of the work they are being given to do. However, as stated above, this is not the case in organisations that impose targets on their employees. Although when targets are imposed they still need to be SMART.

Any objectives must be in line with the strategic objectives of the business and must help the business towards achieving their long-term aims. The overall strategic objectives of the business are set by senior management who will then pass the information on to the next tier of management below them in the organisation. The information will be passed down to each subsequent level in the business until everyone has been informed and included in what the business hopes to achieve. Objectives can be set for each department within a business by departmental management. Each department will then assign work to employees within in it. The targets that are set will be designed to allow the department to meet its targets and fulfill its role in meeting the overall business objective. In this way individuals within a business can each be contributing to the business successfully meeting its stated preset goal.

What are the benefits of management by objectives?

- When targets are agreed between managers and employees, workers feel involved in decisions about what they are expected to achieve.
- Involvement in this level of decision-making can be motivating for employees.
- If employees are involved in agreeing their targets they are likely to be more committed to achieving them.
- Employees have a clear indication of what they are expected to achieve and how that fits into the overall business objectives. This can result in them recognising the part that they play in the success of the business.

Are there any disadvantages of using management by objectives?

- Having to meet and discuss objectives with employees can be very time-consuming for HRM and managers.
- The business might not want to divulge too much about its overall strategy due to a fear that competitors might get to hear about their longer-term plans. Therefore the objectives agreed for individual employees might not be seen in terms of how they can contribute to the overall success of the business.

- The employees might try to negotiate targets that they know will be very easy to achieve, especially if they will receive a bonus or other benefits for meeting them. This could mean that the business underachieves.
- Imposed targets might be too difficult to achieve and therefore could be demotivating for employees.
- In the business world circumstances can change very quickly and this might necessitate a change in the business objectives. For example, during the recent worldwide financial crisis many businesses changed their business objective from one of increasing market share to one of survival. Individual objectives might have needed to be changed in order to help a business achieve its new objective. Flexibility can be an essential requirement of the assessment of objectives and the extent to which they are being met.
- The success of MBO can depend on the accuracy of the assessment of what individual sections within a business are required to contribute to the overall business objective. It can also depend on how realistic the strategic objectives actually are. Unrealistic objectives will result in unachievable targets and goals being set for departments and the individuals working in them.

What happens after individual objectives have been agreed?

The progress of each individual must be monitored. This is so that any issues that might cause the targets not to be met can possibly be dealt with before it is too late. If one employee does not meet their stated target, this can mean that their department also fails to meet its target. This can ultimately cause a failure to meet the overall business objective within the time specified. Constant monitoring is therefore essential to the success of MBO.

Once monitoring has confirmed that individual goals have been achieved, some form of reward is usually offered. This might take the form of a bonus payment or an increase in remuneration. This reward system sends a message to all other employees about the importance of meeting targets. It also confirms that the meeting of targets is appreciated and justly rewarded.

MBO was highly popular and successful for many years, but it has now largely been developed into the greater use of targets set by management (the target culture).

Link

The use of targets in motivation is covered in AS Level Chapter 2.2 Motivation.

Progress questions

6 What is meant by the term "management by objectives"?
7 Outline two disadvantages of using MBO.
8 Explain two advantages of using MBO.

Labour legislation

The majority of countries have some form of legislation that governs how employees are to be treated. This offers some protection to employees and can prevent their exploitation by unscrupulous

employers. It is the role of the HRM department to ensure that such legislation is followed and also to deal with any instances where the laws may have been broken.

It is seen to be advantageous to businesses to meet the requirements of employment legislation because it is hoped that the protection given to their employees will result in employees feeling safer and more secure in their employment. It has long been accepted that the need to feel safe and secure are among the vital issues that should be recognised if employees are to feel motivated to work hard.

Link

See also the section on Maslow in AS Level Chapter 2.2 Motivation.

In the case of any problems arising related to any of the issues outlined below, it is the role of the HRM department to resolve the matter often by discussions with both the employer and the employee. Any failure to resolve such disputes can result in legal action being taken against the business.

What kind of protection does labour legislation offer?

It offers protection related to:

- Hours of work
- Minimum wage and other remuneration issues
- Discrimination issues
- Holiday entitlement
- Minimum age for work
- Health and safety
- Termination of employment contracts
- Employment relations.

Hours of work

Many countries have introduced legislation that controls the maximum number of hours that employees can be expected to work. Although the hours are stated per week, it is usually seen to be reasonable to allow the total hours worked to be averaged out over a two-week or a four-week period. For example, in Mauritius the Employment Rights Act 2008 states that normal hours of work shall be 90 hours over a two-week period. In the UK employees cannot be forced to work more than 48 hours per week but this can be averaged out over a 17-week period. This allows some flexibility if extra hours need to be worked in order for a business to meet orders and to satisfy its customers. Employees can opt out of this if they wish as long as they are over 18 years of age. For employees under the age of 18 the maximum number of hours that can be worked is 40 and these cannot be averaged out over a longer time period. There are some exceptions such as a people serving in the armed forces or the emergency services in certain circumstances.

Remuneration

Remuneration is the payment received by employees in return for providing their labour and/or expertise.

- There is legislation relating to pay and enforcing of a national minimum wage, thus making sure that, as far as possible, all employees will earn enough money to sustain themselves.
- Legislation can also dictate the rate at which overtime should paid. This is often 1.5 times the normal rate of pay.
- Governments can also require some statement about how and when payment will be made to be included in employments contracts. This makes the frequency of payments made to employees enforceable in law which means that employees can insist that they are paid weekly, fortnightly or monthly as agreed. Any failure on the part of employers to meet that requirement would be illegal.

Discrimination issues

Many governments have introduced laws designed to prevent discrimination against employees for reasons of race, gender, colour, age, sexual orientation or religion. Some governments have also made it illegal to discriminate against any employee as a result of them being a member of a trade union, for holding a particular political opinion or because they have tested positive for HIV.

Anti-discrimination legislation is aimed at protecting employees from being excluded from employment or from being treated unfairly while they are in employment due to any of the issues above.

Employees are also entitled to protection against any form of harassment at work. Harassment can take the form of bullying or sexual harassment; in fact any behaviour that a reasonable person would find unacceptable.

Holiday entitlement

Governments can dictate the minimum number of days that should be given as holiday to each employee. Although employers may exceed the minimum number of days given this can often be related to the length of time the employee has been employed by the business. For example, after two years of continuous service an employee may be given two extra days holiday as a reward for their loyalty.

Holiday entitlement can sometimes begin only after a specified term of employment, e.g. six months.

Extra holidays can be used as an inducement to employees to meet targets set by their managers.

Minimum age for work

Some governments have specified that young people should not be expected to work below a certain age. This age varies from one country to another. Legislation can also dictate the type of work that young people can be asked to do.

Health and safety

Employers are expected to provide a safe and healthy working environment for the employees. The extent of health and safety legislation varies around the world. It is usually designed to ensure that the health and well-being of employees is protected as far as is reasonably possible.

Health and safety laws not only govern the working environment but also the safety of equipment that employees are expected to use in their work. Employers are usually required to provide sufficient safety equipment for their employees to make sure that they are protected from accidents whilst working. For example, in Europe employees and visitors on construction sites are to be supplied with a hard hat to protect them from falling objects. Businesses in many parts of the world are required to put safety cages on machines that can cause injury to employees if not operated correctly. For example, in some component factories some machines have rotating blades that are capable of causing serious injury to employees if the blades are exposed; for this reason the safety cage will need to remain closed while any cutting operation is taking place.

Employment contracts and their termination

Labour legislation exists in many countries that will stipulate that all employees should be given an employment contract. The legislation will also dictate the circumstances under which that contract can be terminated.

It is in the best interests of employers and employees to have such a contract as the terms of the employment will be clearly defined and therefore each party knows exactly what they are committed to do.

Employment relations

A majority of governments recognise the right of at least some employees to join a trade union, although what a union can be, what a union is allowed to do, how independent from government unions are able to be and what industries they are allowed to represent varies considerably between countries. Employment relations legislation can outline the rights of employees to belong to a trade union or any rights that they may have to withdraw their labour (strike).

This legislation is useful for many businesses as it often gives details of agreements related to collective bargaining.

Many businesses around the world now accept that employees have a right to join a trade union. Legislation will often protect employees from being sacked simply because they are members of a trade union. Legislation can also detail what action employees are entitled to take if they are in dispute with their employer. This can be beneficial to employers too because they are aware of what kind of actions are and are not allowed if employees are acting within the law.

Link

See the section on employment contracts in AS Level Chapter 2.3a Human resource management.

Getting it right

You do not need to know specific details of employment legislation as it varies from country to country, although it would be very useful for you to know the key features of employment laws in your country.

Key terms

Trade union: an organisation that works on behalf of a group of employees by seeking to improve their pay and conditions of service as well as acting on the behalf on individual members, if necessary, who are in dispute with their employers.

Collective bargaining: when the needs and/or demands of a group of employees are discussed by management and a representative (usually a trade union) speaking on behalf of all the workforce rather than on an individual basis.

Progress questions

9 Explain two benefits to a manufacturing business of following health and safety legislation.

10 Outline two ways in which labour legislation protects workers in a food-processing business.

11 Discuss the importance of labour legislation using examples from your country.

Co-operation between the management and the workforce

How can this benefit both parties?

- It can help to remove the feeling of "them and us" that still persists in many businesses
- It can lead to managers and employees beginning to appreciate each other's point of view
- It can lead to the development of mutual respect and a valuable exchange of ideas.

How can this co-operation be achieved?

- It has been achieved in many businesses by the increased use of employee participation. This can be through regular meetings and the cascading of information through all levels of a business so that each individual feels informed and involved.
- Management who recognise and accept that employees at all levels in a business are capable of making a valuable contribution are more likely to have a workforce that is willing to work in the best interests of the business as well as themselves.

Workforce planning

Why do businesses need to undertake workforce planning?

If too many employees are employed then there will not be sufficient work to keep them all fully occupied and therefore some of the human resource (labour) is wasted.

A business is likely to be at its most efficient when it has the correct number of employees with the right kind of skills. If too few employees are employed, there is a chance that some jobs will not be completed. If employees with inappropriate skills are employed there are perhaps some jobs that will not be completed to a satisfactory standard.

Businesses need to ensure that they have the right number of employees with the right skills employed in the business at the time that they are needed.

What does workforce planning involve?

- The business must have a clear focus on the aims and objectives of the business with some timescale within which they should be achieved because this is what will determine what workforce will be required.
- The business must develop a plan of exactly what kind of labour it will require in order to meet its strategic goals. For example, will it need employees with different skills to those currently employed?
- The business must determine if it has too many or too few employees.

Key term

Workforce planning: to assess the number of employees and the skills required to meet the future needs of the business. To compare that with the number of employees currently employed and the skills and experience of those employees.

Workforce planning might reveal that the business currently employs sufficient employees with the appropriate skills and therefore no further steps would be needed. However, there is frequently a discrepancy between the employees currently employed and those that would be needed if a business was to adopt a new strategy in the pursuit of new business objectives.

If the business does not have enough employees with the right skills, more staff can be recruited. Another decision must be whether employees are required on a permanent basis or whether they can be employed on temporary contracts. Does the business need full-time or part-time staff? Some decisions might be influenced by the labour market that exists in the business's location. For example, if the majority of people looking for work are females who are seeking part-time employment, the business might have to consider how it can accommodate this fact into its workforce plan.

Some existing staff can perhaps be trained to meet the future needs of the business. The cost of this training must be carefully considered. It can sometimes be cheaper to hire new employees who already have the required skills. However, this action could lead to problems of demotivation with current employees who fear that they might lose their jobs because they do not have the skills required.

What steps can a business take if it has too many employees?

It might be necessary to make some employees redundant if the work that they do will not be required in the new strategy.

It is possible that the business will not need to do anything because some employees might leave anyway either because they are due to retire or because they are leaving for employment elsewhere. For this reason workforce planning should take into account the usual labour turnover figure (see pages 102–103) and should include this in any calculations of likely future workforce requirements.

Steps might be taken to ensure that the employees that the business wants to keep are not among those who leave to take up work for another business. Some inducement might be needed if key employees are thought to be planning to leave.

Progress questions

12 Define the term "workforce planning".

13 Explain why it is important to have clear business objectives before workforce planning takes place.

The role of trade unions in human resource management

What is the relationship between a trade union and HRM?

A trade union works on behalf of its members to ensure that the rights of employees are satisfied while in employment. Trade union representatives will meet with representatives of any business to discuss issues related to trade union members employed by that business. These can be issues such as employment legislation that is not being followed as fully as it should be. For example, if a business is persistently asking its employees to exceed the maximum enforceable number of hours work per week, then the trade union might ask to discuss the matter with the business. Such discussions might take place with a representative from the HRM department.

This relationship can be beneficial to both parties. By meeting with someone from the HRM department a trade union representative can make the business aware that some departments are not working within the law. The HRM department can then take action to ensure that all departments follow all employment laws and therefore can remove any cause of dissatisfaction among the employees.

If employees feel that they are not being treated fairly they are less likely to perform to the highest standards. However, if the issue can be resolved by meetings between HRM and the trade union, their attitude towards their work may be improved, resulting in higher levels of productivity for the business.

The benefits to employers of trade union involvement in the workplace

- A business can benefit from the existence of trade unions by knowing that there is an external body that can intervene if it experiences certain problems with its employees. For example, if a group of employees decide that they will refuse to work until better canteen facilities are provided the business can ask a trade union to intervene. It can ask the trade union to explain to the employees that their actions are not lawful and that they must return to work.
- In the same way that a trade union can point out to a business that it is acting unlawfully, a trade union will also intervene to ensure that its members respect the employment laws, thus also aiding the employers.
- Employers can discuss issues with a representative from a trade union who will speak on behalf of the workforce rather than having to meet and discuss the same issue with numerous employees.

The benefits to employees of trade union involvement

- Employees have someone who can negotiate with employers on their behalf. Representatives from the trade unions will be more experienced in negotiating than the average individual employee.
- Trade unions will enjoy more power in negotiations than an individual employee would. They might collectively represent many hundreds or even thousands of employees and have the potential to cause major disruption to a business if they encourage strike action.
- Employees will have legal representation available to them if they are in dispute with the management/owners of a business.
- The trade union will provide them with up-to-date information about employment legislation that applies in their country.

Getting it right

Remember when writing about trade unions that they also work with business owners and management; they are not always a negative force in a business.

Collective bargaining and negotiation

Collective bargaining means that the needs or demands of a group of employees will be discussed, by the management and the representatives of a trade union, for the workforce as a whole rather than on an individual basis. Collective bargaining can benefit the business because issues will only have to be discussed and agreed once rather than many times, therefore saving valuable time.

Trade unions can negotiate with management on behalf of individual employees as well as for the total membership of their union. They can also represent an employee if there is a dispute between management and an individual, for example regarding suspected discrimination against an employee who was unsuccessful when applying for a promotion.

Although trade union membership is still actively discouraged in several countries, many countries and the businesses within them recognise the benefits of accepting trade unions and of working with them.

The business and the trade union representatives do not always discuss legal issues, but they might be able to reach agreement on other issues that are felt to be adversely affecting the employees. For example, in the case of the canteen facilities mentioned above, if employees feel that the facilities do not meet their basic requirements then it might be in the best interests of the business to agree to some improvement. Such an action may result in increased morale among their workforce and lead to harder-working employees.

Negotiation may occur informally with a meeting taking place between representatives of the trade union and the HRM department.

If agreement cannot be reached it may be necessary to involve impartial bodies from outside of the business and the trade union. In such instances, it is hoped that an impartial party may be able to suggest

some way in which agreement can be reached. Someone who is not directly involved in the dispute may be able to see how the issue can be resolved and suggest this to management and the trade union. This is known as "conciliation". The suggestions arrived at through conciliation are not binding and are merely suggestions. However, in some countries impartial bodies will make the final decision about how a dispute should be resolved and both the management and the trade unions will be bound by the agreement. This is known as "arbitration". All parties involved must agree to be bound by the outcome of the negotiations before entering into such a discussion.

Activities

1 Research any trade unions that operate in your country.
2 Make brief notes on what industry is represented by the trade union and, if possible, identify some of the roles performed by the trade union. There might have been some media reports of trade union action taken against a business or industry that can help you with your research.

Progress questions:

14 What is meant by the term "collective bargaining"?
15 Explain two advantages to employees of their employer recognising a trade union.
16 Explain two benefits to a business of recognising a trade union.

Case Study

Home Design Ltd

Xiu Li opened Home Design 18 years ago with only five employees. The business now produces furniture for the home and various home furnishing items such as light fittings, cushions, curtains and bed linen. The increase in the competition in the industry together with the difficulties of selling such products in a global recession has lead Xiu Li and her shareholders to consider different ways of managing the business.

It has become obvious that output targets are frequently not achieved and the poor quality of some of the output has also become an issue. For these reasons the senior managers are considering introducing a scheme of departmental targets. The targets will be set and reviewed on a quarterly basis and financial rewards will be given to departments and individuals who exceed stated goals.

There has been some resistance from the employees because they say that the targets will mean that they will be required to work too fast and therefore the quality of goods produced might suffer.

The managers of Home Design Ltd have also decided to update the equipment being used in some departments. These changes will mean that some employees will not have the relevant skills and that new employees will have to be recruited.

Exam-style questions

1 Analyse the benefits to Home Design Ltd of using management by objectives to improve the output of the business. [8 marks]
2 Discuss the reasons why Xiu Li should undertake workforce planning at this stage in the development of Home Design Ltd. [10 marks]

Key concepts

- **Change** can be explored through the importance of flexibility and changing relationships between employees and management and the changing role of trade unions.
- **Management** can be developed through methods of improving employee performance, management by objectives/targets and the value of consultation.
- **Innovation** can be used to explore new management approaches that could improve on management by objectives.
- **Creating value** can be linked to the idea that employees can have an impact on the quality of products and services.
- **Strategy** is involved in developing methods to improve human resource management and to negotiate successfully with employees and their representatives.

Progress check

You should now be able to:

- discuss the role of HRM in the measurement of employee performance and the importance both to the business and to employees of measuring employee performance
- understand the importance of flexibility and the role of temporary and flexible contracts of employment
- understand the measurement, causes and consequences of poor employee performance
- analyse and evaluate the use of management by objectives and its role in the achievement of business objectives
- understand the importance of labour legislation and how it can influence both the business and the employees
- discuss the ways in which co-operation between management and the workforce can be mutually beneficial
- appreciate the importance of workforce planning in a changing business environment
- discuss the relationship between the human resources department and trade unions and the potential importance of negotiation.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- A the relationship between business objectives, people and organisational structure
- A the difference between types of structures such as functional, hierarchical and matrix
- A formal and informal organisations
- A the significance of delegation, accountability, control, authority and trust
- A the role that centralisation can play in business activity
- A the potential for conflict between line and staff management

2.4 Organisation structure

What is an organisation structure?

An organisation structure illustrates the framework of a business in terms of how authority, responsibility and accountability are distributed throughout the organisation. It also shows the number of levels within the organisation. Each level is usually associated with a different degree of authority and responsibility. For example, an employee on the lowest level of an organisation would not be expected to have as much authority and responsibility as an employee whose job is on the higher levels.

Why do businesses need to have an organisation structure?

The extent to which a business needs to have a formal structure can depend on the size of the business. An organisation structure shows everyone their place in the business and provides a framework for decision-making.

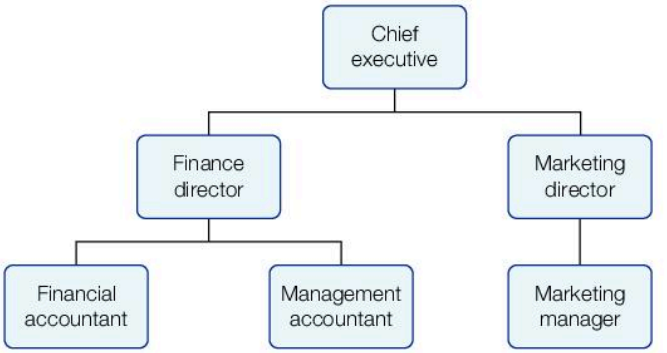


Figure 2.4.1 Example of an organisation structure ▲

Key terms

Organisation structure: the framework of a business indicating the chain of authority and lines of communication.
Authority: the power or right to control or command the actions of others.
Responsibility: to be accountable for any task or action taken.
Accountability: the need for a person or parts of an organisation to provide information on the relevant activities and justify relevant actions.

Key considerations of organisation structures

- They must be compatible with the size of the business. Smaller businesses that have either one or a small number of managers would probably function well without a formal structure. It is possible for the managers to know what actions are required with regard to activities within that business. However, the managers in larger businesses are likely to find it impossible to be able to be fully aware of all aspects of business activity within their organisation. For this reason it is helpful to divide the business into various sections, e.g. marketing, finance or production, with responsibility and authority being assigned to various positions/levels within it.
- An organisation structure must enable a business to meet its stated aims and objectives. Without an appropriate structure a business might fail to achieve its business objectives. For example, if a business's aim was to enlarge the range of products offered or the number of markets that it sold to, it would need to make sure that the business structure supports that objective.

- A structure must be flexible enough to allow for growth and development of the business, to allow the business to be able to meet its changing needs. A dynamic business is likely to constantly review and redesign its business structure. However, if there are too many changes to the formal structure, some employees might find this threatening and might worry about whether their job will still feature in the restructured organisation.

What does an organisation structure usually convey?

- It shows who the decision-makers are in an organisation and who has the most authority.
- It defines the official chain of command. It shows employees in one level of the organisation who they would report to and who they should receive instructions from.
- This can clarify which work should be prioritised if more than one manager is giving tasks to employees.
- It illustrates the formal channels of communication. If any employee wants to discuss an issue, the organisation chart will show them the person who they are answerable to and therefore the person who should be the first one that any issues should be discussed with.
- It allows employees to know where their post fits in the business structure.
- It gives some idea of the different routes for progression and promotion within the business.

Key term

Chain of command: the way in which orders are passed down through the hierarchy from the top to the bottom.

Progress question

1 Outline two functions of an organisation structure.

Key terms

Hierarchical structure: a structure that is designed to represent the various levels of authority and to outline the chain of command and channels of communication.
Functional structure: when an organisation structure is developed based on the different functional activities within a business, e.g. production, marketing, sales etc.
Matrix structure: when groups are formed from across many departments depending on the particular expertise needed to work on a particular project.

Types of organisation structure

There are three broad types of organisation structure: hierarchical, functional and matrix structures.

The type of structure adopted by a business can influence how well it performs, therefore the choice of structure can be one of the most important decisions that a business makes.

There is no right or wrong type of structure. The structure that a business adopts must be the right one for the organisation at that stage in its development and given the business objectives that it wishes to pursue.

Hierarchical structure

A hierarchical structure is one where the various levels within a business are presented in the order of authority and responsibility. The level with the most authority and responsibility appears at the top of the structure and the level of employees who have the least authority and responsibility appear at the bottom of the structure.

Key terms

Narrow (tall) organisation structure: an organisation structure with many levels usually associated with bureaucratic organisations.
Flat organisation structure: an organisation structure with a small number of layers which is usually associated with a smaller or new business or one in which delayering has taken place.
Level of hierarchy: a position within a hierarchical structure at which everyone has equal status within the organisation.

Key term

Span of control: the number of people that one person is directly responsible for.

This can be either a narrow (tall) organisation structure or a flat organisation structure.

Narrow (tall) organisation structure

A tall structure will have many levels of hierarchy and is often linked to more bureaucratic organisations, such as the army or many government departments, because each decision and instruction will have to be passed down through numerous levels.

Table 2.4.1 Advantages and disadvantages of a narrow (tall) organisation structure ▼

Advantages	Disadvantages
• Decision-making responsibilities are distributed between several levels and therefore usually has several management levels. • Having many levels in a business can mean that employees see the range of opportunities that are possible for promotion. Small promotion steps are possible. • Having several levels of people making decisions can reduce the burden of decision-making on senior management. • There is potentially a narrower span of control for each manager or supervisor.	• Too many decision-makers can mean that the most senior managers lose some control of decisions made. This can lead to business objectives being more difficult to achieve. This can also result in bad decisions being made because the managers lower down the organisation might not have the overview of the business that the senior managers will have. • Tall structures tend to be very bureaucratic. Decisions and instructions need to be passed through many levels and this can be extremely time-consuming and can delay the receiving of information. • As with any hierarchical structure there is a danger that there is a lack of contact, and therefore communication, between the various departments or divisions within the business. This can lead to duplication of effort or a lack of co-ordination between the different departments.

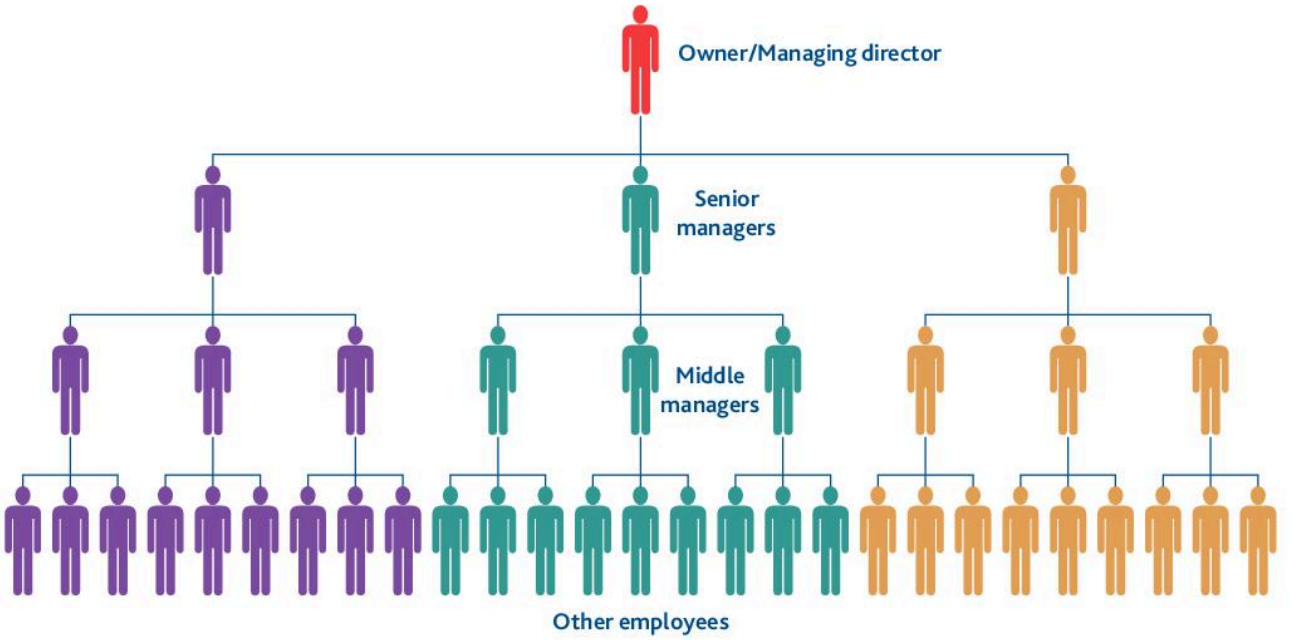


Figure 2.4.2 Example of a narrow (tall) organisation structure ▲

The ideal span of control has been stated as being between three and six employees, but this depends on the skill and experience of the employees involved and the type of task that is being done. For example,

highly skilled researchers working in a pharmaceutical company are unlikely to need much supervision. They can be given a task and then trusted to work without supervision to complete the work allocated to them. The span of control could be wide in this case because minimal supervision is required. However, employees being employed to assemble mobile phones or washing machines might need a lot of supervision to ensure that they carry out their work in a timely manner and to the required standard. The span of control in this instance should be small due to the amount of supervision required.

Link

See A Level Chapter 2.5 Business communication.

Flat organisation structure

A flat structure is often found in young businesses, where smaller numbers of employees are usually involved, or in organisations that have undergone a process of delayering. Delayering involves removing some levels of management from an organisation therefore producing a flatter structure. There are sometimes fewer levels in a business structure simply because fewer levels are required due to the size of the business or the way in which decisions are taken.

Key term

Delayering: the removal of one or more supervisory/management layers in a business.

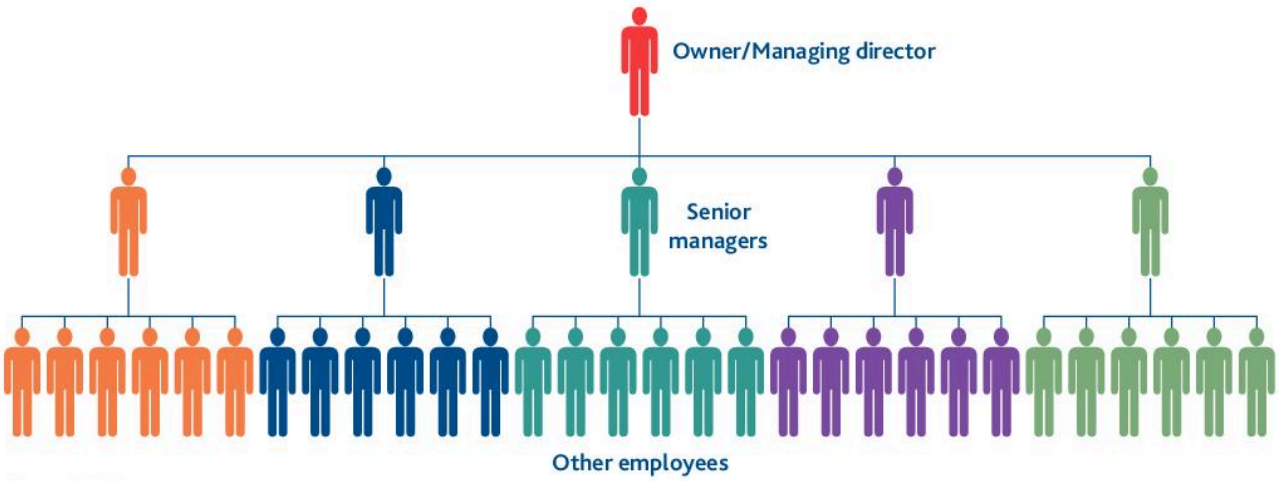


Figure 2.4.3 Example of a flat organisation structure ▲

Table 2.4.2 Advantages and disadvantages of a flat organisation structure ▼

Advantages	Disadvantages
• Fewer levels through which information and decisions need to be passed therefore making this less time consuming. This can be an advantage to a business that exists in a highly competitive market when decisions might need to be made very quickly if a competitive advantage is not to be lost. • There are a smaller number of managers and this is believed to reduce the feeling of "them and us" within an organisation.	• There are fewer opportunities for promotion. This can be a demotivating factor because a promotion is likely to be a much bigger step in terms of authority and responsibility. • There is usually a much wider span of control. This can make it difficult for a manager to be able to communicate directly with their staff. This can be overcome with the use of frequent meetings but this is not always well-received by employees. • The absence of some layers of management can place a greater burden for decision-making on the remaining levels.

Activities

1 Draw an organisation structure for your school or college.
2 Given the number of "layers" in the organisation would you consider the structure to be tall or flat?

Progress questions

2 Explain the term "span of control".
3 Give one disadvantage of a tall organisational structure.
4 Why might it be difficult to manage a flat organisational structure?

Functional structure

Some businesses can section their business activities into clear functional groups. As a business grows, more people might be working to research and develop new products or different materials that can be used to make products. Similarly the growth of a business can result in a larger team of people working to support all of the marketing activities or the financial aspects of the organisation. When a business reaches this stage in its development it can be sensible to organise the business into distinct departments dealing with each of the different functions. For example, a business might have a production department, a marketing department, a sales department and a finance department. Each of these departments might have their own hierarchical structure outlining who should report to whom within each department.

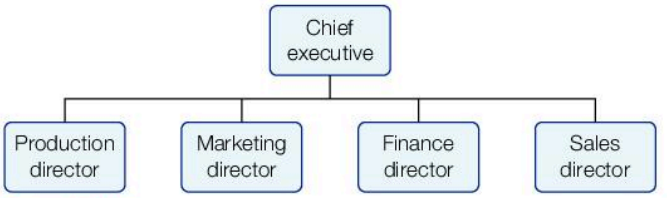


Figure 2.4.4 Example of an organisation structure based on function ▲

Table 2.4.3 Advantages and disadvantages of a functional structure ▼

Advantages	Disadvantages
• Each function within the business is undertaken by specialists in that particular function or employees can be trained to become specialists in that area. • It is clear, within each department who is in charge and who people are responsible for. • Employees will be clear about where they fit into the overall business structure and what their contribution is.	• The departments will need to communicate with each other to make sure that they are all working to achieve the same business aims. • The amount of communication required can be extensive and as a result there can be a need for lots of messages and/or meetings. This is obviously time consuming. • There is a danger that there can be a lack of co-ordination between the departments. For example, if the sales department is having a campaign to increase sales by 20 per cent then they need to be sure that the production department is able to produce sufficient products to support that increase. • There is a possibility that people working in one department will not have any understanding of what takes place elsewhere in the business; the holistic view of the business is lost. This can result in departments seeking to improve their efficiency and status but any steps taken might not be in the best interests of the business as a whole. • Departments might compete for resources, which can prove more costly for the business as a whole.

Organisations structured by product

When a business produces a wide variety of products and each of those products is made on a large scale it can be more effective for the business to divide itself into sections that each deal specifically with one product. Each product might have its own specific needs and in large businesses each product can also be expected to produce its own profit. Very large businesses can have a separate division for each product and within each division there can be functional departments.

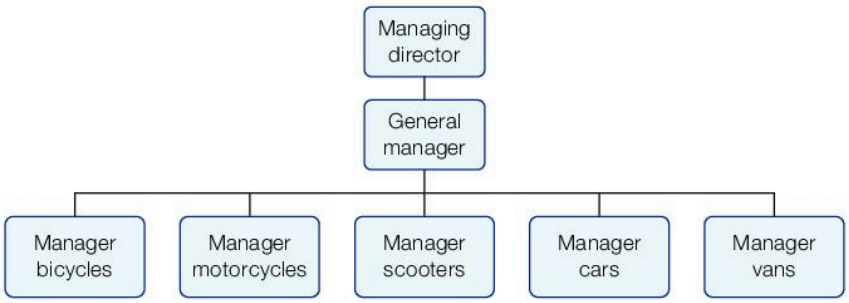


Figure 2.4.5 A business organised by product ▲

Table 2.4.4 Advantages and disadvantages of structure by product ▼

Advantages	Disadvantages
• People working within each division will be specialised in that specific product. • Costs and revenues can be clearly allocated to that particular product.	• There can be some duplication of effort. For example, each product might have a marketing department and a finance department. It could be more effective if these functions were provided by one marketing and one finance department for the whole business. Support could be given to each product or geographical division as and when required.

Link

See A Level Chapter 5.3 Costs for more about using costs to monitor and improve business performance.

Progress questions

5 Give two advantages of organising a business by function.
6 Explain what business functions should be shown on an organisation chart.

Organisations structured by geographical region

In the same way that some businesses produce several products, businesses also may provide products or services for several geographical regions. If the volume of business is large enough, it might be more practical for the business to have a different section to deal with each region. For example, an organisation might divide its business into a European section, a North American section, a Middle Eastern section and a Far Eastern section. Each of these regional divisions would work as a separate organisation, each having its own organisation structure. However, the overall way in which each section works is likely to be overseen by a global headquarters.

In some large countries, a business might have regional businesses within one country. Businesses structured by region usually retain the same overall business objectives.

Table 2.4.5 Advantages and disadvantages of structure by geographical region ▼

Advantages	Disadvantages
• Customer needs might be more easily recognised if people within the business are specialising in the needs of one particular geographical area because they would be more aware of the customers' preferences in that region.	• There is a possibility that each of the geographical divisions might move away from the desired image for the business as a whole. For example, in a clothes manufacturing business one regional division might decide to produce a cheaper range of clothes because they believe that this is what the customers in their area want. However, this might undermine the desired high-class image of the global/overall business. Some standards are expected to be met throughout the whole of the organisation.

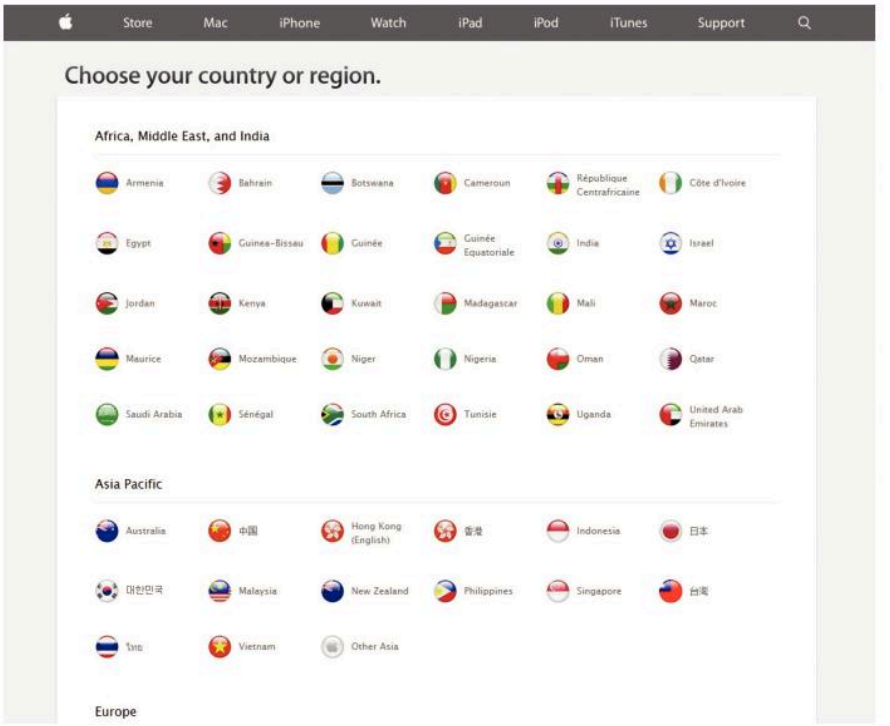


Figure 2.4.6 Apple Inc. is structured by geographical regions ▲

Link

See A Level Chapter 3.5 Globalisation and international marketing.

Matrix structure

In a large business a matrix structure can, and often does, function within an overall hierarchical business structure. To some extent it overrides the normal chain of command that exists within the formal hierarchy of the business.

Matrix structures cross departmental boundaries and bring together all of the skill and expertise required to carry out a particular project. People from various departments and levels in the business will work together to produce the best possible outcome for their project. The project might have a leader from middle management but they might decide to recruit someone to their project team from the senior management level within the organisation. In this way, for the purpose of a specific project, someone from a higher rank within the organisation can be answerable to a project leader who is from a lower level in the overall hierarchy.

Activities

1 Using any businesses for which you can obtain information, identify the type of organisational structure in at least two of them. You might find this information on the websites of larger organisations.
2 Make notes on the type of structure being used and the product or service being offered by each business. Make notes also on the benefits that you expect each business to gain from having its organisation structured in that way.

Activities

In small groups plan to organise a cake sale for your school or college. This will require students and teachers from different years in the school to work together. You will require many tasks to be completed. For example, you will need to publicise the event, you will need artwork for your posters, you will need people to bake the cakes and others to look after the stalls. There will probably be many other tasks that you can think of.

1 Make a list of the various tasks to complete.
2 Draw up a list of the various people that you feel would be appropriate for each task and make notes on the reasons why each of the tasks was given to a particular person or group of people.

You have just devised a matrix structure!

For example, a business that processes and packages tea for sale to customers might decide that it would like to develop an innovative tea-making machine. Such a project would require input from several specialisms within the organisation.

- The research and development department would need to be involved in the actual product development and might lead the project
- The project leader might be a lower-level manager who has been entrusted with the management of the tea-making machine project
- They would need to recruit someone from the marketing department to ensure that some market research was done to make sure that customers would be prepared to buy such a product
- Someone from the production department would need to be involved because they would need to confirm that what the R&D team want to make can actually be produced
- Throughout the process there would need to be some input regarding financial matters; perhaps a budget would be set and monitored.

Representatives from each of these departments would work together until the project was completed. A new project might bring together a totally different team.

Table 2.4.6 A matrix structure ▼

	FUNCTIONAL AREAS INVOLVED IN EACH PROJECT				
	Research and development	**Production**	**Marketing**	**Finance**	**Human resources**
Project Rebus	✓	✓	✓	✓	✓
Project Reliant	×	✓	✓	✓	✓

Table 2.4.7 Advantages and disadvantages of a matrix structure ▼

Advantages	Disadvantages
• It allows the best employees to be brought together to complete a task or project. • It encourages co-operation and communication between departments within the organisation. • The highly skilled employees can be used to the maximum as they are moved from one project to another as required. • A matrix structure may enable a business to be flexible and therefore more able to respond quickly to changes in the business environment. • The employees will be focused on the project rather than on interdepartmental rivalries.	• A person can be answerable to more than one "boss". They will be answerable to their line manager within the overall business structure, but they will also be answerable to the project manager within their matrix. • An employee might find themselves working on more than one project at a time. It can prove difficult, in such situations, to determine which work is the priority. Each project leader will usually claim that the work for their project must take priority.

Progress questions

7 Explain two disadvantages of using a structure based on geographic region.
8 Explain two advantages of using a matrix structure.
9 Explain one disadvantage to an employee of working in a matrix structure.

Changes in organisation structures

Changes can occur for many reasons, for example a growth in demand for the product or service that requires a growth in the business in order to meet demand.

A change in the approach to the management of a business can result in a change to its structure. For example, if a business was to use a more democratic approach to management, then the senior managers might believe that fewer supervisory levels are needed and therefore some management layers can be removed, i.e. delayering will occur, resulting in a flatter organisation structure than previously. If the reverse was to occur, i.e. a business that currently uses a democratic approach to management decides that more supervision and control is needed, then additional layers of management might be created, causing the organisation structure to become taller.

Link

See also AS Level Chapter 2.1 Management and leadership where leadership styles are discussed.

The recent trend in many businesses has been to delayer.

The growth in the market or an increase in a business's market share can often cause an increase in its scale of operation. Such an increase usually includes an increase in the number of people employed and a departmentalisation of business activities (if that has not already occurred). With more people and/or departments, it might become necessary to increase the supervisory/management levels in the business thereby adding more levels to the organisation structure.

Many businesses are structured according to geographical regions served by the business or by the range of products or services provided. Any change in these circumstances will cause a change in the organisation structure. Sometimes a business will diversify its activities and will add another product section to its organisation structure. Sometimes a business will retrench its activities and product sections will be removed. The same applies to business activity in various geographical locations.

Progress questions

10 Explain two advantages of using a narrow (tall) organisation structure.
11 Explain two possible disadvantages of using a flat organisation structure.
12 Explain why a business might wish to change its structure from a narrow (tall) structure to a flatter structure.

Formal versus informal organisations

Formal structure

Key terms

Formal structure: the levels of authority and channels of communication are defined by the organisational structure.
Delegation: passing the authority to perform a task to an employee in a lower level of the hierarchy.
Decentralised: some decision-making is delegated to lower-level managers in an organisation to make decisions regarding their own area of work.

A formal structure is typified by a hierarchical organisation structure. The levels and the positions in the hierarchy will be clearly defined. The formal relationships within the business are illustrated by the organisation structure.

The formal structure will indicate the chain of command, which is the route through which all communications should pass, i.e. information will pass directly from one level in the hierarchy to the level immediately below or, in some instances, above. It is not usual for any level to be missed out when information is being communicated.

The levels of responsibility and authority are also indicated in a formal structure. The person with the ultimate responsibility for how the business performs is at the top of the structure. This is usually a managing director or a chief executive. The responsibility and authority that each person holds reduces as you move down the hierarchy with the employees on the bottom level having the least responsibility and authority.

The structure can also show how delegation can take place. This again should be through the levels indicated by the organisation structure. For example, a manager in a sales department can delegate work to the employees working on the level immediately below them. The person receiving the delegated task would be accountable to the manager who asked them to do the work.

A formal structure also shows whether the organisation is centralised or decentralised in terms of decision-making. A centralised organisation means that decision-making power is retained at the top of the organisation with very little empowerment given to managers to make decisions for their own sections. A decentralised organisation will give more power to managers lower down the hierarchy and will allow them to make decisions regarding their own area of work or product or region. Decentralisation involves the delegation of decision-making rather than just tasks.

Informal structure

Key term

Informal structure: a network for communication and authority other than that outlined by the organisational structure.

In most organisations there will also be an informal structure of authority. This can develop due to the relationship between various employees. A strong amicable relationship is likely to be beneficial to the organisation. However, if there is any disharmony in the workforce this can have a negative effect on the efficiency and effectiveness of the employees.

If one team is seen to be working less efficiently than another team, it could be that the lack of efficiency is due to one employee who does not have a good relationship with the rest of the team. This can sometimes be resolved by simply moving that one employee to another team.

If an employee is found to have a negative influence on the team they are working in, it could be that some form of disciplinary action

is required. Alternatively, there might be an explanation for their behaviour which would need to be investigated if remedial action is to be taken.

Link

See AS Level Chapter 2.2 Motivation.

Some employees can influence those around them, perhaps by suggesting that they all need to approach their tasks in a different way. Occasionally they might suggest that the line manager does not understand the best way to complete the work. This type of informal structure can undermine the effectiveness of a team of employees.

Case Study

Fedilock Ltd

Juan had been employed at Fedilock Ltd for 18 years, the last 12 of those in a lower management role. Everyone who worked with him thought he had a very negative attitude to his work and to the business. The output of whichever team he worked with seemed to reduce after his arrival. When a new factory manager, Helene, arrived in the business she was told that Juan was a disruptive influence and that he thought he should have been promoted to the manager's post several years ago. His colleagues believed that he had not been given the job because he was always very negative. After some investigation, Helene discovered that Juan had developed his negative attitude as a result of not being promoted to the manager's job. He had felt humiliated and undervalued by not being appointed.

As the new manager and many years younger and less experienced than Juan, Helene decided that action was needed if the negative influence of Juan was to be removed. A new project was about to be introduced in the business and Helene decided to take a chance. She decided that the new project should be given to Juan to manage, requiring him to have sole responsibility for a development team within the business. Feeling trusted and valued solved the problem. Within a short time Juan was overheard talking to some of the production employees. He was telling them what a good opportunity the new project was and that this could secure all of their jobs if they could make it a success.

1 Discuss the potential impact of an informal structure on Fedilock Ltd.

Progress questions

13 Define what is meant by the term "chain of command".

14 Briefly explain the difference between a formal and an informal organisation structure.

Span of control

The span of control will also be evident from the organisation structure. This can be narrow or wide and can be determined by the type of work being done or the skills and experience of the employees involved. If the work being done is complex and the employees need a lot of supervision, then it is likely that a narrow span of control would be advisable. The larger the number of employees that one person has to supervise then the larger the potential for errors or inadequate supervision.

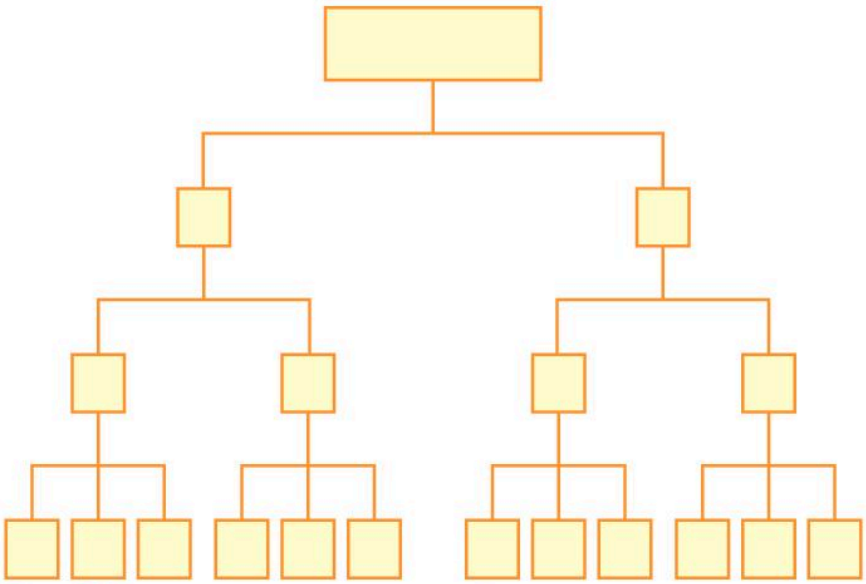


Figure 2.4.7 Example of a narrow span of control ▲

Table 2.4.7 Advantages and disadvantages of a narrow span of control ▼

Advantages	Disadvantages
• Each manager will have fewer employees to be responsible for. • Close supervision of employees is possible. • Communication might be easier as there are fewer people for each manager or supervisor to contact.	• It is often associated with centralised decision-making, which means that employees are given very little opportunity to contribute to decisions. • Communication is often one way.

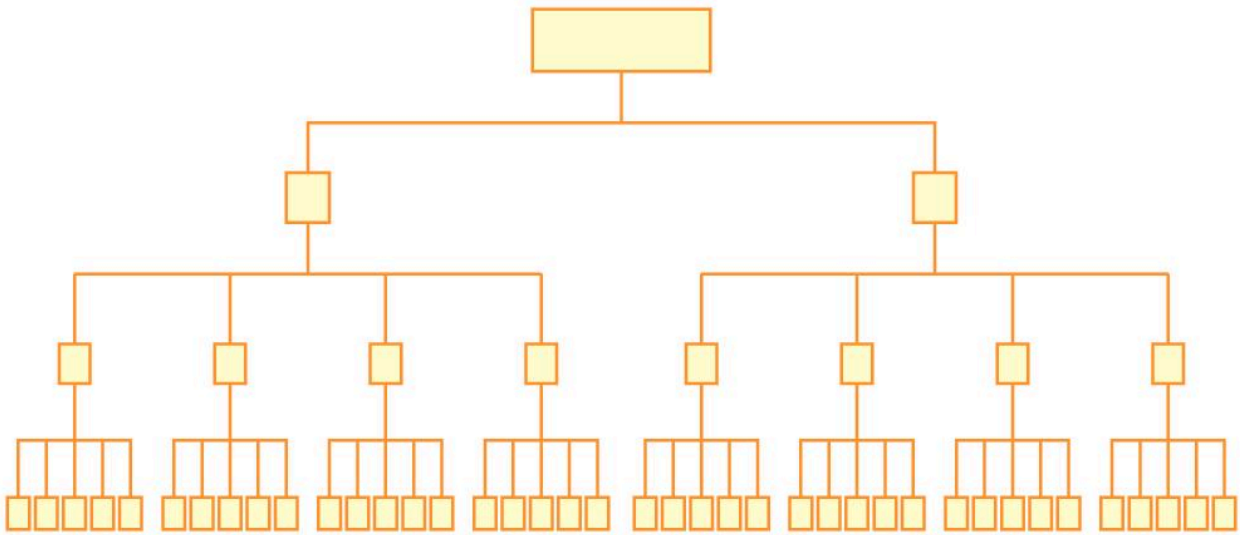


Figure 2.4.8 Example of a wide span of control ▲

Table 2.4.8 Advantages and disadvantages of a wide span of control ▼

Advantages	Disadvantages
• It can allow employees to have some input into decisions made. This can help employees to feel more involved and therefore to derive more satisfaction from their work. • Fewer supervisors or managers are required, which can be a financial saving for the business.	• It can be difficult for supervisors and managers to supervise the larger number of employees in their span of control. Close supervision is unlikely to be possible. This can lead to errors going undetected. • Each supervisor/manager has a larger number of people to communicate with and this can be time-consuming.

Progress questions

15 Outline one advantage of a narrow span of control.
16 Outline one disadvantage of a wide span of control.

Delegation

Delegation is essential in some organisations in order for them to function most effectively. When a task is delegated to an employee by a manager, the employee is accountable to the manager, i.e. they must be able to answer for their actions. If the task is not performed satisfactorily the person doing the work can be disciplined if necessary. This emphasises the fact that tasks should only be delegated to an employee who is capable of completing the work to the desired standard.

The difference between authority and responsibility

Although the authority to perform a task can be passed down the hierarchy, the final responsibility for the successful execution of the work remains with the manager who delegates the work. It is the manager's responsibility to ensure that the employee has the required skills and experience to carry out the work. Therefore, while authority can be delegated, final responsibility cannot.

The relationship between span of control and the levels of the hierarchy

Each person, other than those on the very bottom level of the hierarchy, will have a certain number of people in the organisation that they are responsible for. The span of control of a manager relates to those employees immediately beneath them in the organisational structure. However, because they have direct control over those immediately below them, they will then have indirect control over the employees in the hierarchical levels below that. However, the responsibility for those employees will belong to one of the employees in their span of control and it would indicate a lack of trust if they were to bypass them in any communication of information or work instructions.

As a person moves higher up the organisation, usually their span of control gets narrower. This is because the work of the employees towards the top of a organisation is more complex than the work of those at lower levels. The complicated nature of the work involved means that it

would be extremely difficult for their line manager to keep in touch with everything that is happening if he or she had a wide span of control.

Issues of control and trust in delegation

Delegation requires an element of trust. Trust on the part of the manager that their employee will carry out the work as required. Trust on the part of the employee that the manager will not interfere once the work has been delegated.

When a manager performs a particular task themselves they have complete control about how and when it is done and the standard to which it is done. They must accept that they will lose some control over the work if it is delegated to one of the employees below them in the hierarchy. If a task is delegated but the manager is constantly checking up to see if the work is actually being done and that it is being done to the required standard, then the employee will sense a lack of trust and may no longer be willing to undertake the task. Constant checking by the manager is also wasting the time that could have been gained by delegating the task. However, if the manager does not keep checking, how do they know that the work is being done and is being completed to the required standard?

This is the dilemma faced by people who delegate some of their work to others. According to Charles Handy, there is a clear relationship between the amount of control and the level of trust. A desire to maintain a high level of control by the manager indicates a lack of trust in the employee. High levels of trust in the employee would be demonstrated by a reduction in the level of control exerted over the employee and the work being done.

Link

See also AS Level Chapter 2.1 Management and leadership.

Charles Handy changed the views of many organisations and management theorists through his extensive writing and speaking about different approaches to management. His work continues to influence management theories today.

Table 2.4.9 Advantages and disadvantages of delegation ▼

Advantages	Disadvantages
• Employees can acquire more confidence and skills through being given the authority to perform different tasks. • Delegated tasks can make an employee feel that their manager respects and trusts them and their work. • Time is freed up for the managers to use perhaps on key strategic issues. • It can allow managers to see which employees are perhaps ready for and capable of being promoted to a more responsible post. • Delegation can prepare employees for promotion by exposing them to some of the tasks that they would be expected to perform in a higher-level post. • Tasks can be completed quicker and therefore the business can be more efficient. • It can be a strong motivator for employees.	• Time might not be saved if the manager does not have sufficient trust in the employee and spends too much time checking that the work is being done correctly. • The manager might feel a loss of control over the task that has been delegated. • Managers can feel threatened if the delegated task is performed better than if they had completed it themselves. • Problems of jealousy could occur if some employees feel that they should have been given the delegated task. • Delegation can cause tension among a group of employees if one of them is given the authority to oversee the completion of a group task. An employee can be put in charge of some co-workers for the purpose of a particular task. The roles within the group would necessarily change and this may cause relationship problems within the group perhaps causing a fall in efficiency. • The employee chosen might not have the necessary skills and experience to be able to complete the task to the desired standard and therefore time and resources might have been wasted.

The impact of delegation on motivation

Delegation is one of the non-financial motivators that can be used by managers. The trust placed in an employee to complete a delegated task can lead to the employee developing a more positive attitude to their work and to the business.

Delegation can be motivating for the following reasons:

- Giving an additional task to an employee that would normally have been done by their manager usually causes the employee to feel that their manager believes them to be capable of completing a wider range of more complex tasks than their current role entails. In such a case, the manager is using job enrichment by giving more demanding and varied tasks to employees within their span of control.
- Employees might begin to believe that perhaps they might be promoted and therefore they will work hard to justify potential promotion.
- Delegated tasks can also provide an employee with a feeling of self-esteem which is therefore meeting one of the "needs" on Maslow's hierarchy of needs (see page 88).
- The fact that an employee is given the authority to perform a delegated task can also lead to them gaining the esteem of their colleagues, thereby also meeting their esteem needs on Maslow's hierarchy.

Link

See AS Level Chapter 2.2 Motivation where Maslow's Hierarchy of Needs is covered.

Accountability

Each person in a business hierarchy will be accountable for the people directly beneath them. Overall responsibility rests with the person at the head of the organisation. For example, this will be the owner in a sole trader or partnership business and is usually the chief executive in a public limited company. For this reason when a business does not perform as expected or as required it is not unusual to read in the news that the chief executive of that business is to be replaced. This happened with some of the banks in the UK and the USA following the financial crisis of 2008. Some banks were judged to be behaving in a way that could endanger their customers' deposits. It is possible that poor business decisions had been taken below the level of the chief executive, but final responsibility for the business's performance rests with the person at the top!

The relationship between delegation and accountability

A key thing to remember is that when tasks are delegated, the authority to complete that task is given to the person receiving the task. Although the person undertaking the work might be directly accountable to the person who originally delegated the work to them, the final accountability and responsibility stays with the person at the head of the organisation. At each level in the organisation tasks are delegated from the chief executive at the top of the organisation down to the employees on the very bottom level, but if anything happens that causes the organisation to perform less well it is the chief executive who will ultimately have to answer to the shareholders.

Getting it right

Remember that while authority can be delegated, responsibility cannot.

Centralisation

Key term

Centralisation: decisions are made at the top level within the organisation.

Centralisation means that decision-making is kept at the top of the organisation. Only a limited amount of decision-making will be delegated to departmental heads or to product managers or regional divisions within the business.

Advantages and disadvantages for stakeholders

Centralisation is most likely to affect the owners/shareholders, managers and employees of a business. However, as a result of the decisions that are made the impact could be wider and could also affect the consumers. Financial institutions can also be affected because different decisions might be made depending on whether the business is centralised or decentralised. For example, a centralised business might make a poorer decision than if lower-level managers had been involved and this might result in lower or slower profitability. This in turn might have an effect on the ability of the business to repay loans in the agreed time.

Link

See also AS Level Chapter 1.5 Stakeholders in a business.

Table 2.4.10 Advantages and disadvantages of centralisation ▼

Advantages	Disadvantages
• Decisions made will be consistently across all departments or divisions. • A business image can be maintained due to the consistency of decisions. • Decisions should be made quicker due to the limited involvement of fewer senior managers. • All departments and divisions will be working towards the stated aims of the overall business; there is less opportunity for elements within the business to pursue their own aims, e.g. regional divisions that might want to develop a slightly different business image.	• Centralisation places a greater burden for decision-making on a few people at the centre of the business. • The best ideas might not always be enacted due to a possible limitation on the involvement of departmental and divisional managers. Some decisions made centrally might even be detrimental to the success of some products or regional divisions. • Managers lower down the hierarchy are less likely to develop their decision-making skills. This could prove to be a problem if they are later promoted to a more senior decision-making role.

The difference between line and staff management

Key term

Line management: a manager has direct authority over and responsibility for employees in the level immediately below them.

Line management is where a manager has direct authority over and responsibility for the employees on the level immediately below them. The manager will also have indirect authority over and responsibility for any employee whose place in the organisation structure can be linked to that manager. As seen earlier, organisation structures are usually developed along departmental, product or geographical lines and at any level a link can be seen between those above that level and those below.

For example, the managing director of a company would have direct authority over the departmental managers such as the production manager, the marketing manager and the finance manager. They would have indirect authority over the employees in those various departments

who answered to the manager of each department. A supervisor in the production department would be accountable directly to the production manager but indirectly to the managing director.

Key term

Staff management: employees who might offer specialist advice to any department without having any authority or responsibility for anyone in the department that they are advising.

Staff management involves employees who offer specialist advice to any department, product group or regional division within the business. They do not have authority over or responsibility for anyone working in the department that they are advising. For example, an information technology specialist might be asked to work with the marketing department in order to help it to improve the effectiveness of the information analysis system currently being used. The specialist would not be "managed" by the head of the marketing department. Staff management involves offering a supporting role in a specific field across the whole of an organisation rather than being linked to a specific department.

Progress questions

17 Distinguish between authority and responsibility.
18 Define delegation.
19 Briefly explain one disadvantage and one advantage of delegation.
20 Explain two advantages of centralisation in a business context.

Case Study

Spark Electrical (SE)

Spark Electrical (SE) is a multinational, based in country A. SE manufactures a wide range of electrical components for the car manufacturing industry. The international market for electrical car components is highly competitive but growing rapidly. The board of directors believe that now is the time to expand production and to open a new production facility in country B.

Although there is a good supply of labour in country B, much of it is unskilled. This will probably require employees to be under close supervision if mistakes are to be prevented. After a period of training it is possible that some of the local labour will be able to be promoted to become supervisors in the production of components.

Spark Electrical is also considering diversifying into the production of electrical components for domestic use.
If this decision goes ahead, the board of directors must consider the possibility of locating the new domestic component production in the new factory in country B.

One option the board is considering if the relocation takes place is to change the organisation structure from one based on function to one based on country or product.

Exam-style questions

1 Discuss the factors that Spark Electrical might consider when deciding on an organisational structure if it locates the production of either domestic components or components for the car industry in country B. [16 marks]

2 **a** Discuss the problems that might arise if SE does not delegate tasks to the management in country B. [10 marks]

b Explain why SE needs to ensure that managers in country B are accountable to the board of SE. [8 marks]

Key concepts

- **A** **Change** can be seen in the changing organisational needs of a business as it grows and responds to changing circumstances.
- **A** **Management** has a role in the choice and implementation of organisational structures.

Progress check

You should now be able to:

- **A** discuss the importance of an organisation structure and be able to analyse and evaluate the advantages and disadvantages of each type
- **A** assess the benefits of structuring a business by function, product or geographical area
- **A** discuss the features of a formal structure for authority, accountability, responsibility and delegation
- **A** analyse the potential impact of delegation on motivation and the relationship with span of control and hierarchical levels
- **A** understand the difference between centralisation and decentralisation and to evaluate the advantages and disadvantages of centralisation
- **A** assess the potential for conflict between line and staff management.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- A purposes of communication
- A methods of communication
- A channels of communication available to businesses
- A barriers to communication
- A the role of management in facilitating communication

Key terms

One-way communication: when information only moves in one direction, which is usually from top to bottom of an organisation.

Two-way communication: when information is passed in both directions, e.g. when information passes from the bottom up in an organisation as well as downward from the top to the bottom.

Effective communication: the successful exchange of information between people, including some kind of feedback.

Link

See also AS Level Chapter 2.2 Motivation.

Link

See also AS Level Chapter 1.4 Business objectives.

2.5 Business communication

Purposes of communication

Communication is the passing of information between two or more parties. In some situations information only moves in one direction, usually downward. This is known as one-way communication. In other circumstances information can move both to and from all of the participants. This is known as two-way communication.

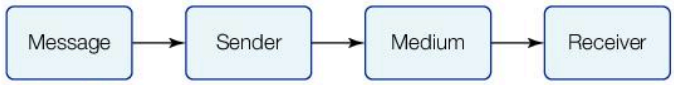


Figure 2.5.1 Communication ▲

Reasons effective communication is essential to businesses

There are several reasons why effective communication is necessary.

- To pass instruction to employees so that they know what is expected of them. For example, if a group of employees is expected to begin the production of a new product, they would need to know what exactly they are expected to make, how many are required and when they are required. The employees might also need some information about what methods they are expected to use to produce the items.
- To communicate with their current customers or target market. This might be in the form of advertising to attract the attention of potential customers or it might be in order to process orders from customers.
- To allow employees to have some input into decisions and working practices. Businesses that use employee participation as part of their motivational activities will necessarily communicate with their employees. In this instance the communication will need to be two-way.
- To allow departments to co-ordinate their activities. Business activities rarely take place in isolation. If the production department is changing the materials that they use in production, there might be some impact on how the marketing department is currently portraying the product. The marketing department might also need to undertake some market research to check whether the use of the new materials will be acceptable to customers.
- To allow employees to be given some information and insight into the business objectives so that they can feel involved and understand their contribution to achieving the business's aims.

Methods of communication

The communications methods used in any business will depend on what information is being communicated, who is sending the

Key terms

Vertical communication: communication between different levels of a hierarchy.
Horizontal communication: communication at the same level of a hierarchy.

Activities

1. Keep a diary of the different forms of communication that you use in a week.
2. Consider whether the form of communication used was the most appropriate for the situation.
3. Identify any instances when a different form of communication might have been more appropriate and state which method should have been used.

information and who is receiving it. Some communications are vertical communications, others are horizontal communications.

Issues likely to affect the choice of methods

The information being communicated will affect the chosen method of communication, e.g. if the contents of a communication are sensitive. One example would be if the information related to the poor performance of an employee.

The intended recipients of information will influence the method of communication used. If information is being passed between two individuals within the same organisation then a method of communication can be used that might not be appropriate if information was being sent to another business. For example, two people within the same organisation who wanted to arrange a meeting might do this in a telephone conversation. If a meeting was being arranged with someone from another organisation, it would be more formal and correct to confirm the meeting details in a letter.

If a lot of people need to receive the same information it would take far too long to inform each person by telephone; some form of written communication would be more appropriate.

When an instruction is being given to an employee and they are not expected to respond other than to fulfill the task they have been given, then a verbal or written communication might be used.

Sometimes it is important to have a record of what has been said, for example the records of disciplinary meetings.

Common methods of communication – written

Letters

Letters are normally used to convey or to request formal information. This can include a letter to confirm whether or not an applicant has been successful following a job application. It is also likely to be used to request a reference from those who have agreed to provide information about the applicant. Written communication of this type might also be used to inform employees of any impending redundancies and what the redundancy terms will be. Letters are also a favoured means of communication between businesses or other external organisations. For example, a letter is likely to be used to confirm the details of a future meeting between the managers of a business and local government officials.

Table 2.5.1 Advantages and disadvantages of letters ▼

Advantages	Disadvantages
• There is a permanent record of what information was communicated. • Very detailed information can be included because the reader will be able to reread as necessary.	• The communication is not instant. In some countries postal communications can take several days to reach their destination. This is even more of an issue if the letter is being sent to another country. • If the letter is handwritten it might not be easy to read. Not everyone has clear and legible handwriting. • Information can be open to misinterpretation. A meaning can be inferred that was not intended.

Reports

These are formal means of communication. Reports are used in schools and colleges to give information about the progress and attainment of students.

- Other types of report include the annual report that would be made public at an annual general meeting of shareholders in a public limited company.
- A report is also a document that can be requested within a business. For example, the production manager might be asked to write a report that explains recent differences in production levels and any action that might need to be taken.

Table 2.5.2 Advantages and disadvantages of reports ▼

Advantages	Disadvantages
• Reports can be very detailed and can include diagrams to illustrate some information and can therefore provide a lot of information to the recipients. • They are usually very structured and therefore present information in a logical way.	• Some information might not be read if the report is very long. • When reports are for general circulation, e.g. the annual report of a public limited company, care must be taken not to disclose sensitive information because the report can be read by competitors.

Noticeboards

This method might be used if information could be of general interest to various people within an organisation. A noticeboard might be used to pass on information about a planned social event or a meeting.

Posters and other forms of visual advertisements might be used to communicate information and to influence existing and potential customers.

Table 2.5.3 Advantages and disadvantages of using a noticeboard ▼

Advantages	Disadvantages
• The information is available to many people at the same time. • It might be the quickest and cheapest way of passing information to a large number of people.	• There is no guarantee that the intended recipients will see the information. • The reactions of people to the information will be unknown. • The information cannot be targeted at a specific group of people.

Emails

Emails are increasingly being used in almost all countries as a quick means of communication both internally and externally.

Table 2.5.4 Advantages and disadvantages of emails ▼

Advantages	Disadvantages
• A fast way of communicating regardless of where in the world the sender and recipient are based.	• Information overload. There is a feeling in many businesses that too many emails are being sent. This can result in important messages being overlooked due to them being "buried" among many less important emails.

Key terms

Information overload: when so much information is received that important messages can be overlooked.

Advantages	Disadvantages
• Complex documents can be attached so that a lot of information can be transmitted quickly.	• There is a danger in the business world that someone might be able to gain access to the computer system and obtain the information that is being transmitted by email. • The use of emails has meant fewer people actually having a conversation. This could lead to lost opportunities to get to know colleagues within a business and to form stronger working relationships.

Websites

Many businesses convey information about their activities on a business website. The kind of information that is seen on business websites includes the mission statement and often details of issues related to the business's policy on the environment or on providing local employment. In this way a business is advertising its focus on being a socially responsible organisation. Business websites also frequently include details of job vacancies they might have.

Table 2.5.5 Advantages and disadvantages of websites ▼

Advantages	Disadvantages
• A lot of information can be made available on a website. • If the website is very professional and sophisticated the business can project a good image. The image created can easily be influenced by the quality of the website. • A website is a relatively low-cost form of communication for businesses once the site has been established. • It allows businesses to make contact with people who they are not yet in formal contact with. This can include getting the attention of potential customers, suppliers or employees.	• The information made available on a website is accessible to anyone who visits the site. Therefore extreme care must be exercised when putting information on a website because it is available to everyone including competitors. • There is the potential for malicious individuals to gain access to websites and to add harmful information or comments. This can be detrimental to the business and could affect its reputation and image.

Social media

Increasingly businesses are using social media such as Facebook and Twitter to communicate with existing and potential customers. Many businesses "invite" people to "follow" them on social media so that up-to-date information can be given out about business activity.

Table 2.5.6 Advantages and disadvantages of using social media ▼

Advantages	Disadvantages
• Faster communication with people outside the business, for example existing and potential customers. New products or offers on products can be communicated more quickly than by using conventional advertising or communication methods. • Immediate reaction from people can be obtained through responses posted on social media. • The business could gain a more modern image through its use of such media. • Such interaction between the business and its customers might allow the business to be more responsive to the needs of its customers.	• There is a danger that information might be released through social media that was not intended for public knowledge. • The target market of the business might not be in the section of the population that habitually uses social media. • Some customers might become dissatisfied if they do not receive a response to their suggestions or communications. • Someone within a business will have to allocate time to manage the Facebook and/or Twitter communications.

Common methods of communication – spoken

Meetings

These can be small meetings between two or more individuals perhaps meeting on a team level to discuss work-related issues. Meetings can also be on a large scale and can be arranged between managers and their employees. These can be for the purpose of outlining any future plans and changes within the organisation. When meetings are held it might be that the manager or owner wants to get an instant response from those attending.

A manager will also meet with employees as part of the appraisal system. This should be a one-to-one meeting with each person having an opportunity to voice their opinion.

Table 2.5.7 Advantages and disadvantages of meetings ▼

Advantages	Disadvantages
• Allows some interaction between those attending the meeting. • Some instant feedback can be acquired. • The body language of people can be seen and interpreted.	• Meetings can be time-consuming. Sometimes issues, other than those intended for discussion, are introduced and the focus of the meeting is lost. • If meetings take place during working hours then no work can be completed during that time.

Telephone

Telephone conversations take place between employees within the same organisation or between employees in different businesses. The conversations might be part of negotiating a new business order or they might be in order to check details of an existing order.

Table 2.5.8 Advantages and disadvantages of using the telephone ▼

Advantages	Disadvantages
• A quick form of communication and an instant response can be gained. • It allows for information to be questioned and for answers to be given.	• There is no guarantee that the person on the other end of the phone is actually listening and paying attention to what is being said. • There is no record of what was said. • The body language of the people involved cannot be seen. Body language might indicate something different to what is being expressed verbally.

Mobile phones

Many businesses provide mobile phones for employees at certain levels of responsibility. This means that they are always contactable by the business. If they are away from their place of work, at a meeting with a supplier for example, they can be contacted directly if a problem arises in their workplace.

Table 2.5.9 Advantages and disadvantages of mobile phones ▼

Advantages	Disadvantages
• Gives the potential for some managers to be contactable 24 hours a day, seven days a week. • Employees can be in contact while travelling, therefore they can still be working whilst away from their workplace.	• The employee can feel that they are never away from work. • Line managers might contact employees when they should not be working and expect the employees to respond.

Common methods of communication – electronic

Video conferencing

Businesses are using more modern electronic communication systems for both internal and external communications. A videoconference can be held between two or more people in a variety of locations.

Table 2.5.10 Advantages and disadvantages of video conferencing ▼

Advantages	Disadvantages
• Saves time because people do not need to travel to meetings. • The costs involved in travelling to meetings are saved. • People working in different parts of the world can hold regular meetings in this way. This allows for geographical divisions within a business to be in contact and therefore lead to better co-ordination of activities. • The cost of the equipment is small compared to the costs saved. • It allows for some eye contact to be made and for body language and tone of voice to be observed.	• Meetings held in this way do not allow for a physical sampling of a new product such as a new chocolate bar or a new blend of tea. • It can be difficult to assess who wants to have input if the group in communication is large. • It is difficult to judge the body language of those participating. • Any time lag can disrupt the fluency of the discussion.

Getting it right

Questions on business communication will have a specific context. Make sure that any methods of communication you include in your answer are relevant to the context given, particularly the organisational structure. Choose the most appropriate method in any given situation.

Activities

Choose an appropriate method of communication for each of the following and explain why you chose the method:

1. Information from a head teacher to parents about a change to the holiday dates for the next school year
2. The finance manager needs to inform the marketing manager that the finance for the next quarter's market research has been cut by 50 per cent.
3. Notify employees that there will be a sports day for them and their families.
4. Ask for the personal details, e.g. bank account details, of a newly recruited employee.
5. Inform several employees that their jobs are to become redundant.

Progress questions

1. Briefly explain two reasons why effective communication is essential to a business.
2. Identify two written forms of business communication.
3. Identify two spoken (verbal) forms of business communication.
4. Briefly explain two advantages of electronic forms of communication.

Case Study

Tredbo Ltd

For many years Tredbo Ltd has been producing packaging materials for sale to other businesses. Originally a small family business, it now operates in two large factories, each one employing 200 people, one in the north of the country and one in the south. The existence of two factories meant that Tredbo could expand the business in different parts of the country. The business mainly supplies other businesses with materials to package a wide range of products. The two factories have proved to be

a great success and the combined orders received in the latest year have grown by 150 per cent.

Tredbo has always sourced its own materials from one main supplier with additional raw materials occasionally being purchased from a large international business.

In recent weeks Tredbo Ltd has received an offer from an international supplier to purchase its northern factory. The managers feel that they will probably reject the offer.

However, an article has appeared in a newspaper local to the southern factory saying that an international purchaser is about to purchase the factory in the south of the country. The article also said that all production would be moved from the factory to one that the purchasing business already owned. Naturally the article has been seen by many employees.

1 Discuss the steps that the managers of Tredbo Ltd might take to make sure that their employees have accurate information and to reassure them that their jobs are safe.

Key term

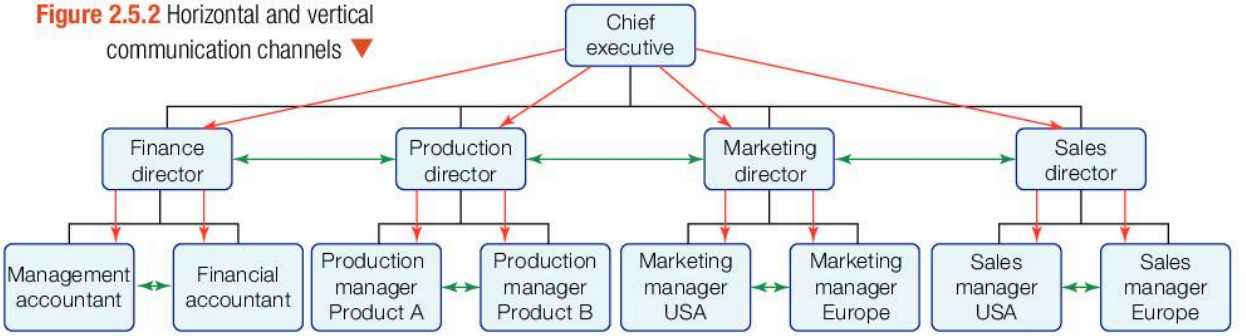
Channels of communication: the routes within an organisation structure taken by an information flow.

Channels of communication

The usual channels of communication are those indicated by the business structure. Channels of communication often follow the chain of command (see page 359 A Level Chapter 2.4). However, as well as passing information up and down the hierarchy within a business there is also, for example, a need for communication between departments. Therefore, in most businesses there is a need for communication to occur both vertically and horizontally.

There are occasions when communication might not take the route indicated by the chain of command. For example, if an employee felt that they were being discriminated against by their manager, they would not feel comfortable complaining to that manager. In such circumstances, the employee concerned would be more likely to speak to their manager's line manager or to take their complaint to the human resources department.

Figure 2.5.2 Horizontal and vertical communication channels ▼



In Figure 2.5.2 the communication can be one-way or two-way communication. This will depend on the culture and the leadership style in the business. Vertical downward communication might be the passing down of orders while vertical upward communication could be giving some feedback on progress on a particular project.

Horizontal communication is when information is passed between people on the same level of the hierarchy and can be essential in order to co-ordinate business activities.

One-way communication can apply to both vertical and horizontal communication. It is usually for the giving of information, orders or direction. This does not allow for any feedback to be given.

Two-way communication means that information can travel vertically both upwards and downwards and in both directions between people on the same level of the hierarchy. It allows for information and feedback to be passed up the hierarchy. Two-way vertical communication can lead to managers receiving valuable input from those below them in the organisation, which can lead to improved products, services or systems being introduced.

Two-way horizontal communication can improve the co-ordination and co-operation between departments or divisions within a business.

Barriers to effective communication

Key term

Barriers to communication: anything that prevents the receiving and understanding of information.

Sometimes communication fails and the message is not received and acted on. There are many reasons why this might occur. Some reasons are the fault of the sender and other problems can be the fault of the recipient of the message. Some messages are not received due to conditions that are beyond the control of both the sender and the receiver. There are many barriers to communication that businesses must be aware of and strive to prevent.

What can prevent a message being received and understood?

Using the wrong communication method

For example, if managers require all employees to attend a meeting then a message on a noticeboard might not be appropriate. It cannot be guaranteed that all employees will see the message. Similarly if managers wanted to let a group of people know that they are likely to be made redundant, it would not be appropriate to put that message on a noticeboard. That is the type of information that should be conveyed using a more personal medium such as a letter to each person involved.

Information overload

If too much information is being received then it might become difficult to filter out the most important messages. Messages that require a quick response might be overlooked among all of the other messages received.

Figure 2.5.3 Email overload? ▲

This is a criticism that has been directed at the use of emails. Emails are very quick and easy to send and some businesses have now realised that people within their organisations are receiving so many email messages that important ones are not always being read.

Too many communication stages

If a message has to pass through many levels in a hierarchy, i.e. in a tall organisation structure, there is a danger that the message will become

Key term

Communication: the passing of information between two or more people.

distorted during its journey from the sender to the recipient. The information received might be slightly different to the message that was originally sent and this can result in wrong actions being taken. Verbal communication might not be appropriate in a long channel of communication.

Noise

If a conversation is being held in a very noisy factory it is possible that some parts of the conversation might not be heard or might not be heard correctly.

Noise might be in the form of many conversations taking place in the same room. Imagine how difficult it must be for the people working in a busy call centre where hundreds of telephone calls might be taking place at the same time.

Figure 2.5.4 A construction site ▲

In a meeting situation several people might be attempting to speak at the same time and this can result in part of someone's input not being heard. If people near to you are holding a conversation when someone else is speaking it can make it very difficult for you to hear the speaker.

A distraction in the room while a conversation is taking place can lead to a lack of concentration and therefore part of the information being missed. For example, if someone asks you to do something in your home while you are watching television or listening to music, you might not hear precisely what they say.

If there is a danger of any noise interference then a written form of communication might be more appropriate.

Language

A frequent cause of information not being understood is the use of inappropriate language. If a technical report is being written for other technicians to read then using technical language would be appropriate. However, if the report is designed to be read by people who do not have technical training then technical jargon should not be used.

The language used should be appropriate for the intended audience.

Words can mean different things in different countries, therefore consideration must be given to how misinterpretation might occur when businesses are communicating across national boundaries. For example, a mobile phone has different names in different countries; in Malaysia is it known as a hand phone whilst in France it is a portable phone.

Local dialect words and expressions should not be used as these are unlikely to be understood by people outside that particular region.

Emotions

Our emotions can be reflected in our attitudes and perceptions. For example, if an employee feels that their job security is threatened by

actions and/or decisions that are being taken by a business then the employee may develop a negative attitude to their work and to their managers. Someone who works in a business that is experiencing growth might develop a more positive attitude to their work and to the business as a whole. They might believe that their promotion prospects could be improved if the business is growing.

Such emotions can change our interpretation or understanding of a message. For example, if we are feeling threatened and insecure during an appraisal interview we might interpret comments made in a more negative way than they were intended. The manager conducting the interview might suggest that more training is undertaken. If the employee is feeling insecure they might interpret that as meaning that their current skills are inadequate. However, the manager might be suggesting training as a preparation for a more highly skilled role in the business.

If a discussion results in one or more of the participants becoming angry then the anger can become an obstacle to their willingness to listen to what the other person has to say and therefore communication breaks down.

Many people have been to an appointment with a doctor and have not been able to remember everything that the doctor told them once they have left the doctor's office. This can be because they have been diagnosed with an illness and after hearing the diagnosis they were unable to concentrate on what the doctor said.

Progress questions

5 Briefly explain two possible barriers to communication.
6 Explain how a negative attitude might influence how a message is interpreted.
7 Give one benefit of written communications.
8 Give two situations in which spoken communication might be suitable.

Activities

1 In small groups identify two occasions when communication within your school or college has not been effective.
2 Discuss why the communication failed and suggest ways in which this might have been improved.
3 Research events in the news related to local or national businesses in which effective communication would have been necessary and suggest what forms of communication might have been used and why.

The role of management in facilitating communication

Effective communication is essential if the objectives of a business are to be communicated to those who need to be informed. Management will need to determine what form communication must take in order for it to be most effective. Some questions need to be considered:

- Will the communication need to involve all departments?
- Will one-way communication be used to simply pass instructions to whoever is involved?
- Will feedback be required on a regular basis, therefore will two-way communication be used?
- Will one person feed information to all those involved or will each participant need to be in contact with everyone else involved?

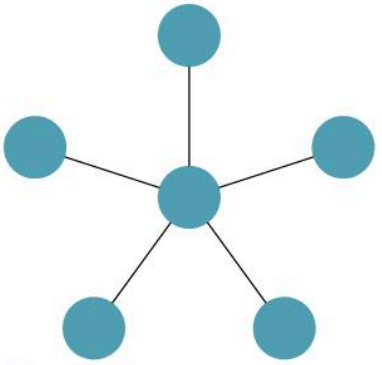


Figure 2.5.5 Wheel network ▲

The person in the centre of the "wheel" is usually the leader of the group and will pass information to everyone else involved.

A wheel network

If one person is controlling the information, and contact between the different participants is not required, then a wheel network can be used. This could be in the case of a chief executive who communicates a change in business objectives to the managing directors of branches in different countries.

A circle network

In a circle network information is not freely exchanged between the members of the circle. Each person within the circle maintains contact with two others. Information would have to be passed on to those who are not in direct contact with each other.

A chain network

The chain network describes the communication within a hierarchical structure. The communication can be one-way or two-way depending on the culture in the organisation.

A connected network

A connected network is when information passes freely between all those involved. There is no set pattern or channels for communication. This can work when meetings are held when all people who are involved are in attendance. Ideas can be voiced and discussed and each individual has an opportunity to comment. One problem with this type of communication is that it can be difficult to reach a consensus of opinion. Someone might need to take control of the discussion in order for agreement to be reached.

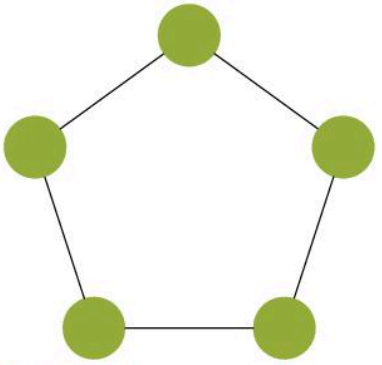


Figure 2.5.6 Circle network ▲

Figure 2.5.7 Chain network ▲

The chain network follows the hierarchical structure within an organisation.

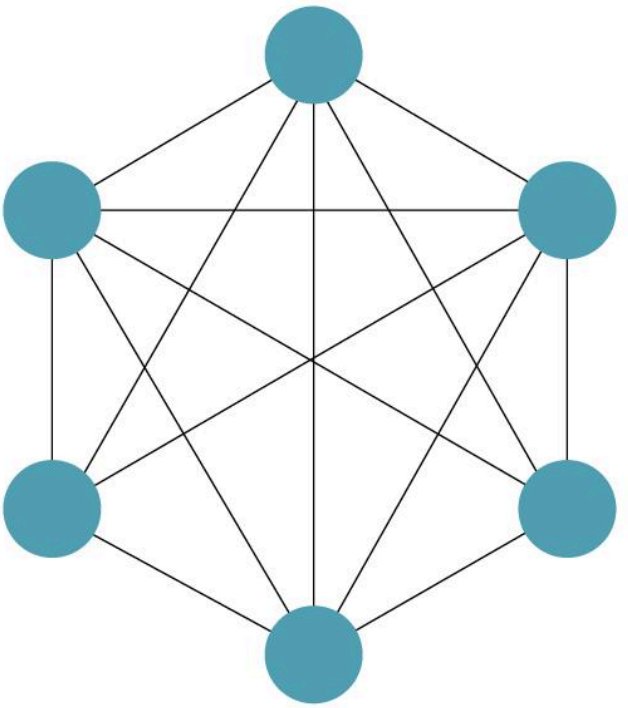


Figure 2.5.8 Connected network ▲

All those involved have the opportunity to communicate with each other.

Progress questions

9 Explain the difference between a wheel network and a circle network giving examples when each may be used.

10 Which type of network might an autocratic manager use?

Formal and informal communication

Key terms

Informal communication: information is passed or exchanged outside the formal communication channels.

Restructuring: in a business context this is when a business makes changes to its organisation structure.

The methods of communication already mentioned have been largely formal means and channels of communication. However, in most businesses it is inevitable that some informal communication will take place. Employees will meet in the canteen or on their journeys to and from work and their conversations will often include some discussion about work. Information will be exchanged that may or may not be factual. This is even more likely to occur if there are issues, such as restructuring taking place. If a business is known to be in discussion with another business about a possible merger, it is understandable that employees will talk to each other about what they think might happen to their jobs as a result. This type of informal communication is known as the "grapevine". Business managers cannot ignore its existence and they cannot prevent employees from talking to each other. However, it is important that managers are aware of it and, if possible, know what is being discussed.

Informal communication can have both positive and negative effects on a business. A disruptive or negative employee can create a negative atmosphere among their colleagues. Managers need to be aware of any such influence and take appropriate action to prevent disharmony in the business.

Informal communication is sometimes based on rumour rather than fact and this can result in employees feeling threatened unnecessarily. For example, in the case of a rumoured takeover of another business, it might be that the jobs at the other business are more at risk, therefore the fears might have been unfounded. Alternatively it could be that there is no truth in the rumours and therefore no threat to jobs at all. If a manager hears about such discussions it is important that malicious rumours are stopped by giving facts if that is possible.

The impact of effective communication on business efficiency

The most obvious benefit of effective communication is that the business will be able to operate in a much more efficient manner. Decisions can be made quickly and communicated effectively to all relevant stakeholders. The required information will be available due to the ability of those involved to communicate the relevant information to the appropriate person or department.

Costs, both in terms of time and financial costs, can be saved through the use of the most efficient means of communication.

Communication between participating departments prevents duplication of effort and ensures that activities are co-ordinated across the business.

Link

See AS Level Chapter 2.2 Motivation.

Getting it right

Some case studies will contain information about issues within a business that can cause communication problems. Make sure that you answer questions using content that is relevant to the specific business situation.

It is essential that in a development project all aspects of the project are ready at the same time. Regular communication between those involved can ensure this.

The extent to which all employees are kept informed about business objectives and activity can influence their sense of involvement in the business. A feeling of involvement can have a significant impact on the levels of motivation of employees.

Progress questions

11 Suggest one situation when it might be appropriate to use a circle network for communication.
12 Explain when a connected network might be used in a business.
13 Distinguish between formal and informal communication.
14 Briefly explain two advantages to a business of effective communication.

Exam-style questions

Creative Robotics (CR)

Creative Robotics (CR) is a public limited company. It has been developing and manufacturing mechanisms that can be fitted to weak arms and legs so that they can function normally. The majority of the people working at CR are highly skilled designers and engineers. However, there are very few businesses making products of this kind and so the skills of the employees are highly specialised.

Rumours have recently begun to circulate among the employees that the senior managers are about to announce a cost-cutting exercise and that there is a proposal to reduce the salaries paid to employees. Most of the employees have ignored the rumours because they have believed them to be untrue. However, some conversations have been overheard that discussed the possibility of job cuts being involved as part of the cost-cutting measures.

The trade union that represents most of the employees has been contacted and asked to take action to protect the jobs and incomes of the employees.

The senior managers have become aware of the conversations and some of their content. They are concerned because they have never intended to cut jobs or salaries. They are looking at cheaper production methods and possible cheaper sources of materials and components.

1 Explain the methods of communication that CR would be advised to use in order to make sure that employees are receiving accurate information about the cost-cutting measures. [14 marks]
2 Discuss the potential impact that the informal communication could have on the efficiency of CR. [16 marks]

Eduplay Ltd

Eduplay Ltd is a manufacturer of wooden toys that have been developed to be educational as well as fun. The business also has its own retail outlets in many parts of the country. The toys are sold to individual customers as well as to schools. It is also receiving enquiries from other toy retailers who want to stock Eduplay toys in their shops.

Although the business has been in existence for four years it is now beginning to experience a sudden increase in popularity and a good reputation for well-made toys that can survive rough handling by children.

As a consequence of the increased popularity the number of orders being received each week has tripled. This is causing some problems in the business. Several shops have placed orders over the telephone while others have put their orders in writing. The managing director has just been informed that some telephone orders have not been passed on to the production department and customers have begun to complain due to their orders not being delivered. There has also been an instance of two orders placed by telephone being mixed up and the orders being dispatched to the wrong customer. Some customers have complained that the wrong number of items have been sent to them while others have not received the colour of toys that they ordered.

In the past, orders have been placed in a tray on the production manager's desk. The manager would then give out the work to the appropriate employees. The work could easily be completed within two or three days. However, since the surge in demand the length of time between receiving an order and completing it has increased to two weeks. Problems have arisen due to orders being completed in the wrong sequence, with the newest orders having been placed on the top of the tray and therefore being completed before older ones. There have also been occasions when production could not take place due to insufficient raw materials having been ordered.

Customers are now complaining about the length of time they are waiting for their orders. Also the business's own retail shops are experiencing gaps on their shelves due to late delivery of orders.

3 Analyse the possible reasons why customers are not receiving the correct orders. [10 marks]

4 Evaluate the methods of communication that Eduplay Ltd could use to improve the processing of orders for its toys. [14 marks]

5 Discuss the potential implications for Eduplay Ltd of not having an effective system of communication. [14 marks]

Key concepts

- **A** **Change** can be seen by considering the changing needs of communicators and new technologies which can enhance communication.
- **A** **Management** can be seen by considering how managers can facilitate and improve communication as well as the various management needs for effective communication.
- **A** **Customer focus** can be reviewed through the perspective of the 4 Cs and the customers' needs for communication.
- **A** **Innovation** can be explored through new means of communication.
- **A** **Creating value** can be developed by considering how customer perceptions of value can be changed by communications.
- **A** **Strategy** can involve corporate policies on improving communication.

Progress check

You should now be able to:

- **A** analyse the appropriateness of various methods of communication in a given situation
- **A** discuss the importance and the benefits of different channels of communication
- **A** recognise potential barriers to communication in a particular situation and recommend ways to overcome them
- **A** assess the influence of informal communication within a business situation
- **A** analyse and evaluate the impact of effective communication of the efficiency of a business.

You should be able to relate these to a range of businesses in different situations.

3 Marketing

APN
We had to make it bigger to carry all the awards it's won.
The new i30 wagon
HYUNDAI
NEW ZEALAND
HYUNDAI i30 - NBR 2008 SMALL CAR OF THE YEAR
www.hyundai.co.nz

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **A** the role the marketing plan plays in planning
- **A** income, promotion and cross elasticity
- **A** the process of product development
- **A** forecasting sales
- **A** co-ordinated marketing strategies focused on achieving specific objectives

Link

For more information on PEST and SWOT see A Level Chapter 6.2 Strategic analysis.

Links

Review setting corporate and marketing objectives in AS Level Chapter 3.1 What is marketing?
Review marketing mix in AS Level Chapters 3.3a The marketing mix: elements and product and 3.3b The marketing mix: price, promotion and place.
For more information on techniques for strategic analysis see A Level Chapter 6.2 Strategic analysis.
For more information on business planning see A Level Chapter 6.4 Strategic implementation.

3.4 Marketing planning

Market planning

Market planning is the systematic approach to developing marketing objectives and setting out specific activities that will implement the marketing strategy designed to achieve the objectives. It will result in a marketing plan setting out these activities. The layout for the plan may take a variety of forms. Whatever the layout and format, the questions below must be covered. The Solo Software case study gives a typical example of the headings for a marketing plan. It involves answering four questions in relation to marketing activities:

- Where are we now? (Carrying out an audit, e.g. PEST, SWOT)
- Where do we want to go? (Setting marketing objectives)
- How are we going to get there? (Deciding segmented target markets and an appropriate marketing mix)
- How do we make sure we get there? (Monitoring using performance standards and benchmarks)

The marketing plan has to fit into the overall business plan for the organisation.

Key terms

Market planning: a systematic approach to developing marketing objectives that sets out specific activities to implement the marketing strategy designed to achieve the objectives.
Marketing plan: sets out the activities associated with developing marketing objectives and strategies to achieve them.
Audit: an investigation to determine exactly what position in the marketplace a business is in.

The benefits of a market plan

Setting a marketing plan will:

- Ensure that the marketing activities are aimed at achieving corporate objectives
- Encourage a rational integrated approach to marketing
- Improve the efficiency of the business in relation to using its resources by providing a framework for marketing activities
- Increase commitment of employees as different roles are given specific actions to carry out
- Better prepare the business for change as there is ongoing monitoring and evaluation.

However, market plans can be complex, time consuming to prepare, only understood by those who draw them up and they may be taken as inflexible, making a business unprepared for change.

Figure 3.4.1 The market plan ▲

Getting it right

Marketing planning has a close connection with budgets. Make sure you refer to budgets when writing about marketing planning.

Link

Review price elasticity in AS Level Chapter 3.3b The marketing mix: price, promotion and place.

Case Study

Solo Software plans

Solo Software Company is a new company aiming to provide dedicated software for businesses that enables resources to be tracked in a secure way. It is planning to enter a market dominated by large companies like Amazon and IBM. Solo thinks that it can offer a more personal service. The marketing manager has prepared a brief market plan which follows.

Audit

The market is expanding, employees are talented, the product is excellent. Competition is high.

Corporate objectives

To become profitable within three years.

Marketing objectives

Win one major company contract within 12 months and sell $1 million in Year 1, increasing sales by 200 per cent in Year 2.

Target markets

Growing businesses with revenues $0.5 million to $10 million per year that operate call centres and have difficulty raising capital.

Marketing mix

Product: secure designer software to meet customer needs.

Price: competitive pricing significantly lower than competition starting with a free month with each order.

Place: online via website.

Promotion: offering information and offers via websites using search engines, plus email marketing and social media. Cost to be 15 per cent of total sales.

Monitoring

Key variables: check the following: that 1 per cent of visitors request a consultation, the level of monthly revenues and profits, the number of industry awards and the number of magazines and media featuring Solo.

1 Comment on the likely effectiveness of this market plan in terms of:
- **a** Its layout
- **b** Its likely success.

Elasticity and its usefulness in a market plan

Price elasticity of demand is useful when trying to determine what the effect of a price change will be on demand or revenue. Other measures of elasticity will help a business see the effects of changes in consumers' income, spending on promotional activities and changes in the price of other products on these variables. This will help a business plan to take account of what is likely to happen if the general economic situation changes, if spending on promotion is being considered or changes in prices of other companies' products occur. It is important to remember that there may be other factors operating to alter sales. Measures of elasticity assume that all these other factors are constant.

Income elasticity of demand

Role of income in demand

Income is a major determinant of sales and demand. Income elasticity of demand addresses the question of how much sales change if there is an income change. Consumer income changes as a result of changes in the economy of a country. Examples include:

- Recession – a fall in incomes causes a fall in demand
- Economic growth – a rise in incomes causes a rise in demand
- Falling unemployment – a rise in incomes causes a rise in demand.

These changes in income may occur throughout the whole economy or in selected geographical or occupational areas and are outside the control of a business. The demand for most products usually rises as income rises and falls as income falls so these are called normal products.

Calculating income elasticity of demand

Key term

Income elasticity of demand (YED): a measure of the relationship between a change in the quantity demanded of a particular good due to a change in income.

Income elasticity of demand (YED) is a measure of the relationship between a change in the quantity demanded of a particular good due to a change in income. (Y stands for income to avoid confusion with I for Investment.)

Mathematically this is shown as

$$\text{YED} = \frac{\%\text{ change in quantity demanded}}{\%\text{ change in income}}$$

Example

A chair was priced at $50 and it sold 200 units in a week. Economic growth led to consumers' income rising by 10 per cent. Sales rose to 230 units a week.

$$\text{YED} = \frac{\%\text{ change in quantity demanded}}{\%\text{ change in income}}$$

$$= \frac{\frac{30}{200} \times 100}{10\%}$$

$$\text{so YED} = \frac{+15\%}{+10\%}$$

so YED = +1.5 (the positive sign indicates that demand rises with income).

A 10 per cent rise in income has resulted in a larger rise in demand of 15 per cent. This means the chair is sensitive to changes in income. It is said to be price elastic (PED is more than 1). The shop will have seen an increase in revenue from $50 × 200 = $10 000 to $50 × 230 = $11 500.

Figure 3.4.2 Butter for sale in India ▲

Knowing YED can help a business in a time of changing incomes. If incomes are falling a business will face falling sales and may need to adjust its marketing mix to try and offset this. Markets may become more competitive as total sales fall. The opposite may happen if incomes rise. There are some products that may see a fall in demand as incomes rise (inferior products). These products are often products of lower quality. Consumers switch to higher-quality more expensive products as their incomes rise. Examples include margarine (switch to butter), and grains (switch to meat), as is currently happening in many countries in Asia.

Activity

Work in pairs. Each person should produce a scenario where a certain change in income produces a resulting change in a demand for a named product. Each person calculates the YED and also produces a possible reason for the result. Check the answers together.

Sample elasticities of demand

Income elastic – YED greater than 1

Cars: 2.3

Restaurant meals: 1.5

Income inelastic – YED less than 1

Tobacco: 0.6

Inferior products – negative income elasticities

Margarine: −0.2

Public transport: −0.4

Promotional elasticity of demand

Key term

Promotional elasticity of demand (PrED): measures how much demand changes as a result of a promotional campaign.

Promotional activity can be a major determinant of sales and demand. Promotional elasticity of demand (PrED) measures how much demand changes as a result of a promotional campaign. Normally this is applied to advertising in particular. Generally advertising increases demand and it is useful for a company to know by how much so that it can decide whether the spending on advertising is worthwhile. If more revenue is gained than the cost of the adverts the business will go ahead with the campaign.

Calculating promotional elasticity of demand

Mathematically PrED is shown as:

$$\text{PrED} = \frac{\%\text{ change in quantity demanded}}{\%\text{ change in promotion spending}}$$

Example

An MP3 player was priced at $50 and it sold 300 units in a week. The shop increased its advertising in local newspapers from $1000 to $1500 per week. Sales rose to 330.

$$\text{PrED} = \frac{\%\text{ change in quantity demanded}}{\%\text{ change in promotion spending}} = \frac{+30 \times 100}{300}$$

$$\frac{\$500 \times 100}{\$1000}$$

$$\text{so PrED} = \frac{+10\%}{+50\%}$$

$$\text{so PrED} = 0.2$$

A 50 per cent increase in promotional spending has resulted in a smaller rise in demand of 10 per cent. This means the MP3 player is not sensitive to the increased advertising. Nevertheless the shop

Getting it right

You must indicate whether income, promotional and cross elasticities are positive or negative. Showing a positive or negative change is an important factor in the effect of the change in income, promotion spending and price of other products on demand.

will have seen an increase in revenue from \$50 × 300 = \$15 000 to \$50 × 330 = \$16 500. An increase of \$500 in advertising has resulted in extra revenue of \$1 500 per week so the increased adverts have been effective in increasing sales revenue. However, it may be that the purpose of the adverts was to raise awareness rather than sales, so this measure should be used with care.

Progress question

A product has a promotional elasticity of demand of 4.5. On the basis of this the marketing manager recommends an advertising campaign costing \$1 million. His assistant is not sure that this spending will be worthwhile.

1 Explain why these two people might have different views.

Knowing promotional elasticity of demand can help a business if it is considering a promotional campaign as it shows how much sales demand will alter and how much sales revenue will change. For example, the average value of promotional elasticity of demand across a range of industries in the USA is 0.22.

Cross elasticity of demand

Key term

Cross elasticity of demand (CrossED): measures how much sales change if there is a price change in another product.

The price of other products can be a major factor in determining the demand for a product. Cross elasticity of demand (CrossED) addresses the question of how much sales change if there is a price change in another product. Some products are substitutes for each other and we would expect that a price change in one will cause a large demand change in the other.

For instance, if the price of margarine rises we might expect the demand for butter to rise too as consumers switch to the relatively less-expensive substitute. These products will have a positive value for cross elasticity.

Some products are not related to each other and we might expect that a price change will not have any effect. For instance, a change in the price of computer games is unlikely to affect sales of potatoes. These products will have a value for cross elasticity of zero. Some products are complementary, that is they are usually bought together or rely on each other. Examples are petrol and cars. Their value for cross elasticity will be negative. If the price of petrol rises, sales of vehicles with high petrol consumption are likely to fall.

Calculating cross elasticity of demand

Mathematically cross elasticity of demand is shown as:

$$\text{CrossED} = \frac{\%\text{ change in quantity demanded of product A}}{\%\text{ change in price of product B}}$$

Example

A radio was priced at \$50 and it sold 300 units in a week. The price of MP3 players with internal radios fell from \$80 to \$60. Radio sales fell to 200 units per week.

$$\text{CrossED} = \frac{\%\text{ change in quantity demanded of product A}}{\%\text{ change in price of product B}}$$

$$= \frac{\frac{100}{200} \times 100}{-\frac{\$20}{\$80}}$$

$$\text{so CrossED} = \frac{-33\%}{-25\%}$$

so CrossED = +1.3 (the positive sign indicates the two products are substitutes)

A 25 per cent fall in the price of MP3 players has resulted in a fall in demand for radios. In this case the radio shop will need to take some action to combat the increased competition.

If the cross elasticity of demand is negative the two products are complementary. A price fall or rise in one will result in a corresponding demand rise or fall in the other. Knowing this will enable businesses to plan for possible price changes in other products.

Progress questions

Cross elasticities are shown for the following products:

Butter and margarine +0.8

Entertainment and food −0.7

2 For each pair of products identify whether they are complements or substitutes.

3 Explain the different behaviours of the two pairs for a price fall in one of the two products.

Getting it right

Always state what kind of elasticity you are writing about – use price, income, cross or promotional elasticity, never just the word elasticity.

Progress questions

Country X is a developing country with steady economic growth of 6 per cent per year. Most people are experiencing rising incomes as wages go up, more skilled jobs are appearing and there is less unemployment. The table shows some statistics relating to car sales, petrol sales and the number of bus tickets sold in two successive years.

Year	Income per head \$000	Number of cars sold	Petrol sales Millions of litres	Bus tickets sold 000
2012	15	40	300	180
2013	15.45	49	303	160

4 Calculate the following and state whether the product is income elastic or income inelastic and whether it is a normal product or an inferior product:
- **a** Income elasticity of cars
- **b** Income elasticity of petrol
- **c** Income elasticity of bus travel.

5 Explain any differences you have found.

6 In what ways might this information be useful to car manufacturers, oil companies and bus companies?

Getting it right

When asked to comment on elasticities remember that they are only estimates, and sales of a business may have been influenced by a wide range of factors. They are only a guide to setting prices.

Link

Product development is also covered in AS Level Chapter 3.3a The marketing mix: elements and product.

Product development

New product development is the creation of products with new or different characteristics that offer new or additional benefits to the customer. Product development may involve modification of an existing product or its presentation, or formulation of an entirely new product. It is important for businesses to consider developing new products all the time as existing products reach the decline phase of their life cycle, as new technologies appear, as market gaps are identified, as a way of expanding into different markets and as a way to maintain their competitive advantage over rivals.

Product development requires planning, it does not just happen. Developing a product starts with an idea and moves on through stages in the planning process as described below. Each stage will follow on from the previous and market potential will be a key factor in deciding how far to proceed with an idea. It is important to remember that product development occurs in providing services as well as products.

Planning process

Developing a new product is a process. There has to be an initial idea that may either be based on market research or on the ideas generated from within the business. This idea must then pass through stages until the product is being sold in the market. The product may be discontinued at any of these stages.

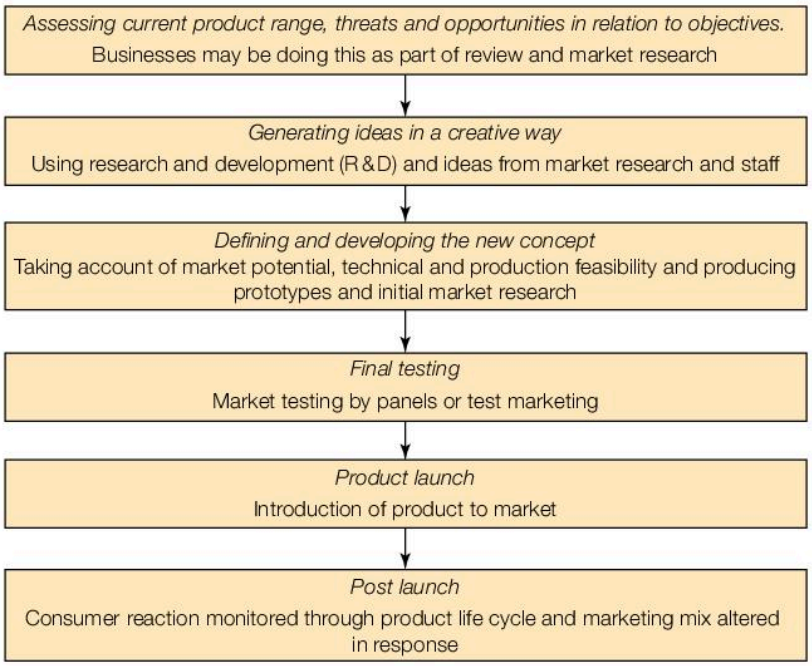


Figure 3.4.3 The planning process ▲

Sources of new products

Many large businesses have specialist R&D departments or draw on other organisations which have dedicated laboratories and ideas programmes. Universities and governments set up centres to develop

Key term

Research and development (R&D): a function within a business set up to investigate new ideas/products/services and then to develop the best of these into marketable products/services.

Fig. 3.4.4 Inside an R&D laboratory ▲

new ideas that can be explored by commercial businesses. Research and development (R&D) spending is typically 4 per cent of sales revenue but a typical large manufacturing business will spend 10–15 per cent on R&D, and high technology and chemical businesses spend much more. Globally $1.6 trillion per year was spent in 2014, a 3.8 per cent increase from 2013, with 50 countries spending over $100 million per year. The importance of R&D is shown by the fact that most countries saw an increase between 2012 and 2014 in a time of static economic growth, with governments continuing to support directly and by granting tax advantages to R&D.

Other sources of product ideas are less organised and include:

- Customers
- Sales staff
- Production teams
- Market research
- Existing products
- Fiction and films
- Ideas meetings.

Ideas from these sources may be taken up by the R&D teams and developed. This interplay between market research and product development is an important feature of many successful products. At each stage market research may be undertaken to check that the developing idea is appropriate for the market and this allows modifications based on the market reaction to take place.

Measuring the effectiveness of R&D

This is quite difficult to do. Possibly only 1 per cent of research projects go on to give a successful product in the market. But this one success may have been dependent on other failed research and most successes take a long time. The number of patents, research papers and licences issued may indicate how successful spending has been, but none of these relate directly to profits and sales.

Case Study

Syngenta

Syngenta is a leading plant science company, employing 4000 scientists and spending $1 bn per year on R&D, developing new plants and products. It begins with market research to identify consumer needs and has focused on new varieties, genetically modifying technology, and insecticides/herbicides. Labs test 50000 chemicals each year, of which c. 2000 have some promise and maybe 1 or 2 progress further to be tested in their fields and glasshouses at a cost of perhaps $200 million. Its Gallant wheat variety was developed to give higher yields and a better grain quality suitable for bread making. It was introduced in 2008 after years of research, three years' test trials and meeting all the regulations for food products.

By contrast, the independent Trevor Baylis invented the first hand-powered wind-up radio. In 1991 he was inspired by a TV programme about the importance of communication for reducing the spread of AIDS and he went straight to his workshop where he put together a prototype. He patented his idea in 1992 but had no money to make the product a commercial proposition. For two years he was rejected by every single company he approached until an appearance on TV led to some financial backers for a new company. Now large companies are producing similar products. He has since set up a foundation to help individual inventors develop, protect and market their ideas.

1 Compare and contrast the approaches to R&D used by Sygenta and inventors like Trevor Baylis.

Marketing forecasting

Marketing data is a valuable tool for a business. It can help make a decision about opportunities for a product and how the marketing mix may be used to meet objectives. Markets are always changing and successful businesses need to know what is likely to happen to consumer choices or competitors' actions so that they can prepare responses to these changes. Information about the market can enable a business to know where its products are on the product life cycle and take this into account in planning. It is important to use information about the market to analyse the current position and forecast future trends. There are several ways of forecasting the future, both qualitative and quantitative. A key quantitative variable to focus on is sales. Sales figures are a determinant of revenue and profit as well as indicating the current and future state of a market. A business can use forecasts of its own sales and total market sales to plan ahead and take actions to meet objectives.

Key term

Forecasting: an attempt to predict the future, particularly in terms of sales and profits.

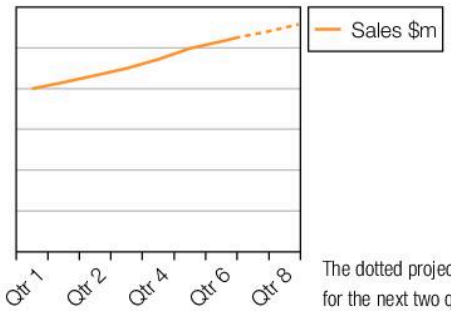
Forecasting sales

Trend analysis – the moving average method

Trend analysis takes data over a period of time and assumes that whatever patterns or trends had occurred in the past will continue into the future. Put simply, if sales have been rising at 4 per cent per year trend analysis assumes the future will see sales continue to rise by 4 per cent per year. This extrapolation is clear when there is a simple and consistent trend in sales.

Key term

Trend: the average change (increase or decrease) for each time period; it shows the overall pattern of movement in the data.



The dotted projected sales line shows the forecast sales for the next two quarters based on the trend in past sales.

Figure 3.4.5 Sales forecast for Quarters 7 and 8 ▲

Many products are affected by seasonal changes and do not show such simple trends. For instance, sales of fuel and clothing will alter in a regular way depending on the season. More fuel is sold in winter than in summer. Clothes often follow an annually changing pattern based on seasonal factors or regular fashion changes. Using a simple method of forecasting will not take into account these important changes. For these products there are three components to forecast sales:

- The underlying trend
- Seasonal variations from the trend
- Random or shock events that alter sales patterns.

Moving average forecasting allows these three components to be detected and taken into account when forecasting sales in a time series with regular fluctuations. It enables the data to be smoothed out to give a trend line that removes the effect of regular changes. The moving average is an average of the sales over a period of time, e.g. three years, Yrs 1, 2 and 3. This average will then be assigned to the middle of that period e.g. Yr 2. The three-year period is then moved forward to years 2–4 and a new average calculated and assigned, in this case to Yr 3.

Key terms

Seasonal variation: the regular variation according to seasonal factors. This is measured by the value for each time period minus the trend.
Moving average forecasting: a method of forecasting into the future that takes account of regular variations, e.g. seasonal changes in sales.
Moving average: averaging sales figures over a set time period and doing this successively, moving the average through time.

Moving average calculations

First the past data is inspected to see if there is a regular time-related fluctuation. If there is, a period for the moving average must be chosen. The period must reflect the length of time the fluctuations occur over.

Calculating moving average for a three quarter moving average

Calculate the average for Yr 1 quarters 1–3 and assign to quarter 2. Then calculate the moving average for Yr 1 quarters 2–4 and assign to quarter 3. Continue doing this.

Table 3.4.1 Three quarter moving average ▼

Year	Quarter	Sales $000	Moving average or trend $000
1	1	200	
	2	220	216.6
	3	230	233.3
	4	250	243.3
1	1	250	253.3
	2	260	263.3
	3	280	

The moving averages are known as the trend because they smooth out the annual variations.

Calculating moving average for a four quarter moving average

The most usual time period for regular changes in sales is a year and many products show variation in quarters. The subsequent calculations will show how moving averages are used to forecast sales where they are varying in a regular quarterly way.

Table 3.4.2 Sales revenue of bed linen 2011–14 in $000 ▼

(1) Year	(2) Quarter	(3) Sales	(4) Sales: four quarter total	(5) Sales: eight quarter total	(6) Sales trend: 8 qtr total/8	(7) Seasonal variation: trend – qtr sales	(8) Average seasonal variation per quarter
2011	1	112					
	2	125					
			511				
	3	146		1030	128.8	+17.2	+15
			519				
	4	128		1049	131.1	−3.1	−2.3
			530				
2012	1	120		1066	133.3	−13.3	−14.2
			536				
	2	136		1082	135.3	+0.7	+1.3
			546				
	3	152		1101	137.6	+14.4	+15
			555				
	4	138		1122	140.3	−2.3	−2.3
			567				
2013	1	129		1144	143.0	−14.0	−14.2
			577				
	2	148		1166	145.8	+2.2	+1.3
			589				
	3	162		1189	148.6	+13.4	+15
			600				
	4	150		1212	151.5	−1.5	−2.3
			612				
2014	1	140		1242	155.3	−15.3	−14.2
			630				
	2	160		1272	159.0	+1.0	+1.3
			642				
	3	180					
	4	162					

For example, in Table 3.4.2 the period is an annual regular pattern of sales changes by quarter. Moving averages can help forecast the sales for each quarter for the next two years. This is done by carrying out the following steps.

Calculating quarterly trend and seasonal variation

1 Calculate four quarter totals by adding each set of quarters in turn (Col. 4).

2 Because the middle point of four quarters falls between the second and third it is necessary to make adjustments so that the moving average falls into a quarter. This is called centring the data. To do this add the quarterly totals to give an eight quarter total (Col. 5).

3 Divide this total by eight to give the sales trend or moving average for each quarter (Col. 6).

4 Deduct the trend from the sales for each quarter to give the seasonal variation (Col. 7).

5 Add up the seasonal variations for each quarter and divide by their number to give the average seasonal variation per quarter (Col. 8).

N.B. If the period is an odd number, e.g. five-year fluctuations, then step 2 will need to divide the five-year totals by five to give the five-year trend and step 3 can be omitted.

Actual sales − sales trend = seasonal variation

This is the amount that the trend differs from actual sales.

Figure 3.4.6 shows the quarterly sales from 2011 to 2014 and the projected trend line for sales in 2011 and 2016 assuming the pattern of sales continues. The trend line does not take account of any seasonal variation so further calculation must be done. The calculation of seasonal variation enables this to be added to the trend line to give the forecast sales for each quarter in 2015 and 2016.

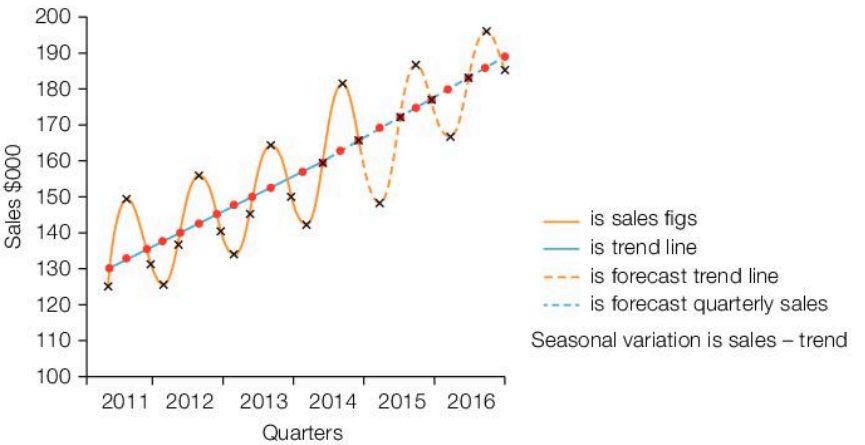


Figure 3.4.6 Quarterly sales from 2011 to 2016 (actual and projected) ▲

Moving average calculations – forecasting trend and seasonal adjustment

The time fluctuations have been smoothed out to give a trend line over time that can then be projected forward to give a forecast for 2015 and 2016. Because it is an average some information has been lost at the start and end of the time period, making the forecast less accurate.

Calculation of trend

Using the figures for the sales trend take the first quarter figure from the final one and divide by the number of quarters to give the average trend per quarter.

$159.0 - 128.8 = 30.2$ now divide by 12.

$$\frac{30.2}{12} = +2.5$$

This average can be added to the last calculated trend to give a forecast trend for each quarter

e.g. 2011 Qtr 2 trend = 159.0

To predict 2015 Qtr 1 trend add the total average trend for the three months since 2011 Qtr 2
$= 3 \times 2.5 = 7.5 + 159.0 = 166.5$

Continue this process (Col. 3).

However, this trend forecast will not take account of the quarterly seasonal changes in sales. In order to account for this the seasonal variation must be added.

The quarterly sales and the trend line are shown in Figure 3.4.6.

Forecast quarterly figures

These are obtained by adding the average seasonal variation to the forecast trend as in Table 3.4.3 Column 5.

Example for Qtr 1

Add the seasonal variations from Table 3.4.2 for the three Qtr 1s as follows:

-13.3 (2012) add -14.0 (2013) add -15.3 (2014) $= -\frac{42.6}{3}$
$= -14.2$

Repeat this procedure for the other three quarters.

The forecast quarterly sales and the forecast trend line are shown in Figure 3.4.6.

Table 3.4.3 Sales revenue bed linen 2015–16 in $000 ▼

(1) Year	(2) Quarter	(3) Predicted trend	(4) Average seasonal variation	(5) Forecast sales
2015	1	166.5	−14.2	152.3
	2	169	+1.3	170.3
	3	171.5	+15.0	186.5
	4	174	−2.3	171.7
2016	1	176.5	−14.2	162.3
	2	179	+1.3	180.3
	3	181.5	+15.0	196.5
	4	184	−2.3	181.7

Getting it right

Calculating moving averages and seasonal variation can take some time. It is unlikely that you will be asked to do this. You might be asked to complete a table of calculations, or comment on the method or results or their application.

The seasonal variation for Qtr 1 means that on average Qtr 1 sales are $14 200 below the trend. This is the seasonal effect for Qtr 1. For Qtr 3, sales are on average $15 000 above the trend.

Evaluating the use of moving average forecasting

Using moving averages will give a forecast which takes account of seasonal variation. It is thus more realistic than simply projecting forward a trend line. However, like any forecast its accuracy and reliability depend on the future behaving in a similar way to the past. This is not always the case. If there are any changes to the external environment, for instance a new competitor, a change in customer's tastes or a recession, then the forecast will not be accurate.

Co-ordinated marketing mix

A successful marketing mix is one that achieves specified objectives. These objectives must be clearly set out and relate to achieving the overall objectives of the organisation. Product, price, promotion and place must all be integrated together to give the same message to consumers and support and reinforce each other.

- A high-quality, high-specification product is likely to be sold to a small target market at a high price where technical expertise and personal selling is available to the consumer. Promotions of such a product are likely to be in appropriate media publications and will focus on the performance and characteristics of the product, or the level of service available to a buyer.
- A low-quality low-price product aimed at a mass market is likely to be promoted in mass media with a focus on the price and be available in a wide range of outlets. Contrast the marketing of a luxury cruise liner with that of discount clothing. If one of the mix elements does not match and support the others consumers are less likely to be interested.

This co-ordinated marketing mix must take account of the position of the product in its life cycle, the economic environment, market conditions and the actions of competitors. There may be new product developments from the R&D programme. All activities will be carried out within a budgeted framework. The marketing mix is therefore very likely to change over time as these things alter.

Getting it right

Whenever you discuss an element of the marketing mix make sure you relate it to the other elements in a strategic way and that it takes full account of the business context.

Case Study

Co-ordination in action – male cosmetics

The marketing mix forms part of the strategic actions of a business. It has to fit into the overall objectives. For instance, a business may be seeking to expand into a new market or move a product's image so it can sell to a different segment.

Cosmetics businesses have been expanding their market by seeking new markets that are different from their traditional pattern. They set objectives to increase sales by specified percentages over a five-year period to a new target group – men, particularly those aged 16–34, with certain levels of disposable income. This group were identified as having a "modern" approach to life. To

meet this objective they planned a consistent marketing mix, developing new products, raising awareness and creating interest and desire with focused promotional methods using specific communication techniques. Each stage contained its own objectives and marketing methods that were closely monitored. The result has been a significant increase in the sale of male cosmetics, which in many countries are now a key element in sales revenue for cosmetics businesses.

1 Suggest reasons why the cosmetics businesses chose men aged 16–34 as their target market.
2 Explain how marketing planning enabled cosmetics businesses to increase sales significantly.

Case Study

A financial service

A finance business specialised in producing retirement plans so that people with an income of $100,000 leaving work could enjoy a protected pension. It had some success but initial growth in sales was slowing. Its objectives were to build a national brand so that 40 per cent of the target population would recognise the name within two years, and increase the clients' assets they held by 100 per cent over two years. Its marketing consultant recommended and organised a series of free one-day educational events, supported by sponsorship. To encourage people to attend these events a carefully chosen name and logo was used in appropriate social media, selected paper and Internet press releases, radio and search engine marketing, emails to selected target clients and professionals with online registration. Podcasts, RSS feeds and a blog supported this direct promotion. Sponsors were encouraged to publicise the events to their mailing lists.

The goal for attendance at the events was 50–100 and average attendance was 82.

The results were that client assets went from $750 million to $2.1 billion in three years. Email marketing was used and analysis showed that 34 per cent of those mailed opened the email, 10 per cent read the email and 7 per cent actually attended the events. All the sponsors renewed their contracts.

1 To what extent was the marketing campaign successful?
2 Explain how important setting the objectives was for the success of the marketing campaign.
3 Suggest ways the promotional mix used supported the product being sold.
4 Suggest how the business might use an understanding of the product life cycle to plan the next step in its marketing.

Progress questions

7 State two ways in which sales forecasting might be useful to a business whose products show distinct seasonal variation
8 A business sells a product whose demand is relatively price inelastic. Explain the effect on sales and revenue of a price increase.

Exam-style questions

Big Boxes

Extract from statement by the chairman of Big Boxes
We need to change. Imported raw-material costs and higher interest rates have increased our costs. Decreased economic activity means that businesses are not moving to new premises, so there is a large decrease in the demand for our products. Also e-commerce and the increased use of computers mean that there are far fewer documents to store. The following financial information highlights the problems.

	2015 ($m)	2016 (forecast) ($m)
Sales revenue	180	120
Cost of products sold	70	60
Overheads	20	30

Extract from statement by the marketing director of BB

We must look at ways of improving the business or we will not survive. Our research teams have identified that consumers need more storage boxes in their homes while businesses need fewer. We must change our market from business customers to final consumers. However, consumers are likely to be more demanding than businesses in terms of prices, appearance and quality.

Extract from statement by the government

We faced a difficult time during the country's recent recession. Inflation is now a risk. Interest rates may have to rise. The environment still remains one of our priorities.

1 Discuss how BB might change its marketing mix in response to the change in the market for its products. [10 marks]

Alto Aluminium

The current situation

Alto Aluminium is a public limited company that produces aluminium. It has been through a period of change in the last five since being privatised. Now the organisational changes have been completed the directors are looking to focus on profit as an objective.

Global demand patterns

Aluminium is used in many industries including construction, vehicle and ship building, furniture and a range of industrial products. The overall pattern of demand for Alto's product is seasonal as its major customers are affected by weather conditions. The marketing department forecasts demand by using the moving average technique. There are wider patterns in world demand that are more difficult to forecast. Economic growth has resulted in increasing use of aluminium over the last 15 years but the effect of the global recession in 2008–9 cut demand by 15 per cent and it is only slowly recovering.

The directors are keen to use their access to aluminium to produce products made from it and gain the resulting added value, rather than simply be a raw-material supplier. They have begun investigating supplying the aviation industry with ready-made parts and have set up a research and development department.

2 Analyse the benefits to Alto of investing in research and development. [10 marks]

3 Evaluate the usefulness of sales forecasting to Alto Aluminium. [14 marks]

4 Evaluate the benefit to Alto of preparing a thorough marketing plan before it decides to manufacture ready-made parts for the aviation industry. [16 marks]

Key concepts

- **Change** can be developed through considering forecasting which can explore changes in markets etc.
- **Management** can be seen through the planning role of managers.
- **Customer focus** can be developed through the study of elasticity and the factors influencing customer demand.
- **Innovation** can be explored in relation to product development.
- **Strategy** is central to the idea of developing a co-ordinated marketing mix to achieve marketing objectives.

Progress check

You should now be able to:

- evaluate the use of a detailed marketing plan
- use income elasticity, promotional elasticity and cross elasticity to assess the effects of changes in income, promotion and prices of other products on demand for a product and apply this understanding to contribute to a marketing plan
- understand the need to forecast marketing data and use and interpret results from the moving average method in a given situation
- understand the need for a co-ordinated marketed mix and develop marketing strategies focused on achieving specific marketing objectives.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **A** the meaning of globalisation and economic globalisation
- **A** how increasing globalisation and economic collaboration affects marketing
- **A** how an international market might be identified, selected and entered
- **A** the choice between pan-global or local marketing
- **A** the choice of a strategy to develop a global market
- **A** factors influencing the method of entry to a global market

Link

Globalisation is defined in AS Level Chapter 3.1 What is marketing?

Getting it right

Economic globalisation (meaning trading, capital movements, marketing opportunities and incentives to set up in another country) is a very important business development. The social and cultural aspects of globalisation are relevant where they impact upon economic decisions.

3.5 Globalisation and international marketing

Globalisation

We live in an increasingly global community. The products we buy in our shops could come from anywhere in the world. Call centres are often overseas, the television programmes or YouTube clips we watch are often made in another country and cars we travel in have parts made all over the world. Globalisation is the growing integration and interdependence of economies and cultures involving increased trade, movement of capital and people. It results in the convergence of economic indicators such as inflation and non-economic factors such as consumption patterns. Regions, countries and cultures become more able to communicate and trade with each other. Products and services can increasingly be produced anywhere in the world. The materials and skills needed can increasingly be obtained from anywhere and the output sold anywhere, with the resulting profits being moved anywhere. Effectively it means moving towards a borderless world.

Globalisation is characterised by:

- A rapid expansion of international trade in products and services between countries
- A large increase in finance moving between countries, both money and foreign direct investment or inward investment by multinational companies
- Increasingly similar products and services are sold in more and more countries
- Increasing changes to where products and services are produced, e.g. the expansion of outsourcing of components or services to different countries
- Increased international travel and instant global communications
- Increasing similarity between cultures and societies.

Economic globalisation means a decrease in barriers to trade for products and services, increased freedom to move money from one country to another and more incentives for businesses to set up in another country. This includes producing products and services and also selling them.

Progress questions

1 Explain the main features of globalisation.
2 Describe two ways globalisation might affect a business.

Key terms

Tariff: a tax on imported products or services.
Foreign direct investment (or inward investment): when a business sets up production facilities or distribution networks as separate businesses in another country.

Link

AS Level Chapter 1.2 Business structure considers the way that international businesses are organised.

The marketing implications of globalisation

Globalisation means increasing opportunities for businesses to produce and sell in other countries. Tariffs (taxes on imports) have reduced significantly across the world. Developed countries doubled the value of duty-free imports between 2004 and 2014. The tariffs facing developing countries exporting to wealthier areas have halved since 1995. Since 2008 foreign direct investment (or inward investment) by businesses has slowly increased and is running at about $350 bn per year across a range of wealthy and less wealthy countries.

These large-scale changes are matched by changes in customer behaviour and outlook. Globalisation reduces costs of production and prices through businesses using the cheapest labour, by expanding production and using more efficient transport and communication systems. Using computers and mobile phones, customers have the means to find out about products and obtain the cheapest prices. They can shop around and can also be exposed to marketing campaigns. Competition in national markets has increased as new businesses from other countries can appear at any time.

Global brands are increasingly important – for example, Apple, Toyota, Coca-Cola are found in most countries. "Coca-Cola" and "OK" are the two most understood phrases in the world. Globalisation means businesses are faced with two possible marketing challenges.

- A nationally-based business must respond to increasing competition from overseas businesses. If the business is small and has a localised customer base it may be possible to respond to competition by focusing on this strength. Larger businesses must consider their strengths and build on them to combat the effect of multinational brands.
- A business looking to expand must consider marketing its products or services in other countries. Smaller businesses will find this more difficult because of the costs required. The Internet and easy international payment systems like PayPal have now made it possible for even small businesses to sell in other countries through web-based marketing. Larger businesses will have to consider developing a brand image.

In both cases the business will have to make sure that it has a planned strategy and the resources to carry this out. Globalisation has increased the opportunities for businesses and also the risks and the competition.

The effect of increasing economic collaboration

There are two forces acting on the world economy as countries attempt to maximise the gains from trade. Firstly there is a move to freer trade by removing the barriers to trade, led by the World Trade Organization, the Organisation for Economic Co-operation and Development (OECD) and many national governments. As trade becomes freer, countries are able to sell their products and services more easily in other markets and buy a wider range of products more cheaply. This achieves faster economic growth and a rising income

Key terms

Protectionism: the process of making it difficult or more expensive for trade to occur.
Trade blocs: agreements between states, regions, or countries, to increase trade between the participating regions by removing barriers to trade.

for all those trading. The second force is the temptation to protect an economy from foreign competition by protectionism, by making it harder and more expensive to trade. This might involve placing a tariff or tax on imports, restricting the quantity of a product imported (quota) or forcing importers to carry out expensive bureaucratic procedures. Any of these will reduce trade.

Effect of trade blocs

There are an increasing number of trade blocs – groupings of countries with formal agreements on trade. These include APEC (Asia Pacific Economic Co-operation), ASEAN (Association of South East Asian Nations), EU (European Union) and NAFTA (North American Free Trade Agreement). These blocs are increasing free trade between their members but often maintain barriers to trade with non-members. This means that there are areas of the world where opportunities for economic collaboration are increasing, yet access to their markets and products by non-members is difficult and/or more expensive.

These blocs are also negotiating with each other to increase free trade, as are large trading partners like the EU and the USA. It seems likely that the move towards freer trade globally will continue as more countries sign up to trade blocs and remove barriers to trade between themselves. This process of negotiation and agreeing free trade will open up more markets and increase the effects of globalisation and international competition.

The BRICS countries

Key term

BRICS: an acronym for Brazil, Russia, India, China and – since 2011 – South Africa, all of which are major economic powers that are not yet fully developed but are developing rapidly.

The BRICS countries are Brazil, Russia, India, China and – since 2011 – South Africa, all countries that are major economic powers but not fully developed, with relatively fast-growing markets and national income. They account for over 40 per cent of world population, 25 per cent of world income and production, and have large trade surpluses and foreign money reserves. They have not formed an economic alliance or trading bloc with each other but account for 18 per cent of global trade. They represent enormous potential as markets for consumer products as they have a rapidly increasing middle income group of households and are major suppliers of raw materials, components and finished products, holding 55 per cent of the world's inward investment. International tourists from the BRICS countries to the rest of the world are forecast to increase by 500 per cent by 2025. As their economies continue to grow and attract greater trade their markets will become increasingly important for the world economy and as key market opportunities for foreign businesses. This will increase trade and income levels but requires specific targeted marketing strategies.

Globalisation and marketing tactics

On the one hand globalisation acts to make economies and cultures more similar. On the other it leads people to consider their own cultures and strengths, and a business entering international marketing must keep this in mind. Businesses selling globally often adapt their

Figure. 3.5.1 A global business ▲

core marketing plans for each country. McDonald's has the same logo and colours in every country it sells in but in, India it features families and local languages in its adverts.

Marketing in another country means that research must be carried out into the language, customs and behaviour of the region or country. A marketing campaign should be planned to take account of these.

Table 3.5.1 Examples of culture differences which may affect marketing plans ▼

Family	• China and Mexico have extended family, aunts, grandparents	• USA has nuclear family, parents and children
Uncertainty	• Many less-developed countries are reluctant to try new products	• In high-income countries, new products are desirable
Language	• Car "trunk" in USA, India	• Car "boot" in UK
Colour	• Black in Europe is mourning	• White in China is mourning, purple is mourning in Latin America
Behaviour	• Gestures – head shake up and down is "No" in India	• Head shake forward and back is "Yes" in eastern Mediterranean
Religion	• Christians have Sunday as a "holy day"	• Muslims have Friday as a "holy day"

Progress questions

3 Assess one positive and one negative effect of globalisation on the marketing plans of a business.
4 How has the OECD influenced globalisation?
5 How might growth in BRICS influence globalisation?

Strategies for international marketing

The importance of international marketing

The decision to expand into an international market is a key one for any business. It is potentially very costly, firstly in terms of the market research needed, then to set up the distribution systems and marketing plans. This kind of expansion must match the objectives of the business and there must be resources of money and the right people available. Businesses that enter an international market are driven by a range of factors. The most important underlying one is that many markets in other countries are growing and offer opportunities for increased sales.

Activity

In groups think of three products which are sold in more than one country. Discuss how the businesses try and get sales in your country.

Case Study

L'Oréal

L'Oréal is the largest cosmetics manufacturer in the world by sales revenue (2013). Its products span the whole range: professional use, retail and luxury brands. It operates 41 factories and 74 distribution centres and sells in 130 countries. The global skin product market is forecast to grow 4 per cent per annum 2012–15, but this disguises big differences between regions. The emerging markets (Asia and South America) are set to grow 6–8 times as fast as the nearly stagnant European and US markets. L'Oréal obtains about 35 per cent of its total revenue from these emerging markets and it must make sure that it continues to keep or grow its market share. China is set to become the largest single market by

2025. Although L'Oréal is the largest cosmetics business in China it faces high risks: there may be problems with patents and licences and there is stiff competition from multinational businesses and Chinese companies.

Other markets have similar difficulties – large businesses compete heavily everywhere, especially in the emerging markets. A major objective of L'Oréal is to increase sales and market share in the emerging markets

L'Oréal has a pan-global strategy with some customisation for each country. However, in South America where direct marketing of cosmetics is common it has failed to penetrate the market as it does not use this method.

SWOT analysis of L'Oréal's global position – see page 511 for more on SWOT.

Strengths	Weaknesses
• Brand awareness and loyalty • Expansion in new markets (SE and S Asia) • Strong ethical position • Strong partnerships • Excellent research facilities • Strong supply chain	• Large size means lack of control and inefficiency • High advertising budget • Pan-global approach means some markets not penetrated • Low profit margins • Failure to penetrate South American markets
Opportunities	**Threats**
• Increasing incomes and population • More consumers health driven • Growth in emerging markets • New product lines • Buying up suitable companies	• Risk of economic downturn • High cost of marketing to emerging markets • Higher raw-material costs and supply disruption • Competition • Inefficiencies due to size increase costs

1 Explain the importance of global marketing to L'Oréal.
2 Outline two advantages and two disadvantages of a pan global approach for L'Oréal.
3 Suggest a possible strategy for L'Oréal to maintain its leadership of the cosmetics industry.

Factors influencing the decision to enter an international market

A saturated home market

A business may have reached such a high market share that it is difficult to expand further without an expensive extension strategy or facing investigation for being anticompetitive.

Tesco in the UK reached this situation in the late 1980s and began looking for opportunities elsewhere. In 1992 it opened stores in Poland and by 2004 had stores in a number of Asian countries. It is now set for expansion in China. This worldwide strategy took advantage of the increasingly global economy to ensure that Tesco could continue to expand.

Not enough demand in the home market

A small business producing specialist products or services may not be able to find enough customers in its own country to justify continuing. The Internet and good communications have enabled such businesses to offer their products to customers in other countries.

Grave in the Czech Republic manufactures protective crash bars for a small number of motorcycles. Grave holds no stock and makes products only when an order is received. It cannot get enough business in its own country. Its website and contributions to motorcycle Internet forums have generated enough work to satisfy its objectives, one of which is to maintain a constantly full order book.

Many small-scale tourist services in Asia are offered by domestic businesses selling via the Internet to clients in Europe, North America and Australasia.

To meet management goals of growth

Owners and managers of businesses have their own goals and objectives and these may involve continuous expansion. The Virgin group of companies is now a global brand operating in transport, finance, media, holidays and many other markets. Virgin management is interested in continuing to find and enter new markets wherever they are and this motivation has fuelled Virgin's international growth. It has also enabled diversification into a range of different products and services. This enables the business to survive falling sales in one product area by increasing sales in another.

To escape competition in the home market

It may be that increasing competition makes a business look outside its own country for opportunities. This is the case with Galanz, a Chinese manufacturer of microwave ovens. From 2000 Galanz faced increasing competition from Chinese brands such as Midea and Kelen but also from increasing importers such as Samsung and Electrolux. Despite a growing market Galanz decided that expanding into selling across the world was a better strategy for growth than depending on successfully facing this competition in China.

Identifying, selecting and entering an international market

This process is very similar to that faced by a business considering introducing a new product into a market in its own country. Thorough research is the main element for success. At the start a business will have an idea of the kind of market it might consider selling in. It is likely that a business will start by considering selling in only one other country. It must then apply the factors below to make a final choice.

Factors influencing selection of an international market

Product factors

The business must consider its product in relation to possible markets. A business manufacturing large ocean liners will have relatively few possibilities; a business making chocolate could sell to most countries. The position on the product life cycle may also be a factor.

Organisation factors – objectives, risk and resources

A business will have objectives. It must decide if international expansion will fit the objectives. A business will have an attitude to risk. It must decide if it is willing to take large risks in expansion or only prepared to accept a low risk of failure. A business will have a certain amount of resources, financial and personal. It must decide how much of these are available to fund international expansion. The result of these decisions will help identify possible markets to enter.

For example, if a business has an objective of expanding sales by 20 per cent in two years, a risk-averse attitude and fairly limited finances, it is unlikely to choose to expand into a small country that is undergoing political change. It will seek a country with a growing market, a stable political situation and limited competition.

Market factors

Product and organisation factors will identify a range of possible countries to expand into. Market factors are key in selecting the final choice. It is vital that market research is carried out positively and in detail – this may be expensive. It will identify the following:

- Size of market.
- Market segments.
- Market growth and possible forecast sales.
- Economic factors including currency stability and exchange rates, tariffs, relevant laws and regulations, government incentives like subsidies, low-rent accommodation or tax breaks.
- Strength and nature of competition. Domestic or other foreign businesses, prices charged.
- Existing and possible distribution channels and after-sales service.
- Costs of setting up marketing campaigns and distribution channels.
- Political and cultural factors affecting the market.

Once these have been established the business can investigate possible countries in detail to obtain the best fit for their objectives, products and resources. It must then decide how to enter the new market.

Progress questions

Two businesses are considering expanding their sales internationally.

Lasdat is a high-tech company producing and installing a new communication system that uses lasers to carry data. It is currently quite expensive and there are no other companies offering a similar high-speed system.

Jayneel produces facial cleansers which are produced from flower extracts. Its new one is environmentally friendly and compatible with all skin types. Jayneel claims that its product enables deep cleansing and that make-up can be applied more effectively after its use.

6 Compare and contrast the main factors that Lasdat and Jayneel might take into account when identifying and selecting a country to start exporting to.

Factors influencing method of entry to an international market

Once a business has selected a market to sell to it must decide how it will do this. The choice will be determined by the strategy of the business. This in turn is determined by its objectives and the resources

it has in relation to the characteristics of the market being entered. There are two options for entry.

Acquiring an existing foreign business

> **Link**
> Mergers are considered in AS Level Chapter 1.3 Size of business.

Many Chinese companies entering the global marketplace choose this route. Lenovo obtained the IBM PC business in 2004. Using this method a business directly acquires brand names, distribution networks, experienced employees and customer relationships. However, there may be difficulties associated with merging two very different ways of working, making it difficult to realise the advantages.

Internal growth through increasing sales

This may be achieved in a variety of ways.

Exporting

Exporting is marketing and selling products (goods or services) to another country. The start-up costs and ongoing expenses are largely the costs of marketing, so profits will be quickly realised. The business will need to find an importer and a transport provider and deal with the government. The business might deal directly with government ministers, civil servants or government agencies. Discussions might take place about tax rates, subsidies for employing people, availability of industrial sites, legal restrictions or working with existing national businesses. An agent might be used to arrange the practical details of selling. Agents often organise sales through existing channels in return for a commission or agency fee. Customers are reached quickly and there is control over the marketing arrangements. However, there may be trade barriers such as quotas and tariffs, legal restrictions or high transport costs. These factors mean the marketing plan has to be appropriate and succeed if sales are to increase.

Exporting is suitable for businesses which are small; there are low trade barriers, cost advantages with home production, and distribution systems are in place.

Licensing involves a contractual arrangement to distribute the product or service in return for a fee. This means there is a low initial cost, trade barriers are not relevant and the risk is born by the licensee. However, the business loses control of the marketing process and possibly the knowledge in the product, creating competition.

Licensing is suitable if the technology or knowledge is well defined, there are strong legal property rights and a reason for being based in the country.

Franchising

> **Link**
> Franchising is covered in AS Level Chapter 1.2 Business structure.

A franchise business (franchisor) charges a fee to other businesses (franchisees). In return for this money the franchisee obtains the use of trademarks, logos, recipes, promotional material and the use of the brand. It also benefits from the marketing campaigns undertaken by the franchising business. McDonald's, Avis and The Body Shop are examples of franchise-based businesses. This means the franchising

Link

AS Level Chapter 1.2 Business structure considers franchising and joint ventures as business contractual arrangements.

Key term

Joint venture: a business agreement in which organisations agree to develop a new corporate identity, separate from their own, for a finite period of time.

business has few start-up costs apart from marketing, but its income is limited to what has been agreed. This method is most suitable for selling a service.

Joint ventures

A joint venture is an alliance where two or more businesses agree to contribute products, services and/or capital to a common commercial enterprise. There may be legal and regulatory requirements to do this and these will differ from country to country. For instance, Haier (China) joined with Fujitsu (Japan), and TCL (China) with Thomson (Europe) to sell their products. Joint ventures enable businesses to share risk, rewards, technology, local knowledge and marketing. However, there may be conflict, loss of control or information and one business may not have the incentive to be efficient.

A joint venture is suitable where the businesses can bring different expertise and advantages, when these can be easily measured and large mutual gains are expected.

Foreign direct investment

Direct investment is the construction of production facilities such as offices or factories. This method of entering an international market may not be marketing as such but it clearly offers a means of making a product or service available in another country. The product must then have a marketing plan designed to achieve objectives. This method will sidestep trade barriers, achieve lower costs, e.g. labour, provide access to country-specific expertise, enable control of profits and may attract considerable government aid. However, start-up costs are high, a country-specific understanding of the way business operates is needed and it will take time.

Foreign direct investment is suitable for large businesses where there are tax advantages, government aid, trade barriers and a long-term commitment.

Progress questions

Belanger operates a chain of launderettes and is a large business with a high market share.

Desjardins offers finance and accountancy services to construction businesses.

Both these businesses are considering expanding into one or more neighbouring countries.

7 Advise these two businesses on which method of entry they should adopt.

Choosing between pan-global marketing and maintaining local differences

Entering an international market is the start of becoming a global business. Exporting to a country can progress into international marketing. The business becomes more than just a seller in another country and develops separate strategies. However, these must relate

to the strategy used in the domestic market and this relationship may bring about significant change in the business. It must take account of the different market environments it is operating in.

Global marketing involves considering marketing to many different countries. The business must create a single strategy for the entire global market that will work in a range of different countries yet be suitable for local differences. These may be cultural, social or economic factors which differ from one country to another. In deciding a strategy it will be useful for a business to decide whether it is ready to expand and whether it wants to enter a global market (see Figure 3.5.2).

Figure 3.5.2 Phases of global growth ▲

Pan-global marketing

Key term

Pan-global marketing: marketing products and services to many different countries using a single strategy.

Pan-global marketing means marketing products and services to global markets in many different countries using a single strategy. The same businesses are able to compete all over the world with the same products and integrate their activities across borders. The business must have a single strategy to do this. It must build a consistent brand image, use the same logos, colours and advert styles that give customers the same message whichever country they are in. Successful pan-global businesses include Tata, Nike, Toyota and Nestlé. This will be expensive and a business must have the confidence in its products and marketing methods, often developing these over a planned long period.

Case Study

Li Ning plans for pan-global status

Li Ning is a Chinese sportswear business founded in 1989. Within ten years Li Ning began exporting and is now an international marketer, selling in a large number of countries. Its success is based on a firm platform of being a market leader in China. Ninety per cent of its sales are there and this provides finance for strategic planning. After 2000 Li Ning decided to aim to become a pan-global enterprise and began building a worldwide brand to achieve this. It has focused on sponsoring a range of teams in different sports and countries and has two major USA basketball stars signed up. Sponsoring

Figure 3.5.3 Li Ning sponsors NBA player Dwyane Wade ▲

well-known athletes is an important factor in winning brand awareness and customers. It used the 2008 Olympics Sports Channel as a sponsorship medium to make global customers aware of its existence. In 2009 Li Ning purchased the Kason brand selling in Europe and in 2011 agreed a distribution deal with L-Fashion who will market Li Ning products in nine European countries. That year Li Ning began a partnership with an American business who will distribute and market in the USA with a $10 million budget. It now has a logo and a slogan which it uses worldwide and an objective of increasing its sales outlets outside China by 20 per cent in seven years. The competition from Nike, Adidas and others is massive.

1 Which global growth phase is Li Ning currently in?
2 Explain why you think Li Ning has used other businesses to distribute its products in Europe and the USA.
3 Assess the likelihood of Li Ning becoming a pan-global business.

Pan-global marketing is most effective where markets in different countries are similar and the competition is also pan-global. The buying behaviour of customers across the world is similar so pan-global marketing has been extremely successful in the case of businesses like Coca-Cola or Levi Strauss.

Marketing for local differences

Pan-global marketing runs the risk that the standard nature of the products and the marketing methods means that variations in markets are ignored and businesses may lose sales in some countries because the standard product does not meet the exact needs of that market. Marketing techniques may have to take account of local cultural differences if sales are to be maximised. (See Table 3.5.2.)

There are many factors that affect cultural differences and these might act as barriers to a pan-global strategy. They include:

- Language – brand names need to be carefully chosen so that they do not take on unwanted meanings in different languages.
- Religion – cultural differences are often related to religious beliefs.
- Moral values – different cultures can have different attitudes to what roles are appropriate for men and women.

All of these must be taken into account when planning a marketing or advertising strategy.

Many businesses are now using segmentation in their global markets to target particular countries or groups of customers in order to achieve objectives. For instance, McDonald's has meal variations in different countries, it is called Donald McDonald in Japan but still offers the same basic products everywhere. Businesses like Colgate-Palmolive use different advertising agencies in different countries, so that local experts can adapt the global message to local markets.

Activities

1 Research the way multinational companies market their products across the world.
2 Find examples of businesses that adopt a pan-global approach and those that alter their marketing methods according to the country they are operating in.

Table 3.5.2 Factors influencing the decision between pan-global or local marketing ▼

Factors for pan-global marketing	Factors for adapting to local differences
• Large size of business • Technical product/large development costs • Long history of international marketing • Similar customer behaviour/segments • Economies in marketing • Similar global attitudes • Standard distribution methods	• Small size of business, few export markets • Non-technical product/small development costs • New entrant to international marketing • Different customer behaviour/segments • Different regulations • Different cultural patterns • Local distribution methods

A business selling across the world has to decide between:

- A pan-global strategy using products marketed with little or no variation across the world
- A globalisation strategy with products marketed in a way which allows for local differences
- A multi-domestic strategy with products marketed very differently in each target market.

Case Study

BearingPoint

BearingPoint offers a range of consultancy services to businesses. The business employs several thousand consultants in 24 countries and believes that it is important to have a well-defined global strategic marketing framework without over-centralising. It works on a basis of 60 per cent local control and 40 per cent global control of its marketing, spending 20 per cent of the budget on global campaigns. The local campaigns often modify the global message for each specific market. For instance the Japanese culture means people in meetings tend to search for harmony and do not talk a lot, so a round-table discussion is less effective than in other cultures. In 2004 BearingPoint planned a global campaign to gain more business with a headline repeated in all communications – "Wake-up Call … fix the customer experience now". It was soon apparent that this approach succeeded in the USA but not in Japan or Germany.

Original global marketing plan	Revised "global" marketing plan
• A global press release announcing the research results • An e-mail push with a link to the white paper; registration to capture leads • A webcast reaching ten countries • A global roadshow for 8–12-person round-tables led by US/UK presenters • Speaking slots at banking conferences	• A toned down press release in the more sensitive markets • Four versions of the white paper, in US English, UK English, German and Japanese • An e-mail blast to the United States, Germany and Spain • Webcast only in the United States • Hard copy direct mailer in the United Kingdom, Japan • Telesales follow-up to registrations in the United Kingdom, United States, Germany • One-on-one meetings in Japan, France; round-tables in the United Kingdom, United States, Germany

Source: BearingPoint Finds the Balance Between Global and Local Marketing, An Interview with Guy Nielsen by Julie Schwartz, ITSMA Viewpoint, June 2005, V0024, Table, p. 7

This table sets out the way BearingPoint modified the initial global campaign for different local markets.

The result was a successful stream of bookings from all countries, which mirrored the marketing spending and level of operations in each region.

1 Explain why it was so important for BearingPoint to carry out pan-global marketing.
2 To what extent did revising the marketing plan contribute to its success?

Figure 3.5.4 Strategy for developing a global market ▲

Choosing a strategy to develop a global market

A business aiming to develop a global market will be starting from a particular position. It may be just at the start of the process of marketing in other countries or it may be in the international marketing phase without a global strategy. The strategy must contain an appropriate marketing mix for the business and its products. It must take account of the nature of the product being sold and the resources available to the business. These factors are exactly the same as when planning a marketing strategy for a domestic market with the added dimensions of much bigger scale and the tension between a global market and local conditions.

Implementing a global strategy is a long-term commitment which will take years. Market research is crucial to success and will enable precise identification and targeting of global customers. The method of entry to different markets is also a crucial choice to make and it may well involve working jointly with other businesses who have knowledge and expertise in the target markets. Global marketing is about developing long-term relationships with customers so after-sales service may be a key factor to build into a marketing strategy.

Key term

After-sales service: the help and information offered customers after they have purchased a product.

Getting it right

Choosing a global strategy is similar to any other strategic marketing decision. Businesses must consider their strengths and weaknesses in relation to the opportunities and threats. They must be sure to have carried out appropriate market research and organised a marketing mix that is related to the target market. Global strategies must consider possible variations from one country to another including cultural variations and different government attitudes and policies.

Case Study

New World

New World manufactures and sells a child's toy. It consists of a set of buildings that are built up from small pieces. This gives the child the opportunity to design their own house, street, shops and communities. There are cars and people to go with the building kits. New World already operates in two large neighbouring countries that are similar in terms of culture and economic structure. The business is extremely successful and the directors wish to expand to other countries. They have arranged funding do this. The business needs more information.

Advise the directors on the following:

1 Should it adopt a global or a pan-global strategic approach?
2 Once this is decided, how should it develop a strategy that meets its objectives?

Progress questions

8 Explain pan-global marketing.
9 Give three advantages of marketing for local differences.
10 Explain two benefits of entering into a joint venture when expanding into international markets.

Exam-style questions

Read the following extract and then answer the questions.

FlyLo Air was set up by Mik Layso in 2007 soon after meeting Peter Bassett. Mik was a retired pilot who used to work for a major airline and had then set up a company which trained pilots and other inflight staff. He still retained a variety of key contacts in international airlines, airports and government transport departments. Peter was a marketing expert with links to the banking industry. Their contacts and skills enabled them to begin operating within a year of setting up the business. They flew passengers and small amounts of freight between local airports linking towns and cities. The market opportunity was for cheap flights compared to other carriers. They were able to offer low prices because they had cut costs by selling food and drink on board, providing Internet only tickets and check-ins, and charging for baggage. Their inflight staff were the minimum needed for legal requirements.

FlyLo Air rapidly expanded and by careful leasing of aircraft, choice of destinations and landing slots it became the largest domestic airline. Mik and Peter were determined to continue the expansion but realised that this would not be possible without becoming an international airline. They began investigating the prospects of flying to and from other countries and soon realised there were real market opportunities. They decided to go ahead with operating in the world market.

1 Discuss how FlyLo Air might set about deciding in which international markets to operate. [16 marks]

2 Recommend and justify an appropriate marketing strategy that FlyLo Air might use in developing its global operations. [20 marks]

Key concepts

- A **Change** can be developed through consideration of changing global markets and trading conditions.
- A **Management** can be developed through decisions about globalisation and the implementation of global marketing strategies.
- A **Customer focus** can be explored through considering the global nature of many markets and the impact on customer choice.
- A **Innovation** can be linked to the development of new markets and new products for those markets.
- A **Strategy** is involved in the development of approaches to global markets and the appropriate strategic decisions.

Progress check

You should now be able to:

- A understand globalisation and international marketing and their increasing importance
- A assess how increasing globalisation and economic collaboration might affect the way businesses market their products and services
- A evaluate choices for businesses considering entering international markets
- A recommend whether a particular business should adopt a pan-global strategy (the same for all markets) or adapt its strategy to take account of local differences.

You should be able to relate these to a range of businesses in different situations.

4 Operations and project management

4.4 Capacity utilisation

Measurement and significance of capacity and capacity utilisation

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **A** how capacity utilisation can be measured
- **A** implications of operating under or over maximum capacity
- **A** choosing methods of improving capacity utilisation
- **A** the benefits of outsourcing

Figure 4.4.1 Building in Rio illustrates the perceived need for an increase in capacity ▲

Case Study

Olympics 2016

Getting the planning right for an enormous event like the 2016 Summer Olympics and Paralympics in Rio de Janeiro, Brazil, always attracts a great deal of media attention. When a city holds an event like this, there is great discussion over whether the infrastructure will be ready in time – for example the stadia, swimming pools and cycling tracks.

Just as important are details such as:

- Will transport systems cope with the extra traffic?
- Will there be sufficient hotel accommodation?
- Will immigration systems be able to cope with large numbers of people arriving in a short time period?

Each of these details raises the question: "Is there enough capacity to cope with the large increase?"

If, for example, new hotel accommodation is provided just for the Games period there could be far too much capacity both before and after the Games. If extra capacity is not provided there could be chaos when the Games are taking place. However, providing extra roads, trains and so on can be extremely expensive, particularly for a short period of time.

An alternative to providing additional trains may be to find ways to use the existing capacity more effectively. Managers must determine to what extent trains and the railway network are being used. Perhaps not all trains are full, perhaps some services are not important, perhaps the tracks could be used more, perhaps there are times when insufficient employees are available. Looking at the level of use of existing capacity – the level of capacity utilisation – managers can identify ways of accommodating large increases in passengers without having to go to the huge expense of new trains, track and staff.

1 Why is it likely that railway systems are not currently always operating at full capacity?
2 Suggest two ways that the rail network could increase capacity without buying new trains.

Key terms

Capacity: the maximum output, with current resource and normal operations, that a business activity can achieve.
Output: in this context output can refer to either products or services. It is the amount (volume) that is produced, in the case of products, or provided, in the case of services.

Capacity

Capacity is usually defined in terms of the output of products or services that *could* be provided in a given time period using the current resources available. This is a relatively simple concept in some situations:

- The capacity of a football ground or theatre is usually governed by regulations
- A piece of machinery is often designed to be capable of producing a predetermined amount per hour
- A bank will have a given amount of queuing space, staff and service points.

However, in some circumstances the idea of capacity is less clear.

What would be the capacity of a restaurant? In normal circumstances it would be determined by the number of chairs and tables available for customers and the number of employees there are to prepare the food and serve it. However, for a special occasion a restaurant can often squeeze in extra people.

What is the capacity of a supermarket? It would normally be determined by the number of staff available, the checkouts available and the size of the car park. However, at peak times (festivals etc.) throughput of customers can be increased beyond the normal capacity by taking special measures – e.g. opening longer hours, employing temporary staff and helping customers pack their bags.

It is usual, particularly for the service industries, to consider capacity to be the maximum possible output in "normal circumstances".

Getting it right

You will be expected to be able to calculate capacity utilisation from data that you are given. You will then be expected to interpret your result. You may then be asked to develop ways in which capacity utilisation could be improved. It is important to remember that the concept of capacity utilisation applies just as well to services as it does to production systems.

Capacity utilisation

Businesses need to know how effectively they are using the resources available to them. If a hotel is regularly less than half full then a lot of its rooms will be unused and this is a waste of resources. If a restaurant is always so full that customers have to wait half an hour for a table, it cannot provide the best service to all of its customers. If a car manufacturer is producing significantly below the maximum possible level then expensive equipment is idle.

The extent to which existing resources are being used is measured by capacity utilisation.

$$\text{Capacity utilisation} = \frac{\text{Current output level} \times 100}{\text{Maximum output level}}$$

If capacity utilisation is 100 per cent then the business is producing as much as it possibly can with its existing resources and method of working.

Key term

Capacity utilisation: the current level of output in a situation compared with the maximum possible with existing resources.

Progress questions

1 Define capacity utilisation.
2 Why is it difficult to measure capacity utilisation in a hospital ward?

Activities

Managing your life

Over a two-day period, write a diary of the things that you did with your free time, including when you did them.

1 What proportion of your time was spent working on your A Levels?
2 What proportion of time was unproductive?
3 Would you regard the time you spent relaxing as wasted?
4 How could you improve the time spent on your work?

Implications of operating under or over maximum capacity

Common sense probably tells us that the higher the level of capacity utilisation, the better.

- Greater utilisation means greater production. This means there is potential for more sales which will, if the price is right, mean more profits.
- Greater utilisation means that valuable resources do not stay unused – if they are unused that would be wasting opportunities.
- Greater utilisation means spreading fixed costs out over a larger volume of production.

Example

Suppose a machine has fixed costs of $500 per day. If the machine can produce 1000 units per day at maximum capacity then:

- the average fixed cost at maximum capacity is $0.50 per item ($500/1000)
- the average fixed cost if only 250 items are produced is $2.00 per item ($500/250)

If the higher level of production is achieved it would be easier for the business to make a larger profit.

What reasons are there for ensuring capacity utilisation does not go too high?

- When people and machines are working as hard as they possibly can and for long periods of time there is a greater risk of things going wrong. Machines break down, people make mistakes, systems go wrong.
- There will be no possibility of increasing output to meet any special orders – perhaps from a highly valued customer. The order will have to be turned down and the customer might take their business elsewhere.
- Scheduling and planning may be difficult. In particular it may be difficult to stop machinery for repairs or routine maintenance.
- Employees, including managers, may feel under pressure and become demotivated or leave.

What if there is too much capacity?

A business may find itself facing declining demand for its products. Although it may continue production at current levels (and therefore maintain capacity utilisation) inventories will increase, causing increased costs and possibly increased wastage. The business could also decide to cut back production, which means working well below capacity either from time to time or for long periods. In either case, there is too much capacity at a point in time. There can be a variety of reasons for declining demand including responding to fluctuating demand patterns (perhaps due to seasons) or overcapacity in an industry – the worldwide steel industry and the car industry both suffer from having the capacity to produce far more than is demanded.

We have seen that there are risks associated with working too close to maximum capacity. On the other hand, if the capacity utilisation is too low there is a waste of resources. In addition unit costs will be relatively high.

A short-term problem could arise, for example through seasonality. To illustrate the point, some products or services have quiet summer months, e.g. winter clothes, whilst other products and services have quiet winter months, e.g. summer dresses. Here the problem is temporary and can be planned for:

- Production can be maintained and stocks allowed to increase ready for the next season.
- Production levels could be reduced for a period, possibly also reducing employment. Flexible working conditions for employees would help management.
- Production systems can be adapted to produce other products.
- New markets can be developed with an opposite seasonality pattern (e.g. a southern hemisphere business could explore markets in the northern hemisphere).

Link

A Level Chapter 2.3b Human resource management: further functions of HRM discusses temporary and flexible contracts.

Other short-term production problems may arise from:

- Short-term economic difficulties
- Aggressive marketing by competitors
- Customers anticipating new models.

The problem is more difficult if it is long term. Long-term capacity utilisation problems are likely to have arisen through a fundamental change in market conditions for the product. This might arise, for example, through changes in: customer tastes and preferences, actions by competitors, persistent adverse economic conditions or adverse publicity for the product. In these instances any spare capacity is likely to exist for a long time and stocking surplus production will not be a realistic option. More drastic measures may be needed.

Three main options for dramatic measures are:

Key term

Rationalisation: organising resources and working methods in a better way so that the result is greater efficiency. This often involves reducing capacity by cutting overheads, for example by closing a factory or a production line.

- Reduce the production capacity by closing a production line or factory. This is an example of rationalisation. Whilst this will reduce costs and increase capacity utilisation, the business will have to make employees redundant. This may be expensive both in terms of redundancy payments and in loss of "goodwill" in industrial relations. It is also a "one-way" option, which means that if ever demand recovers – perhaps a recession ends unexpectedly – the capacity may be needed but is not available.
- Make major changes to the production capacity to produce new products. This could be very expensive and may take a long time. Employees may still have to be made redundant or retrained.
- Explore new markets overseas. It is sometimes the case that outdated products in some countries may be acceptable in others. For example, older models of cars may be suitable in countries with less stringent environmental or safety standards. However, there may be ethical issues involved in selling "second best" to other countries.

Figure 4.4.2 Queuing – not enough capacity ▲

What if there is insufficient capacity?

Situations can arise in which a business is unable to cope with customer demand. This may be continuous or just a problem caused by a "spike" in demand. The business may be working to its absolute limit but it is still unable to produce enough. This is not only extremely frustrating for dissatisfied (and probably lost) customers, it also means the business is unable to maximise its sales. If a business operates for any time at its limit, it can lead to major problems with equipment breakdown, more mistakes and worker fatigue. A business operating at A Level of capacity utilisation that is too high will have to find ways of reducing it either through greater capacity (if the problem is long term) or better efficiency.

Activities

The world car industry

1 Find out what you can about worldwide car production.
2 Which countries produce the most cars?
3 Which companies have declining production?
4 Which countries have excess capacity?

Case Study

Furious passengers

Passengers returning home from their summer holiday were furious when they had to queue for two hours at immigration. "We thought we'd be pleased to be home after a fantastic holiday," said one angry passenger. "Instead we were met with total incompetence and no one explained what was going on."

The public relations director for the Immigration Service said, "We are sorry for the delays, but we cannot relax our border controls just because of the holidays. We have a large number of our employees on holiday too and the number of arrivals exceeded our capacity. New procedures are slowing us down and we can't recruit any more staff because of government financial cutbacks."

1 To what extent is this a capacity utilisation problem?
2 What possible solutions are there to the queuing problems?
   a In the short term
   b In the long term.

Choosing methods of improving capacity utilisation

Low utilisation

The issue is whether the low capacity utilisation problem is caused by short-term issues (in this context only for a few weeks or months), in which case it may be relatively easy to improve utilisation, or long term in which case strategic decisions may have to be taken.

In the short term, utilisation could be increased by trying to stimulate demand and hence production. It could also be increased through increasing inventories; however, that will incur costs which may be too high. It might even make sense to simply wait for demand to increase again if the problem is only temporary.

In the longer term, however, strategic changes will probably have to be made.

One possibility is rationalisation – by changing the nature and amount of capacity there can be better utilisation of the resources the business has.

High utilisation

When capacity utilisation is very high, and there are consequent operational problems, the business may want to take action to avoid the difficulties. As with under-capacity utilisation problems, the solution to having insufficient capacity or working close to full capacity depends on whether the problem is short term or long term.

Often short-term problems can be managed within existing resources provided they are not stretched beyond their limit. Employees may be willing and able to work under pressure for a short period of time particularly if there is some kind of financial incentive such as a bonus or overtime payments. Machinery, too, may survive being used above recommended levels for a short time.

Another possibility is to increase maximum capacity through investing in more plant, machinery and equipment, i.e. make the production facility "bigger". This is likely to be expensive and time consuming.

A further alternative can be through subcontracting, when production is transferred to other businesses that may have far more efficient production capacity, and so may be able to produce cheaper than "in house".

Key term

Subcontracting: involves paying another business to undertake part of the functions required to produce a product or service. An example is that a builder will pay an electrical business to install all the electrical cables and fittings in a house.

Table 4.4.1 Advantages and disadvantages of methods of improving capacity utilisation

Action	Advantages	Disadvantages
Rationalisation by re-organising the way resources are used	• Can be relatively quick and inexpensive, and probably should be done in any event	• May cause resistance from managers and employees • May work well "in theory" but not so well in practice • Success not guaranteed
Acquire more resources to expand capacity	• An opportunity to update equipment and procedures • Possibility of economies of scale • Long-term solution	• Can be expensive with large capital investment • There would be too much capacity if demand subsequently fell • May take time, and be disruptive. Customers may not want to wait
Subcontract out some of the work	• No major capital investment • Offers greater flexibility in relation to future changes in demand • Quicker solution than capital investment	• Potential loss of control over quality and output • Unit costs may increase as the subcontractor will want to make a profit • May not be best long-term solution

Progress questions

3 Why is it unrealistic to expect to maintain 100 per cent capacity utilisation in a factory?
4 Why would a computer manufacturer be concerned with low capacity utilisation?
5 Why would a university want high capacity utilisation?
6 Give three reasons why a head teacher would want to reduce the capacity utilisation of a school if it was consistently too high.

Benefits of outsourcing

Key term

Outsourcing: using another business (third party) to undertake some of the functions of a business (the host business).

Getting it right

The term "outsourcing" does not have a precise definition, indeed its meaning varies from book to book. When answering a question it is a good idea to make it clear what definition you are using – hopefully the one in this book!

Outsourcing is recent terminology for a particular type of subcontracting. The difference between subcontracting and outsourcing is rather subtle but it is useful to think of subcontracting in terms of transferring tasks to another business and outsourcing in terms of transferring functions.

So a builder might subcontract the task of installing the electrical components in a house to a specialist firm of electricians, and outsource all of the accounting functions to a firm of accountants.

Difficult economic conditions, globalisation and increased competition, particularly in the 1990s, forced businesses to re-examine their operations and seek cheaper ways of operating. Sometimes small, specialist businesses can carry out some functions previously carried out by large businesses, and they can do it a lot more efficiently and cheaper. As a result many large businesses outsource most of their non-core activities, such as HRM, accounting, IT, training and so on. Outsourcing is also used as a means of indirect privatisation when public service organisations outsource to private sector businesses.

Case Study

Outsourcing at Newtown Hospital

Newtown Hospital's management expects to save over $2 million over ten years through a project to outsource the computerization of patient medical records. MedRecs, with offices based in Newtown, will be paid $12.6 million for developing and maintaining the system. Computerized records will:

- Save time for medical staff who will be able to do more useful work
- Save space in offices and wards
- Improve the accuracy of patient records
- Ensure records do not get lost or misfiled
- Make it easier to transfer patient records within the hospital and to health staff outside the hospital, such as aftercare teams and GPs.

Some of the hospital's office staff will be employed by MedRecs, and both they and the unions are happy with the arrangement.

1. Why might it have been difficult for Newtown Hospital to develop its own medical records system?
2. What additional skills can MedRecs provide for the project?
3. What are the potential problems that might result from this outsourcing?
4. Do you think it is a good idea?

Key term

Offshoring: a type of outsourcing where the relocation of functions is to a business in a different country. The term sometimes includes the possibility of transferring functions to a subsidiary of the outsourcing business.

A particular type of outsourcing is offshoring in which the business relocates some of its functions overseas, usually to businesses in a country with cheaper labour.

It is not only large businesses that outsource. Often small businesses will outsource functions in which they have little expertise. For example, a small business may outsource its HRM or accounting functions to businesses specialising in those activities. This type of outsourcing services is sometimes known as business-process outsourcing.

Before undertaking outsourcing, a business needs to weigh up the situation.

Table 4.4.2 Potential advantages and disadvantages of outsourcing/offshoring ▼

Potential advantages	Potential disadvantages
Enables the business to focus on its core activities	Functions and jobs will be lost in the outsourcing business
Increases opportunities for flexibility – outsourced contracts can be renegotiated, or even ended	Quality may be more difficult to manage
Greater scope for growth without high capital investment	Issues to do with different cultures and languages, especially with offshoring
Possibility of reduced operating costs	Outsourcing functions involving sensitive information (e.g. accounts, HRM) may create greater security risks
Third party may do job better	Could be difficult and expensive to reverse the process if circumstances change

Progress questions

7 Give three advantages of outsourcing the accounting functions of a small manufacturing business.
8 Give three disadvantages of outsourcing a school's HRM functions.
9 Why are so many call centres outsourced to different countries rather than the host country?

Exam-style question

Zoom Travel (ZT), like many international airlines, is facing rapidly increasing costs as well as increased competition. Increased costs come from higher fuel prices and landing charges at airports as well as environmental taxes from governments. Competition from other international airlines – especially those describing themselves as "low cost" means that airfare revenues are falling. With decreased profits ZA is looking for ways to reduce costs.

ZT's board is considering four business functions that could be outsourced.

Activity	Comment
Aircraft maintenance	ZT has its own specialist aircraft maintenance team. Competitors have outsourced maintenance to low-wage countries. ZT's maintenance costs are significantly higher than for other airlines, but ZT has far lower numbers of aircraft faults.
Cabin crew and check-in staff	All employed by ZT on wages higher than the industry average. ZT regularly wins awards for service. There are outsourcing possibilities that would significantly reduce overheads.
Customer services	Currently the call centre is based in ZT's country in a building with very high overheads. The alternative would be in another country with much lower costs.
Aircraft painting	Currently undertaken by ZT employees in ZT facilities which are significantly underused as aircraft only need repainting every two years.

1 Discuss the factors that ZT should consider in deciding whether to outsource any of its functions. [10 marks]
2 Only one function is to be outsourced. Recommend which one. Justify your answer. [14 marks]

Key concepts

- **Change** can be considered by exploring factors that influence capacity utilisation.
- **Management** can be developed through considering how managers can change capacity utilisation.
- **Strategy** can be developed through consideration of outsourcing decisions and other related strategic decisions.

Progress check

You should now be able to:

- explain how capacity utilisation can be measured
- interpret capacity utilisation calculations
- discuss the implications of operating under/over capacity
- choose methods of improving capacity utilisation
- discuss the benefits of outsourcing.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- A the nature and importance of lean production
- A links between lean production and inventory control, quality, employee roles, capacity management and efficiency
- A the role of Kaizen in lean production
- A the role of just in time (JIT) in the context of lean production
- A the implications of using a JIT approach
- A quality in terms of what the customer wants
- A quality control and quality assurance
- A the link between quality and training
- A aims and effectiveness of total quality management (TQM)
- A the potential of Kaizen in TQM
- A the importance of benchmarking in quality control

Key term

Lean production: using resources as efficiently as possible to minimise waste and improve quality.

4.5 Lean production and quality management

The nature and importance of lean production

On hearing the term "lean production" it is easy to think that it is another production system along the lines of "job, batch, flow".

It is not. Lean production is a "way of life" rather than a set of processes.

The idea behind lean production is that a business takes a systematic approach to ensuring that the whole process of producing and supplying products and services works to provide the customer with the highest possible appropriate quality with the minimum waste. A business achieves this by examining all of its activities and processes and finding ways in which to improve on the methods employed.

By employing the ideas behind lean production a business can expect to:

- Have systems that are more responsive to rapidly changing markets
- Meet the demands of customers through prompt delivery and appropriate quality
- Reduce costs through elimination of all types of waste.

Case Study

GSEP Limited

GSEP limited is a business in India manufacturing rubber and plastic parts for cars, e.g. windscreen seals. In a very competitive market GSEP needed to reduce costs. A thorough investigation into all aspects of the business's operations revealed:

- Considerable areas of unused space
- High levels of machine breakdown time
- A long time spent maintaining machines and resetting them
- Large amounts of waste material
- Quality problems.

Application of lean production ideas enabled GSEP to change the thinking in the business. The "culture of blame" has become a "culture of continuous improvement" with employees wanting to play a positive role in the development of the business. Employees are empowered to make decisions. Redesigning the production system, increased training and improved operating procedures have eliminated a lot of the waste. Quality has improved and productivity increased dramatically.

These changes are all part of the lean production programme at GSEP.

1. Why is a "culture of blame" a problem?
2. What benefits and disadvantages can there be from empowering the employees?
3. Why has increased training had a key role in the changes at GSEP?
4. What do you think "lean production" means in this context?

Key term

Quality: the fitness for purpose of a product or service, with "fitness" defined by the customer. It may relate to durability, appearance, lack of defects, reliability.

Although quality issues will be discussed later in this chapter the concept is a very important feature of lean production so we need a clear idea of what we mean by it before discussing lean technology.

Quality is a relative concept depending on the perceptions of the customer:

- The buyer of a "top of the range" luxury car will expect a different standard of quality from the buyer of a cheaper, smaller family car
- The buyer of a pair of "designer" trousers will expect a different standard of quality than the buyer of a pair of jeans to wear to work on a building site
- An aircraft manufacturer would expect higher quality in the engine than for a light bulb
- Someone telephoning emergency services would expect their phone call to be answered immediately; someone phoning their bank may not mind waiting for a few minutes.

Getting it right

It is very important to remember that the concept of quality relates just as much to services as it does to products. Customers have expectations about services as well as products.

So, the idea of quality is not absolute. It is a subjective term that varies from person to person and from situation to situation. In business terminology it can relate to:

- Whether the product meets the customers' expectations: the buyer of the luxury car will have a higher expectation of performance and appearance than the buyer of a family car.
- Whether a product or service satisfies its stated or implied uses: the workplace jeans (see above) will have to be very hardwearing; the designer trousers do not need to be as hardwearing but do need to be fashionable.
- Whether the product or service is free of deficiencies: the failure of the aircraft engine would be catastrophic, the failure of the light bulb would be a nuisance.
- The emergency phone call not answered quickly could mean the loss of a life, the unanswered call to the bank is only frustrating.

Activity

Conduct a short survey of your parents and teachers about the meaning of the term "quality" for:

- A car
- A piece of furniture
- A telephone service.

What differences do you notice?

Lean production techniques

Those implementing lean production need to explore the *whole* of a business's operations looking for ways to make improvements. What they find, and how they make the improvements is likely to be highly business specific so it is only possible to give guidelines and not universal procedures.

Thus lean production will examine processes which include:

- Inventory control: how inventories are managed can affect the efficiency of the whole business process
- Employee roles: if these can be developed and improved the whole process can be more efficient
- Capacity management: if underutilisation can be limited, or unwanted capacity removed, then the business will be leaner

- Efficiency: improved efficiency is central to utilisation
- Quality: improved quality will mean less waste.

These together with a review of *all* aspects of a business should lead to a leaner, more efficient enterprise.

Lean production can be illustrated by means of the practical application of the ideas to a business in a service industry.

Table 4.5.1 Application of lean production techniques ▼

Business area	Historical approach to business area	Following implementation of findings of lean review
Service provided	• Gradual development following market changes	• Flexible products • Quick reaction to market changes
Management of employees	• Narrow job specifications • Specialised roles • Standardised procedures	• Multitasking • Flexible contracts • Teamwork • Multifunctional roles
Leadership	• Co-ordinating role for managers within procedures framework	• Project leaders with full authority over designated project
Approach to competition	• Price • Cost reductions	• Quality • Flexibility
Quality control	• Managed by quality department • Compliance procedures set internally	• All employees responsible for quality through a TQM system • Internal markets
Outcomes	• Low quality, low cost, traditional services leading to falling profits	• High quality, innovative low-cost services leading to increasing profits
Inventory control for office materials	• Large buffer inventories (stocks)	• Lean system (minimal inventories)

Table 4.5.1 demonstrates that the lean review will have covered working practices, quality issues, inventory polices, marketing issues such as changes to markets and customer expectations, and service provision.

In addition to these kinds of improvements in processes, any programme to introduce lean production will also need to look for signs of waste within the organisation:

- Quantities of defects – products or services that do not meet customer expectations
- Excessive stock holding of raw materials, finished products, work-in-progress or, in the case of services, the means to supply the service
- Excessive movement of people, components, products in the process of providing the product or service to the customer
- Producing or supplying a greater quantity than is needed
- Excessive capacity
- Over-complicated designs and production processes
- Wasted time
- Wasted resources.

Activity

What examples of waste can you identify at your school or college?

Progress questions

1 Why does "quality" mean something different from perfection?
2 How can improved inventory control change the efficiency of a business?
3 Explain why the involvement of employees is key to implementing total quality management.

Activity

Find out about lean production at Toyota.

Tools to help introduce lean production

Although total quality management (TQM) is about looking at the business as a whole, there are some tools that will help the business to implement TQM. These include:

- Kaizen. This is a Japanese term that means that a business should seek continuous improvements
- Cell production
- Flexible specialisms
- Simultaneous engineering
- Just in time (JIT).

Getting it right

Lean production needs to apply to the whole of a business organisation and its procedures.

These tools are discussed below. However, not all the tools will apply in particular circumstances and there may be other ways of cutting down on waste and inefficiencies.

Kaizen in the context of lean production

Key term

Kaizen: any process that has continuous improvement built in.

Kaizen is a Japanese word meaning "continuous improvement". The concept became prominent when Toyota introduced it into its car manufacturing production. The basic idea is that the employees of an organisation are the best people to know how a task should be undertaken. The Kaizen idea is that employees should be given the responsibility of working out how their jobs can be changed so that efficiency and quality can be improved.

This contrasts with the traditional view that "the manager knows best".

Implicit in this idea is the concept that a series of small improvements suggested by the workforce can produce results that are just as good as massive new investments, hence the notion of "continuous improvement".

The Kaizen process can be summarised as:

- Standardise an operation and activities
- Measure the operation (find cycle time and amount of in-process inventory)
- Gauge measurements against requirements
- Innovate to meet requirements and increase productivity
- Standardise the new, improved operations
- Continue cycle ad infinitum.

For Kaizen to work, particular conditions must be met by the business:

- Employees must be empowered to make the necessary improvements (see the ideas of Herzberg (page 92))
- Team working should be part of the organisation's culture
- Management culture should be sympathetic to employees being empowered and involved in decisions (i.e. management should not be autocratic or centralised)
- All staff should be involved, no matter how seemingly insignificant their contribution.

Link

Management and leadership styles are covered in AS Level Chapter 2.1 Management and leadership. Motivation is covered in AS Level Chapter 2.2 Motivation.

However, Kaizen will not work if:

- There is a lack of management commitment
- Employees do not understand what is required or the principles of lean production
- Employees are unwilling to take on responsibilities
- Management are not prepared to provide the necessary resources
- Potential benefits cannot be identified or realised
- The whole organisation does not subscribe to the ideas of Kaizen
- The nature of the business is not suitable.

Ways of introducing lean production

Cell production

One method of improving team-working is to introduce the ideas of cell production. Cell production provides the framework for greater empowerment and the mechanisms for Kaizen. Cell production involves arranging the workforce and work tasks in such a way that the cells (semi-autonomous teams) can manage their own processes, defects, scheduling equipment and so on.

Examples of cell production can be found in manufacturing (the car manufacturing industry provides some good examples) although the ideas apply just as well in service industries.

Figure 4.5.1 Cell production in operation ▲

Each of the various stages of a production line will be allocated a cell – a team of employees who have the responsibility to perform a task. That task could be, for example, to fit the engine. The team decides who, within the team, does what part of the task. It decides how jobs will be rotated to relieve the boredom, it ensures the specialist skills are available and then carries out the task of installing the engine. This team is then responsible for ensuring that the job has been done properly before the car moves on to the next stage in the production process. The team can make changes to their part of the process and is held responsible for making improvements.

Activities

1 Get hold of a brochure for a model of new car. List the options that are available.

2 Discuss how flexible specialism could help the manufacturer.

Key term

Flexible specialism: a manufacturing production system based on mass production, but through flexible use of machines and employees it allows a wide variety in individual product specification.

Key term

Simultaneous engineering: managing the processes for launching a new product so that various stages in development can take place at the same time instead of sequentially.

Flexible specialisms

Another TQM method is flexible specialisms. If you were looking to buy a new laptop computer you would probably find a bewildering range of options including: screen size, amount of memory, size of hard disc, processor speed and installed software. We might expect there to be individuals in the factory each assembling a computer to the chosen specification – job production much like making bespoke clothes. However, it is probable that your computer is being assembled using mass production on a flow production line. Flexibility of operation, flexible machines and a flexible workforce enable changes to be made to each item produced. Mass produced cars also have a bewildering choice of options. Manufacturing in this way, flow production with built-in specialisation and flexibility, is known as flexible specialism. Flexible specialism helps to respond to customers' different needs and to changes in markets and technologies.

Simultaneous engineering

One of the key features of lean production is improved responsiveness to customers' needs. To an extent that can be met with flexible production, but that will not work when a product has become obsolete. What is needed in this situation is a new product. If the time taken to launch a new product can be reduced then the business will be more responsive to customer needs. This can happen using simultaneous engineering – managing the process for launching a new product in such a way that some of the development processes can take place at the same time.

Traditionally the process for a new product is as shown in Figure 4.5.2.

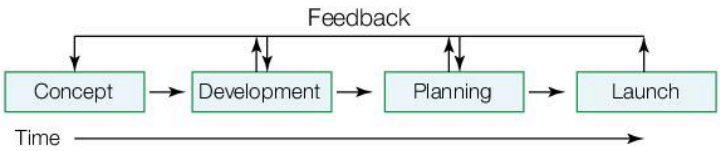


Figure 4.5.2 Traditional approach to product development ▲

If some of these activities can be undertaken simultaneously then the length of time from conception to launch can be significantly reduced, improving the likelihood that the product is successful in launch.

A better approach would be as shown in Figure 4.5.3.

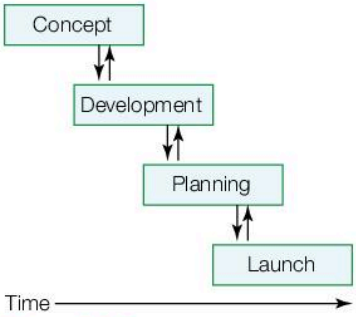


Figure 4.5.3 Simultaneous approach to product development ▲

Link

See AS Level Chapter 4.3 Inventory management for JIT inventory control.

Key term

Just-in-time production: managing the flow of raw materials, work in progress, finished products and production systems so that these items are available exactly when they are needed and not before.

Getting it right

When answering a TQM question it can be a good idea to link the ideas of lean production with the motivation of the employees: see AS Level Chapter 2.2 Motivation.

Activities

1 Identify situations in which JIT could be used at your school.
2 How might the use of JIT save the school money?

Just in time (JIT) in the context of lean production

Just-in-time inventory control was discussed in Chapter 4.3. We saw that in many businesses stock control can be inadequate and there can be waste, particularly of money which could better employed elsewhere. Apart from the potentially high opportunity cost, there is the physical cost of storage as well as possibly wastage costs.

Just-in-time ideas can be employed throughout any business process from the ordering and receipt of raw materials and/or other supplies, through the production line process to the delivery of the finished product/service to the customer. This is known as just-in-time production.

An effective lean production system will minimise inventories and flows throughout the process by ensuring purchases, production and deliveries to customers have as much co-ordination of flows as possible.

Case Study

Lean production and health service resource use

Health services around the world are facing the same pressures:

- Medicines and treatments are becoming more widely available but more complex and expensive
- People are living longer and need more heath care
- Costs are generally increasing
- People are becoming more aware and demanding about health issues.

Health services rely mainly on people to provide services – doctors, nurses, administration staff – and on suppliers to provide medicines and equipment.

The costs of treating people need to be reduced. It is not realistic to reduce wages, nor would it be acceptable to reduce the treatment given to ill patients. What is needed is an increase in the efficiency of the use of resources that the health service has available.

A recent survey of nurses in a hospital showed that they were concerned about:

- Excessive paperwork
- High levels of waste
- Storage rooms full of unwanted items but shortages of essential items
- Duplication of some tasks such as interviewing new patients
- Having to repeat patient details to the various different doctors
- Not knowing what to expect next
- Some wards over full, others nearly empty
- Hospital facilities only available for short times each day.

1 Why is it important to improve efficiency in health services?
2 How could lean production ideas help reduce costs at the hospital?

Implications and justification of adopting a JIT approach

A consequence of JIT production means that stock levels of raw materials, components, work in progress and finished products can be kept to a minimum. It also means carefully planned scheduling and flow

Link

Process innovation is covered in AS Level Chapter 4.2 Operations planning.

of resources through the production process. Modern manufacturing businesses use sophisticated production scheduling software to plan production for each period of time, which includes ordering the correct stock. Flows of information between customer and business, and between parts of the business, are critical. This need for information flows is closely related to process innovation.

Supplies are delivered right to the production line only when they are needed. For example, a supermarket might receive exactly the right number and type of bananas for one day's sales, and the supplier would be expected to deliver them to the correct loading bay on the production line within a very narrow time slot.

Getting it right

It is important to remember that JIT production does not only apply to the physical production of products but can be used just as effectively with the provision of services.

Table 4.5.2 Advantages and disadvantages of JIT production ▼

Advantages	Disadvantages
• Lower inventories of all types means a reduction in storage space, which saves rent and insurance costs • As inventory is only obtained when it is needed, less working capital is tied up in stock • There is less likelihood of products becoming obsolete or out of date. • Avoids the build-up of unsold finished product that can occur with sudden changes in demand • Less time is spent on checking and reworking the product of others as the emphasis is on getting the work right first time	• There is little room for mistakes as minimal inventory is kept for reworking faulty product • Production is very reliant on suppliers, and if deliveries are not on time the whole schedule can be delayed • There is no spare finished product available to meet unexpected orders, because all product is made to meet actual orders – however, JIT is a very responsive method of production

Progress questions

4 Define Kaizen.
5 Explain the difference between just-in-time inventory control and just-in-time production.
6 Outline two features of cell production.

Quality control and assurance

Quality in terms of what the customer wants

As we have seen, quality is defined by the customer. However, it is in the interests of all businesses to know the quality levels that customers expect and to have systems in place to minimise the risk of customers being dissatisfied with the quality that they receive.

Businesses can use a combination of three possible approaches:

- Quality control
- Quality assurance
- Total quality management (TQM).

It may be thought that these are ideas only relevant to large businesses. However, a clear focus on quality for even the smallest of businesses can save money, attract customers and may even be the route to growth.

Benefits and costs of improved quality

Although it must be remembered that quality is a relative feature of a product or service, whatever level of quality is chosen there will be a trade-off between the benefits of improving quality and the costs of achieving a higher level of quality. The costs will be largely dependent on which system of improving quality is chosen; however, in most situations the costs and benefits shown in Table 4.5.3 are likely to apply.

Table 4.5.3 Benefits and costs of improved quality ▼

Benefits of improved quality	Possible costs involved in improving quality
Improved customer satisfaction	Market research needed to establish customer expectations
Improved reputation	Inspection may be expensive in a quality control system
Important part in developing a brand	Rejected items will either be waste or will need to be corrected
New products can benefit from reputation of brand name	Production may need to be stopped to trace and correct faults
Reduced costs of putting things right	Training expenses particularly for TQM
May allow for higher prices to be charged	Better-quality materials will cost more
Gives a new dimension to competing	Suppliers may charge more for improving their quality standards

Case Study

Starlight Fireworks

The managing director of Starlight Fireworks (SF), Sue, is having an angry discussion with the production manager, Steve. "Half the fireworks at the New Year display failed to go off and our customers want their money back. Our reputation has been badly damaged," she said. "Our competitors always get it right, why not us?"

"Well it was raining that day and I was short of staff," said Steve. "It's not my fault. I checked everything myself before the fireworks were sent out, and they looked all right. I can't set them off to see if they work," he said angrily.

"We spend a lot of money on quality control, why isn't it working?" said Sue.

"We only test about 1 per cent of our production so a lot of faults get through especially now we're using a new cheaper supplier of raw materials," said Steve. "Some of our machines are very old, and the workforce don't help, always complaining about having too much to do."

1 What are the shortcomings of the quality checking techniques used at SF?
2 Why do quality procedures need to be improved?
3 Why should Sue be concerned that Steve blames things outside his control for what goes wrong?

Key term

Quality control: a system for improving quality based on inspection, normally using sampling.

Methods of quality control

Quality control is a traditional method of working towards a desired level of quality. It is based on inspection (through testing and random sampling) of a product or service before it is provided to the customer. It may involve the workforce (employees) through quality control inspectors and quality control departments, often at the end of the production process, but generally it does not involve all of the employees.

There are usually three stages of quality control:

- **Prevention**: When a product is designed the designers should take into account the customers' quality requirements. Processes (such as manufacturing, providing a service) should be designed to achieve this level of quality.
- **Inspection**: Products are regularly inspected/tested to see if quality standards have been met. In a production process this could be undertaking random sampling, for a service it could be using a mystery shopper or something similar.
- **Correction and improvement**: Once the product/service has been found to be significantly unsatisfactory, faulty products/services need to be corrected and design or processes adjusted to ensure that the problem is not repeated.

Figure 4.5.4 Quality control in action ▲

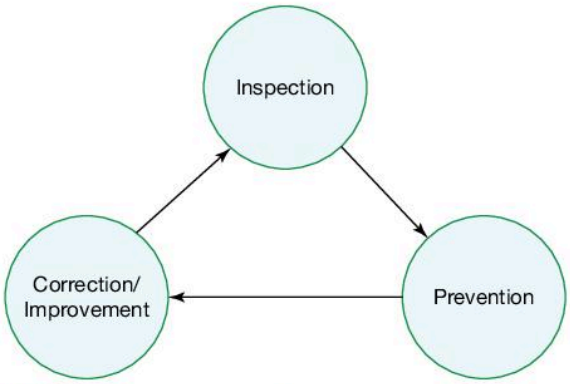


Figure 4.5.5 Quality control ▲

Quality control suffers from the disadvantage that it finds problems only *after* they have happened. Also, because it only identifies the problem after it has happened, it may be difficult to identify what stage of the process is causing the problems, and, in turn, which employees are responsible for the problem. It is also an "add on" to the production process rather than part of the whole process. The quality control process relies on the skills of those involved in the inspection process – a job that may be tedious and demotivating – rather than relying on all employees.

Key term

Quality assurance: a system for making sure agreed standards are met at each stage of a process in order to ensure customer satisfaction.

The importance of quality assurance

Quality assurance refers to ensuring a process meets agreed standards. These standards may refer to the product/service at the end of the process or may refer to a series of standards set at stages throughout

the process. Quality assurance may involve the workforce more than quality control as it can involve quality throughout the production process.

Quality control focuses on the end result; quality assurance focuses on the processes to ensure that the end result meets an agreed standard.

Quality assurance works on the principle of "right first time" This can be achieved by looking at the processes, from beginning to end, of getting the product, or service, from design to the customer.

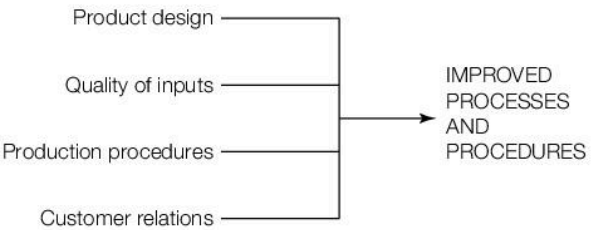


Figure 4.5.6 Quality assurance ▲

The benefits of quality assurance are:

- Problems should be identified before the end of the process thereby saving costs of putting things right
- There is little need for final inspection thus saving the costs of an inspectorate
- When there are problems it should be easier to trace back to where the fault is occurring in the processes, saving future costs or problems
- The responsibility for quality at various stages can be identified, improving accountability
- There are greater opportunities for employees to take pride in their work thus improving motivation.

In some circumstances quality assurance procedures will enable claims to be made about the business and its products. So, for example, the ISO 9000 award is given to businesses that demonstrate quality assurance procedures that meet particular standards. Other examples include industry and government awards – certificates of safety and other levels of quality such as the organic nature of a product, sometimes known as "kite marks" – which can be used in marketing when particular standards are achieved.

A useful quality assurance technique is benchmarking. This is discussed below.

Aims and effectiveness of TQM

TQM takes the ideas of quality assurance a stage further. TQM is an integrative philosophy for ensuring the continuous improvement of products, processes and services. It makes everyone in a process

Activities

Find examples of products or services for which there are claims that they are quality assured.

1 To what extent is this concept used in the marketing of the product?
2 Who is making the claim? Do you think that it is a reliable claim?

Getting it right

Quality assurance guarantees that the processes should meet agreed standards, but it does not necessarily guarantee the outcome – processes can go wrong.

Key term

Total quality management: an approach to quality that changes the culture of all aspects of a business and all employees with the aim of ensuring the best possible processes.

responsible for the quality of their own part within the processes. This means that management, workforce, suppliers and customers all work together to achieve the quality that meets or even exceeds customers' expectations.

Although TQM originated in American businesses, managers in Japan took on the ideas of TQM more enthusiastically than American managers. Through information and feedback, committed leadership, planning, employee involvement and training processes companies such as Toyota were able to raise quality standards to levels never before thought achievable.

Key aspects of TQM are:

- Quality chains: Each stage of the process behaves as part of a supplier/customer relationship. So the team that cuts out material for a dress is the supplier to the team that sews the dress together, the internal customer. The sewing team then becomes the supplier to the delivery team, who then become the customers, and so the sequence continues. So the process chain consists of the groups shown in Figure 4.5.7.

Key term

Quality chain: setting up a procedure so that parts of the procedure can be identified as "internal customers".

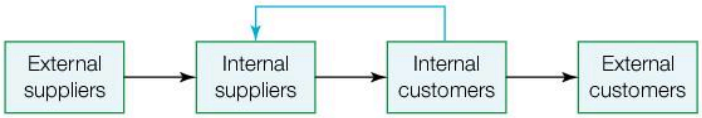


Figure 4.5.7 A quality chain ▲

- Quality circles: small groups of employees are created to meet regularly and discuss ways in which they can improve the quality of their work and cut out waste. Ideally these groups are empowered to put their ideas into practice, making improvements at their stage in the quality chain.
- The internal customer: businesses are set up as if each stage of a process is a new "customer", providing checks and balances in the process. So, very simplistically, if a person stacking shelves in a supermarket notices damaged tins of food, they will behave just like a customer, and complain to the warehouse people who provided the tins to the stacker.

Key terms

Quality circle: groups of employees who meet regularly to discuss work-related issues and problems and to identify potential improvements.
Internal customer: part of a procedure that is a recipient of the output of another part of the procedure and is dependent on that other part for quality.

TQM differs from quality assurance in one key way: TQM is about a culture of improving the whole process, including external suppliers, whereas quality assurance is about improving procedures.

Getting it right

Remember, in your answers to questions relating to TQM you should refer to the strategic nature of TQM. TQM is not so much a solution as a way of thinking that can lead to solutions. It is an integral part of the lean production philosophy.

The potential for Kaizen in TQM

Although the origins of Kaizen are in improving production processes to achieve greater efficiency, it can clearly be applied to a product or service to focus on quality. Indeed the best uses of Kaizen will aim to improve both the processes and quality at the same time.

Key term

Benchmarking: comparing a procedure with other similar procedures, particularly the best available in order to identify ways to improve the procedure.

Activities

For your school identify all of the main business activities that take place.

1 Which parts of school experience could be regarded as "internal customers"?
2 For one example, how could quality of service be improved?

Benchmarking

Benchmarking can be part of quality assurance programme. It involves investigating a product, service or procedure. The product/service or procedure is then compared with other businesses in the same field of activity to identify "best practice", that is, better methods than those currently used.

Weaknesses can be identified, acted upon and new standards and procedures can be set.

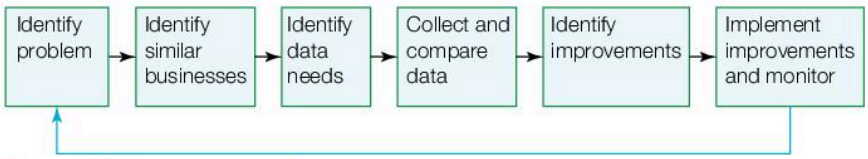


Figure 4.5.8 Benchmarking ▲

Potential problems with benchmarking include:

- Copying does not necessarily mean understanding, and implementation of new ideas might be difficult
- Benchmarking may be expensive
- It may be difficult to obtain sufficient data.

However:

- Benchmarking may be cheaper and get results more quickly than the alternative methods of improving quality
- Benchmarking may provide a clear focus on which areas of the business to improve
- It may create new ideas particularly if the workforce is involved.

The link between quality and training

All of the methods for improving quality will involve the need for managers and employees to be able to undertake tasks effectively:

- When quality control methods are used, employees will need to know how to select samples, what to do when they are selected, and what to do when the samples show up unacceptable errors.
- Where quality assurance methods are used, employees will need to know the standards of assurance and the methods used to achieve the desired standards. They will also need to know how to react when standards do not meet assured levels.
- To implement TQM, a business will need to train employees so that they know how concepts like the internal customer and quality circles work. They will also need to know how quality circles work. They will need to understand and be able to implement Kaizen. Managers will need to adopt new management techniques. In addition, the whole culture of the organisation will need to change and adapt.

For all of these methods it will be essential for managers and employees to be trained effectively. TQM, particularly, will need major training programmes to facilitate the thorough change in attitudes and working methods that will be needed. Indeed, TQM cannot be successful without appropriate training of all employees and managers.

Progress questions

7 Explain why relying on sampling products can still lead to customer complaints.
8 Explain why different groups of customers may have different ideas about quality standards.
9 Give three benefits of quality assurance.
10 How can "internal customers" improve quality?
11 What is the main difference between TQM and quality assurance?

Exam-style questions

Using the case material above for Starlight Fireworks (see page 440):

1 Analyse the factors causing quality problems at SF. [10 marks]
2 Evaluate the usefulness of total quality management in solving the quality problems at SF. [18 marks]

Key concepts

- A **Change** can be developed through study of Kaizen – continuous change.
- A **Management** can be linked to methods of implementing and managing quality methods and lean production systems.
- A **Customer focus** needs to be considered by recognising customer needs and expectations in relation to quality – customers define quality.
- A **Innovations** are developed through new methods of improving quality.
- A **Creating value**: improved quality = improved added value.
- A **Strategy** is involved in decisions involving implementation of new quality systems.

Progress check

You should now be able to:

- A explain the nature and importance of lean production
- A explain the links between lean production and inventory control, quality, employee roles, capacity management and efficiency
- A analyse methods of lean production
- A evaluate the role of Kaizen and just-in-time within lean production
- A discuss the implications of using a just-in-time approach
- A explain quality in terms of what the customer demands
- A evaluate the roles of quality control and quality assurance in managing quality
- A evaluate TQM as a method for improving quality
- A assess the role of TQM in quality control
- A analyse the role of benchmarking in quality control
- A describe the link between quality and training.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- A the need for projects and project management
- A reasons and impact of project failure
- A main elements of network diagrams
- A the construction of project network diagrams
- A finding the critical path and project duration
- A calculation of floats
- A interpretation of the results of network analysis
- A uses of critical path analysis (CPA) as a project management tool

Key terms

Project management: the discipline of planning, organising, securing and managing resources to achieve specific targets in relation to a project.
Project: a sequence of activities that has a clearly defined beginning and end designed to achieve a desirable business outcome.

Key term

Activity: a clearly identifiable stage, or task, in the completion of a project.

4.6 Project management

The need for projects and project management

Project management is the discipline of planning, organising, securing and managing resources to achieve specific targets. Very often these targets have been set in response to the need for the business to change. First, we need to be clear what we mean by a "project". Unlike the day-to-day operations of a business, a project is a business endeavour that has a specific life defined by a beginning and an end and has a variety of discrete tasks involved. Major projects, such as building a new factory or launching a new product, come about because of the need for a business to change.

At A Level we are concerned only with the time management of projects. Other project management techniques, such as optimisation of the allocation of resources, or transport scheduling, are outside the scope of this syllabus.

Consider the following, which all involve time management:

- Building a new factory
- Launching a new product
- Designing a new piece of computer software
- Building a house
- Launching a new marketing campaign
- Rationalising business operations
- Reorganising a business structure
- Replacing old machinery with machinery that is more up to date
- Allocating resources to a major task
- Ensuring a business complies with a new industry standard
- Organising a staff training day.

Each of these situations has the feature of a project – that is, a finite life, a beginning and an end. These situations also involve a need to co-ordinate resources. Each of them also needs to be finished on time – delays will cost money and have an impact on other business operations. Each is capable of being "broken down" into a discrete task known as an activity.

All of the situations described above are complex in nature. For example, building a house requires many activities such as: getting planning permission, getting the design right, appointing contractors and subcontractors, raising the necessary finance, laying the foundations, laying drainage, building the walls, putting the roof on,

installing water and electricity, decorating the inside, appointing an estate agent to sell the property.

The project manager and other stakeholders will be very keen to know:

- When the project will finish
- When intermediate stages can be started.

So the estate agent will want to know when they can show prospective buyers around, the electrical subcontractors will need to know when they can arrive to install the electrical cables and fittings.

These processes involve managing and co-ordinating:

- People
- Equipment
- Materials
- Money
- Time.

The aim of the project manager is to organise all of these to work together as efficiently as possible. If successful, the house building will be completed successfully, within a specified time period and at the budgeted cost.

Activity

Identify a project in your local area. It could be at your school or where you live. It could be a building project or some other kind of project. Identify the main activities that will be needed to complete it. What do you think would be the consequence of the project being late?

Case Study

Planning for the Football World Cup 2014

Planning for the World Cup in 2014 was an enormous operation. Matches were to be played at 12 different football grounds. Two were going to be completely new, five were to be rebuilt and five were to be significantly upgraded. Airports had to be upgraded so that the extra traffic was managed, and there were significant investments in improved roads and railways to facilitate transport for football fans around Brazil to the various locations.

It was imperative that all of these massive building works were completed on time. This meant a large amount of planning and sustained effort in management of the various projects.

Resources (such as building materials, employees, and finance) had to be at the right place at the right time, and the various tasks had to be completed on schedule – delays could have threatened the competition itself.

1 Why was it important to finish the projects on time?
2 How might planning have helped?
3 As well as planning, what else would have helped ensure completion on time?

Progress questions

1 Why would you not describe managing stocks as a project?
2 What are the main features of a project?
3 Explain the term "project management".

Reasons for and impact of project failures

We have all probably got examples of "things that went wrong": buildings that took longer to build than planned; major construction projects that ended up costing far more than originally planned; new products that nobody wanted.

Some examples include:

- Concorde – the supersonic aircraft that was technically outstanding, but cost far more than planned and never earned a profit
- Tacoma Narrows Bridge in the United States that collapsed owing to a design fault
- Airbus A380 – major delays and design changes
- Berlin Brandenburg Airport in Germany – planning difficulties, legal problems, major construction delays
- In Africa, Microsoft's Digital Villages have not materialised as planned
- In Australia, Kaman Super Seasprite helicopters did not live up to specification and were cancelled/returned by the Australian government.

Activity

Investigate at least two of the projects mentioned above to find out likely causes of failure and how the problems might have been avoided.

These "failures" create problems for the business and its customers:

- Businesses may have to make penalty payments if the project is late
- Businesses may lose money if costs are higher than planned
- The business may have its reputation damaged and lose future customers
- The customer is dissatisfied and may, in turn, let down its customers
- The customer might face financial penalties.

Research indicates a number of reasons why projects fail.

Table 4.6.1 Project failure statistics ▼

PROJECT FAILURE STATISTICS	
Bull survey	
CATEGORY	%
Bad communication	57
Lack of planning	39
Poor quality control	35
Missing interim deliverables	34
Poor budget management	29
Poor project management	20

Source: Adapted from The Bull survey 1998. www.it-cortex.com/Stat_Failure_Cause.htm#The%20Bull%20Survey%20%281998%29

These translate into more specific reasons:

- Changing requirements of the customer that cause delays and overspend
- Lack of consultation with the customer
- Insufficient resources allocated
- Poor planning
- Lack of effective management
- Changing business environment.

Central to each of these problems are poor planning and use of information. Network analysis can help a business plan a project more effectively and it provides a very useful monitoring tool to provide information and to adjust to changing circumstances.

Key term

Network analysis: a planning tool that identifies all of the activities in a project and allows analysis of the project in terms of completion times and other key features.

Case Study

IT projects and their failure

Many large companies undertake IT projects to improve their operations. These might, for example, be part of process innovation, improving communications, or setting up an online presence. According to Innotas, 50 per cent of IT projects in the US failed in 2013. Failure causes delays in achieving business objectives and increased costs potentially leading to reduced profits.

Failure can have major consequences for a business. This may be writing down of assets (Sainsbury's in the UK had to write off over $500 million of its investment in an automated supply change management system in 2005). In 2013 the US government had to try and rescue Healthcare, the IT system that was to be part of President Obama's healthcare reform. There were concerns over confidentiality of patient records, massive delays and excessive costs. The failure threatened the whole of the healthcare reforms.

Project managers are blamed for project failures. However, the problem may lie elsewhere. Businesses sometimes expect too much of project managers by expecting them to take strategic leadership of projects rather than the operational managing and monitoring of the projects.

IT objectives are often confused by strategic decision-makers who do not understand the limitations of IT systems. Users frequently change their minds during the design and implementation stages of projects, and the speed of change continues to increase relentlessly.

1. Identify three possible consequences of failures in IT projects.
2. To what extent could the failures have been avoided with more careful planning?
3. Why might project managers be the wrong people to provide leadership in the implementation of an IT project?

Key term

Critical path analysis (CPA): another name for network analysis.

Network diagrams

The process of analysing projects to show time sequences and to answer questions such as when the project will be completed or when particular stages will be completed is known as network analysis or critical path analysis (CPA).

"When will the project be completed?" might seem a trivial question to ask, but many projects overrun, as seen in the Sydney Opera House in Australia, The Millennium Dome in London and the Kashagan oil project in Kazakhstan.

This is because many business projects are complex and are made up of a number of activities.

Key term

Network diagram: a diagram that shows, in a logical progression, the activities involved in a project together with their time sequence.

Network analysis consists of the following stages:

- Identify all of the activities involved in a project
- Get estimates of the time taken for each activity
- Identify which activities must be sequential
- Identify which activities can be done at the same time as others
- Draw a network diagram showing the logical sequence of events
- Undertake critical path analysis using the diagram
- Draw conclusions from the results including "What if?"

These stages should become clearer as this chapter develops.

Consider the activities that are involved in putting on a school play (Table 4.6.2).

Table 4.6.2 Putting on a school play ▼

Activity	Identifier
Buy scripts for actors	A
Choose the cast	B
Rehearse	C
Print tickets	D
Sell tickets	E
Design advertisements	F
Print advertisements	G
Display advertisements	H

Some of these activities need to be sequential (one follows another), others can be done simultaneously (can be done at the same time as another).

So, for example, tickets have to be printed before they can be sold (E follows D: sequential), but scripts can be bought while tickets are being printed (A and D can be done at the same time: simultaneously).

These activities can be represented in a diagram. Consider Figure 4.6.1.

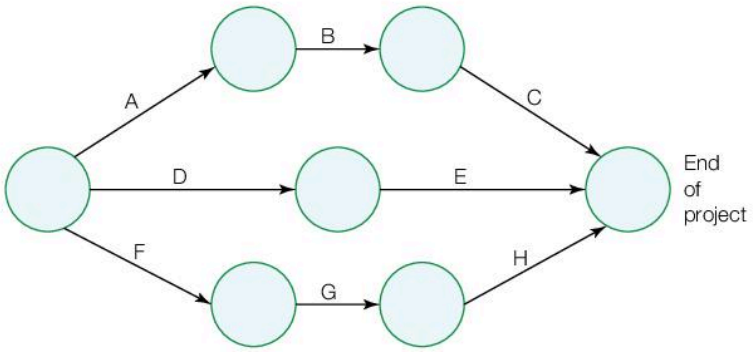


Figure 4.6.1 A network diagram for putting on a school play ▲

Key term

Node: a diagrammatical way of showing the beginning/end of an activity.

Activity

In groups decide on the main activities involved in organising a school magazine. See if you can draw a network diagram.

How difficult will it be to estimate the time taken by each of the activities?

Getting it right

It is very important to remember that whereas activities are shown as lines on network diagrams, nodes are the beginning and ends of activities. Many students make the mistake of thinking the nodes represent the activities. It is also very important to use arrows on the activities to show the flow of the logic of sequences.

Key terms

Earliest start time (EST): the earliest possible time an activity can start relative to the beginning of the project.
Latest finish time (LFT): the latest possible time an activity can finish relative to the beginning of the project.
Minimum project duration: the shortest possible time within which a project can be completed.

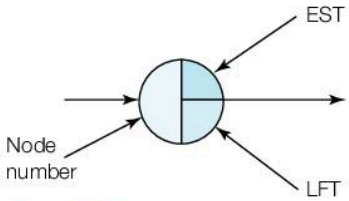


Figure 4.6.3 Labelling a network diagram ▲

In Figure 4.6.1 activities are represented by lines (with arrows to show the sequence of activities) and circles represent the beginning/end of activities – the use of these circles will soon become clear.

The circles are known as "nodes".

Progress questions

4 What distinguishes a node from an activity?
5 What are represented by lines on a network diagram?
6 Why is it important to use arrows on network diagrams?

The sequence of events is an important part of project planning – drawing the diagram can help clarify thinking about a project. However, the diagram, so far, does not contain one critical piece of information – how long each activity takes, known as the "activity duration".

Critical path analysis

Once activity durations are included on the network diagram, the network is ready for analysis. The analysis of the network is called critical path analysis (CPA).

The analysis of our network from the previous section is as follows.

Let us suppose the durations for each activity, in days, are:

A = 5; B = 2; C = 25; D = 5; E = 20; F = 5; G = 5; H = 20

The diagram then changes as shown in Figure 4.6.2.

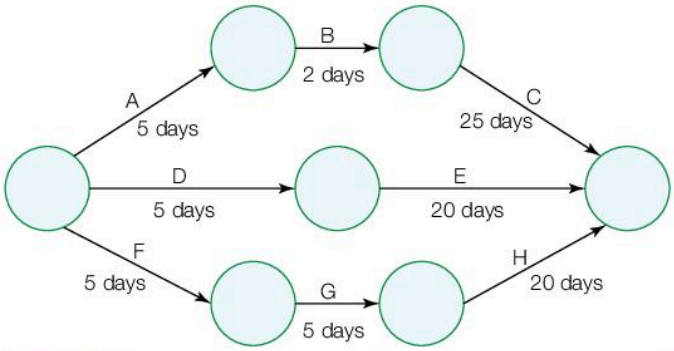


Figure 4.6.2 Network diagram with details of durations of activities ▲

At this stage each node takes on a meaning. It is going to be used to contain information about the activities that connect to the node as shown in Figure 4.6.3.

Where: EST means the earliest start time of the activity that *follows* the node, LFT refers to the activity that *precedes* the node. LFT means the latest finish time – the latest activities can finish without delaying the project as a whole. The LFT of the final activity is the minimum project duration.

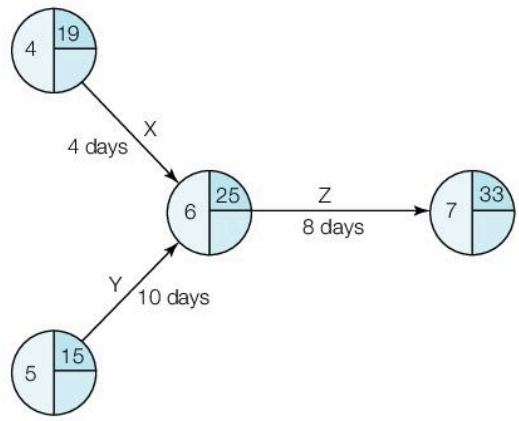
The node number is just a convenient way of identifying a node – used when computer software is employed in solving networks.

You should note, however, that the lengths of the lines representing the activities have no meaning in terms of activity duration and that every activity must finish at a node.

Earliest start times (ESTs)

Consider Figure 4.6.4.

Figure 4.6.4 Extract from a network diagram: Finding ESTs (earliest start times) ▶



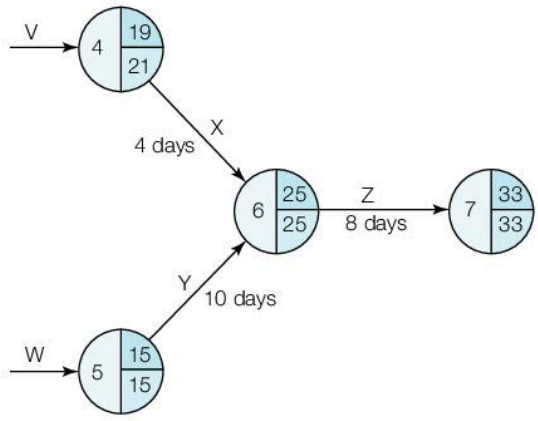
To calculate ESTs, start at the beginning of a project and work towards the end, building up ESTs as you progress:

- For Activity Z, both X and Y must finish before Z can start
- X can finish on day 23 (it can start on day 19 and takes 4 days)
- Y can finish on day 25 (it can start on day 15 and takes 10 days)
- So Z must wait until day 25, when both X and Y are finished.
- If Z is the last activity in the project it can finish on day 33. This is the project duration.

Latest finish times (LFT)

LFTs can only be calculated once ESTs have been done for the whole project. To calculate LFTs work from the end of the project backwards in time towards the beginning.

Figure 4.6.5 Extract from a network diagram: Finding LFTs (latest finish times) ▶



Key terms

Critical path: the sequence of activities that are critical to completing the project on time.
Critical activity: an activity within a project that cannot be delayed without delaying the overall project.

If the Z finishes on day 33 then X and Y must finish on or before day (33 − 8) or day 25, or the project will finish later than day 33.

X takes only 4 days so V, which precedes X, could finish as late as day 21 in order for X to finish by day 21 + 4 = 25 and Z to finish by day 21 + 4 + 8 = 33. So 21 is the LFT of V.

On the other hand, Y takes 10 days, so W cannot start any later than 25 − 10 = day 15 or the project will be delayed.

What can be seen here is that V could be delayed by 2 days but the project can still finish on time, whereas any delay in W will delay the project. The sequence of critical activities is known as the critical path.

W is known as a critical activity – its completion on time is critical to ensuring the project as a whole is completed in the shortest possible time.

V is non-critical – there is some scope for delay.

Critical activities can be identified by nodes which have EST = LFT, in other words the earliest time an activity can start is the same as the latest time the preceding activity can finish.

Clearly, knowing the critical activities helps managers to assess where their priorities should be.

The completed network diagram for all the activities involved in a school play is shown in Figure 4.6.6.

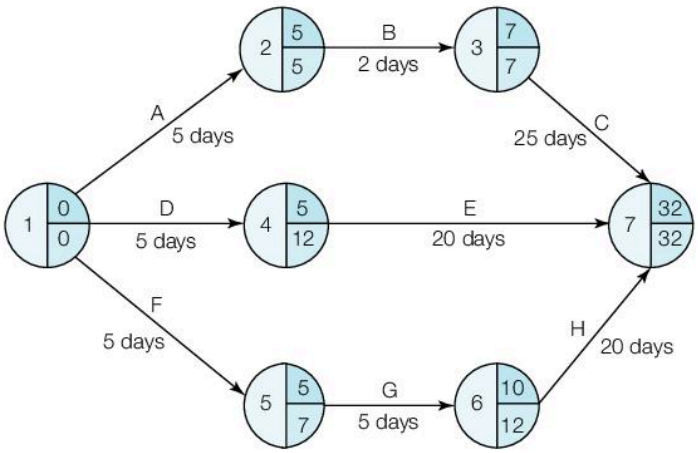


Figure 4.6.6 Completed network diagram for putting on a school play ▶

What can be seen is:

- The earliest the project can be completed is 32 days
- Activities A, B, C are critical to the completion of the project
- Activities D, E, F, G, H are non-critical.

Progress questions

7 Explain the term "critical activity".
8 Give one use of knowing the value of the LFT.
9 Why is EST = LFT for a critical activity?

Floats

We have seen how to calculate the duration of a project and to recognise the activities that are critical.

There are two further questions that can be answered with the information that is available so far. For the non-critical activities:

- How long can an activity be delayed without delaying the overall project?
- How long can an activity be delayed without delaying the next activity?

Consider the following situation.

Key term

Total float: the maximum time an activity can be delayed without delaying the overall project.

Total float

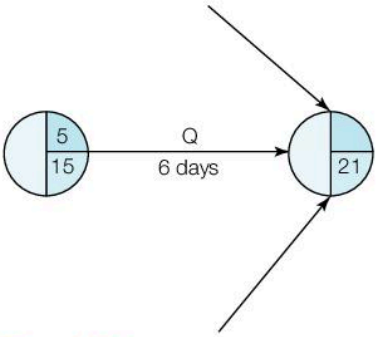


Figure 4.6.7 Extract from a network diagram showing need for float ▲

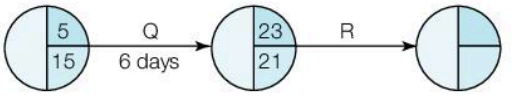
Consider Figure 4.6.7, which is an extract from a network. The latest possible finish time for Q is day 21. Its earliest start time is day 5. It takes 6 days to complete. It could be delayed to as late as day 21 − 6 = 15 in order for the project to finish on time. So there are 15 − 5 days, = 10 days' slack in which the project could be delayed. This is known as total float.

The formula for calculating total float is: LFT − duration − EST (in this instance 21 − 6 − 5 = 10)

The total float is zero for a critical activity.

Free float

Figure 4.6.8 Extract from a network diagram: calculating free float ▶



Key term

Free float: the maximum time an activity can be delayed without delaying the next activity in the sequence.

Consider Figure 4.6.8, which is an extract from a network. To avoid activity R being delayed, R has to start at its EST, in this instance day 23. This means Q must finish by day 20. Q can start on day 5 and takes 6 days. So Q can start no later than day 23 − 6 = 17. So there are 17 − 5 days' slack = 12 days. This is known as free float.

The formula for free float is: EST of next activity − duration − EST (in this instance 23 − 6 − 5) =12.

The free float is zero for a critical activity.

Knowing floats enables managers to identify those activities that can be allowed to fall behind schedule, perhaps freeing up resources for more critical activities.

Getting it right

Remember: free float and total float are zero for critical activities. For non-critical activities free float and total float are often the same.

Progress questions

10 Why are the floats on a critical activity equal to zero?
11 Explain the difference between free float and total float.
12 Why can free float not be larger than total float?

Dummy activities

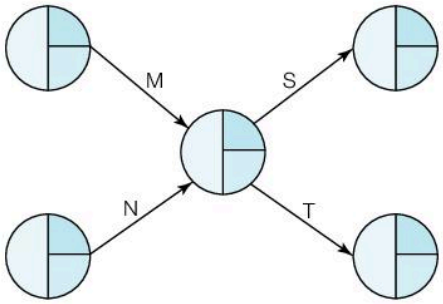
Sometimes the situation arises that when the logic of a situation is translated into a network diagram the resultant diagram is ambiguous.

For example, consider the following logic:

S follows M and N, T follows N

Figure 4.6.9 is a simple network that shows this.

Figure 4.6.9 The need for dummy activities ▶



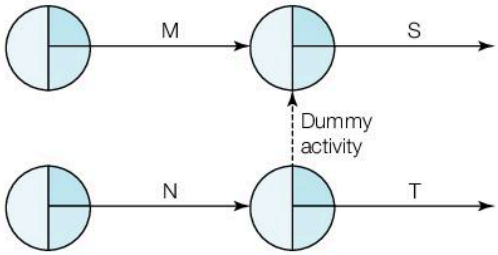
Key term

Dummy activity: an artificial activity used to ensure the logical representation of a project is not ambiguous.

However, this creates ambiguities. Does T follow M as well? Is M on the critical path or N? Does the LFT refer to M or N?

These ambiguities can be resolved using a dummy activity (Figure 4.6.10).

Figure 4.6.10 Previous figure now including dummy activity ▶



The dummy activity D is not a real activity – it takes no time, it requires no resources – but is a logic mechanism. Now if we carry out the usual analysis we can see that S follows M and N, while T only follows N.

The dummy has no impact on any other aspect of the CPA other than resolving ambiguities.

Progress question

13 Explain why dummy activities are not real activities.

The value of CPA as a management tool

As with most business studies techniques CPA has strengths and weaknesses. Its greatest strength is that it assists in the management of a large range of complex projects in a variety of situations. It achieves this by:

- Calculating project duration. This means that delivery dates can be estimated and negotiated and other operations can be planned.
- Knowing when activities should start. This means that managers can allocate resources to activities at the right time. This helps co-ordination.
- Knowing latest finish times. This means that managers are able to monitor progress and see the possible consequences if activities are running late.

- Knowing the critical path. This means that managers can focus on the timely completion of these with greater priority than non-critical activities.
- Knowing floats on non-critical activities. This means that managers are able to assess the significance of delays to non-critical activities. Where there are significant floats managers can divert resources from these non-critical activities to critical activities to ensure the latter are completed on time.

Construction of the diagram, particularly for very complex tasks, helps focus on tasks that can be completed simultaneously, linking in with lean production and simultaneous engineering (see page 437). Software for doing the calculations is readily available. The technique lends itself very well to "What if?" analysis which enables managers to simulate consequences of a range of options.

However:

- The analysis is only as good as the data. Estimating activity durations can be difficult.
- New projects do not have past experience as a guide.
- There may be costs involved in the planning, but it is unlikely that these costs will exceed the savings from planning the project.
- While the analysis is a great help to managers, it does not ensure that the project is managed effectively.

Progress questions

14 Give three advantages of using CPA.
15 Explain the benefits of "What if?" analysis.

Exam-style questions

Media Marketing

MM is planning a new marketing campaign for a chocolate bar. It has collected the following information.

Activity	Description	Weeks' duration	Sequence of activities
A	Design leaflets	2	Start of project
B	Negotiate advertising with television channels	3	Can be done at same time as A
C	Get materials for producing chocolate bars	4	Can be done at same time as A
D	Make chocolate bars and build up stocks	6	Must follow C
E	Get leaflets printed	3	Must follow A
F	Make TV adverts	5	Must follow B
G	Distribute chocolate bars to shops	3	Must follow D
H	Post leaflets	1	Must follow E
I	Start advertising on television	2	Must follow F
J	Launch product	3	Must follow G, H, I

1 Draw up a network. [6 marks]
2 Identify the minimum project duration. [4 marks]
3 Identify the critical path. [2 marks]
4 Calculate the free float and total float for activity E. [2 marks]
5 Evaluate the usefulness of CPA to the management of MM. [10 marks]

Key concepts

- **Change** can be seen from the viewpoint of the impact of changes in parameters in projects.
- **Management** is involved in the planning and implementation of projects.
- **Strategy** relates to the decisions involved in major projects.

Progress check

You should now be able to:

- explain the term "project"
- explain the need for project management
- discuss and give examples of reasons for project failure
- explain the main elements of a network diagram
- construct a network diagram
- analyse a network/CPA diagram to find the minimum project duration and identify the critical path
- calculate free and total floats
- interpret the results of network analysis
- evaluate the usefulness of critical path analysis (CPA) as a project management tool.

You should be able to relate these to a range of businesses in different situations.

5 Finance and accounting

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- A the purposes of budgets for appraising business performance
- A benefits and drawbacks of budgets
- A producing budgets
- A flexible budgets and zero budgeting
- A the use of budgets for allocating resources, controlling and monitoring a business
- A the role of budgets in appraising a business
- A the meaning of variances
- A calculation and interpretation of variances

Key term

Budget: a financial plan for the future. It differs from a forecast.

Link

See A Level Chapter 4.6 Project management for more on CPA.

5.6 Budgets

The purposes of budgets

AS Level Chapters 5.1 and 5.2 emphasised the importance of the need for planning in even the smallest business. This chapter develops the planning idea further with the concept of budgets. Budgets give financial plans for the future. You might think that this is what cash flow forecasts do (as in AS Level Chapter 5.5). However, cash flow forecasts are forecasts not plans, and they only cover cash inflows and outflows. Budgets are plans and they have a much wider scope than just cash.

First it is important to distinguish between "forecasts" and "plans".

Forecasts are what we *think* is going to happen in the future. We use forecasts, for example, to anticipate likely future problems and convince investors to invest in our business.

Plans are what we *want* to happen in the future – what we are going to aim for. We use plans, for example, to set targets in the workplace and as a mechanism for monitoring and controlling.

Budgets can be set at various levels.

- **The sales budget**: will estimate for each product, or service, the volume and value of sales that the business aims to achieve over a period. These budgets can be at various levels including product level, department level or regional/country level. Sales budgets are likely to be used for setting sales targets.
- **The production budget**: will set production levels and input costs for a period. These budgets can be at various levels including production line, factory, region or country levels. Production budgets are likely to be used for setting production targets and for controlling production costs.
- **Marketing budget**: will estimate the finance needed or available for marketing a product or service (e.g. using promotion/advertising). The marketing budget sets the boundaries for marketing strategies.
- **The financial budget**: will, based on other budgets and the cash flow forecasts, identify the needs for outside financing.
- **Project budget**: will, for an individual project, identify costs and their timings. The project budget is often broken down into specific tasks, with task budgets assigned to each. These budgets will be used, together with CPA (see page 451), for monitoring and ensuring progress of individual projects.
- **Capital expenditure budget**: will set levels of capital expenditure throughout the organisation. It should relate closely to both the project and financial budgets.
- **Master budget**: will be aggregates of individual budgets. Master budgets can be set at various levels, from the bottom up to factory, country and company for example.

Activity

You are planning to put on a school play. Decide amongst yourselves what items you will need to buy, and how you will get your income. Try to estimate what each income and cost will be and when they occur. Try and draw up a statement of income and expenditure week by week.

Progress questions

1 Explain the term "budget".
2 Explain why a budget is different from a forecast.

Uses of budgets

Budgets help to aid the planning of actual operations by forcing managers to consider how business conditions might change. They get managers to think about considering problems before they arise. Budgets also help to co-ordinate the activities of the organisation by getting managers to examine relationships between their own operations and those of other departments. Uses of budgets include:

- Allocating and controlling resources for day-to-day operations
- Communicating plans to various managers
- Monitoring progress
- Motivating managers to strive to achieve budget targets that provide the means of motivating the workforce
- Evaluating the performance of the business, managers and functions (appraisal)
- Providing an insight into the company's performance
- Managing money effectively
- Allocating appropriate resources to projects
- Monitoring project performance
- Improving decision-making
- Identifying problems before they occur– such as the need to raise finance or anticipating cash flow difficulties
- Planning for the future
- Increasing staff motivation.

Getting it right

When answering questions relating to budgets it can be useful to tie your answer in with management and motivational theories and with the ideas of total quality management.

Case Study

Snazzy Clothes (SC)

SC is a family business that manufactures fashion clothes for men. After ten good years when profits continued to grow, the family were all shocked to find that this year was not looking good. The family, Pierre, Alan, Monique and Isabelle, met with their parents, Giscard and Eva, to discuss the situation. Pierre, the finance manager, produced figures to show that profits are expected to be 50 per cent down on last year. Alan, the production manager, said, "Well I've done my bit, the new machinery we bought earlier this year is more efficient than ever before – we've produced so much I've had to pay bonuses to all the production employees." "That's no good," said Isabelle who is in charge of sales and marketing. "It is no good when we can't sell what you produce. Fashions have changed and we haven't." That comment upset Monique who did all the designs. "The problem is that the sales staff has not put the effort in," she said. Giscard and Eva looked distressed. They had hoped that, now they were getting older, they would be able to hand the business over to the children. "But with arguments like this I don't think we can," said Eva. Alan, the managing director, said, "We are victims of our own success. Because we've been lucky and had ten good years we haven't had to do any financial planning. Now things are tough we need to plan – and plan very carefully."

1 How might financial planning help SC?
2 What kind of plans could SC make to improve the situation in the future?
3 Who do you think is right?

Figure 5.6.1 Performance outstrips budget ▲

Links

See AS Level Chapter 1.4 Business objectives and AS Level Chapter 2.2 Motivation for more on targets and performance.
TQM is covered in more detail in A Level Chapter 4.5 Lean production and quality management.
A Level Chapter 2.5 covers communication roles.

Benefits and drawbacks of budgeting

Looking at the list of possible uses of budgets it is fairly clear that these uses can produce benefits for a business.

- Most of the uses should lead to greater efficiency and hence reduced costs
- The use of budgets in setting targets can improve motivation and performance if chosen carefully
- Monitoring can help the business to achieve its targets
- Evaluation should enable problems to be put right for the future – it could easily be part of a TQM system
- Communications are also important.

However, there are potential problems. Budgets project the future, and the future is uncertain. Budgets could be unhelpful, indeed they could be a hindrance, if the expectations about the future (the assumptions) are unrealistic. This could happen for a number of reasons:

- Circumstances change: for example a budget might be built on the assumption of a period of economic growth, but instead there is a recession.
- Lack of budgeting skills: the usefulness of a budget depends on who produces budgets. Often they are produced at departmental level and not all managers are skilled in budgeting.
- Manipulation of budgets: managers might find it difficult to put in a budget figure lower than the previous year because they may not want it to look like they overestimated the previous budget. Budgets are very often overstated.
- Human nature: managers are likely to be over-optimistic in case they are criticised by senior managers.
- Aggregation problems: individual managers will only see part of the picture.
- New projects: it may be difficult to plan for new projects as the business may not have previous experience of these projects.
- Lack of data or other information: not all budgeting can be based on past costs or other data.

There may be other difficulties arising from budgets:

- Demotivating: unrealistic targets will not have the desired effect of motivating staff. If objectives are not achievable people may not try.
- Inflexible: if managers have to stick rigidly to budgets, but circumstances change, then managers may be unable to react to the change, causing problems for the business. For example, if the marketing budget of Business A is fixed, and a competitor suddenly increases its marketing budget, then Business A may lose sales to the competition unless it has the flexibility to increase its marketing budget.

- Conflict: managers may argue fiercely to protect their own budget. It may be in the business's interest to reduce costs, but an individual manager is unlikely to want to reduce costs in their own area of influence.

Despite these undoubted potential problems with budgeting, businesses can design budgeting systems that work well. Well-designed budgets will need to be:

- Realistic
- Flexible
- Agreed with managers
- Holistic (look at the business as a whole)
- Reviewed regularly
- Seen as supporting managers, not challenging them
- Set for the short term with long-term aims in mind.

Progress questions

3 How could budgets increase motivation?
4 Why might budgets decrease motivation?
5 Give three factors that help to ensure budgets work effectively.
6 Explain how you could overcome the problem of budgets demotivating managers.

Getting it right

Budgets are plans, but not forecasts. However, like forecasts they cannot be "right" or "wrong" but they can be good plans, based on realistic assumptions, or poor plans, based on poor, unrealistic or wrong assumptions. Only hindsight will enable a judgment as to whether things have turned out as planned or not.

How budgets might be produced

The first stage in preparing a budget will be to clarify objectives, in order to decide the likely developments the business will undertake and to specify a plan. In large organisations this is often done with extensive consultation between the various areas of the business, the managers and senior managers. This should lead to a clear picture of likely costs and revenues for specific areas of the business. These then become part of the financial plans of the business for a given future period. The plans will include strategies for the business as a whole and more detailed plans for key areas of the business.

The second stage should involve approval and authorisation of these detailed plans (for each area and for the business as a whole) that takes into account the strategic objectives of the business. Once senior managers approve these plans then managers and employees have a formal "statement of future expectations" to work towards.

The third stage involves the business executing these plans.

The final stage requires managers and employees to be accountable to senior managers about their progress towards achieving these plans.

Types of budgets

There are several ways of producing budgets. If you were to ask your parents to produce a household budget for next month they would probably look at their income and spending for last month, and for the same month last year. They would then use this information to produce a statement of likely income and spending next month.

This is the most common method used by businesses for budgeting. It is intuitive and simple and in many circumstances it works well. This is known as incremental budgeting.

Key term

Incremental budgeting: use of financial information from previous periods to produce a budget for a future period.

However, incremental budgeting does not take account of unforeseen events and it is built on the major assumption that what has happened in the past is the only guide to the future. In addition, by only focusing on the past it is not encouraging innovation in the business or taking a fresh look at the future. The biggest danger is that, through the assumption that the future is like the past, business behaviour is trapped in past practices.

Zero budgeting

One technique that is used to encourage budget holders (managers usually) to be more innovative is the concept of zero budgeting.

Key terms

Budget holder: the individual who is responsible for preparing a budget and trying to ensure that it is achieved.
Zero budgeting: creating new budgets for each time period. Managers have to justify the budget "from scratch".

The idea behind this budgeting process is that budget holders should rethink their plans each year and justify any spending or sales not based on past data but on realistic views of the present. This concept fits in well with ideas of Kaizen – continuous improvement – and TQM. It is, however, more difficult and challenging than incremental budgeting and is likely to be time-consuming. Its greatest strength is in the need to include in budgets changes that are taking place and are going to take place. It should, therefore, lead to better budgets, more suited to a changing world.

Link

See A Level Chapter 4.5 Lean production and quality management for more on TQM.

Flexible budgeting

A flexible budget is similar to a fixed budget but with a "What if?" dimension built into it. Managers are asked to complete budgets based on a range of assumptions. So, for example, a production manager could prepare budgets based on different assumptions about output. The output levels would be dependent on the sales levels achieved by the sales department. In a fixed budget system a manager could be criticised for failing to meet a budget when the reasons for the failure could be outside the manager's control. For example, a production manager may not meet target production because the sales department have not achieved the desired levels of sales. In a flexible budget system the production manager will be judged against the budget appropriate to the outcome level of sales, which will be fairer than judging against past performance alone.

Key term

Flexible budgeting: budgets are prepared for a variety of situations to anticipate outcomes that are out of the control of budget holders.

Progress questions

7 Explain why zero budgeting might improve innovation.
8 Explain why managers might not want to change to a system of zero budgeting.
9 Give two assumptions that could be varied when preparing a flexible budget.

The practical uses of budgets

Allocating resources

Budgets provide an opportunity for forward thinking and help in planning processes. When planning a major project, such as an expansion, or managing plans for the future operations of a business, it is important to have a clear "road map" of where the business is going and how it is going to get there. Producing a budget provides the right kind of discipline to help in the planning process, forcing managers to think very carefully about what resources they will need, when they will need them and how much they will cost. With a well-produced budget it will be easier to ask "What if?" questions that can help in the planning process.

Controlling and monitoring a business

Links

Targets are discussed in more detail in AS Level Chapter 2.2 Motivation.
See also A Level Chapter 2.3b Human resource management: further functions of HRM where appraisal and targets are covered.

Budgets assign responsibilities to managers through the use of cost centres. They can also be used in setting targets. Budgets give managers a useful tool to help them control their area of business operations. With a budget a manager should have an idea of what they are trying to achieve and when. This will enable the managers to produce more detailed plans for themselves and their employees. Budgets can give a clear statement of managerial responsibility, which clarifies controlling functions. All of these things can help to improve efficiency, motivate staff and provide positive direction to the area of the business. This then provides a vehicle for resolving possible conflict when things do not go according to plan, or managers are unclear as to what their role should be. Priorities, too, might be an area of dispute which can be clarified through the use of budgets. Budgets can be used for communicating with employees and setting targets, which, in turn, may motivate employees. This can be seen as part of delegation.

Budgets also help the monitoring process. With the "road map" provided by the budget, the business will be able to see how it is progressing. Having set levels of costs and incomes, the business will be able to compare what it has achieved with what it planned to achieve. Analysis of the projections (budget) and the outcomes will enable managers to identify problems and make decisions about how situations can be improved (see variance analysis below). Review of budgets also helps businesses in their future plans and budgets for the business by identifying where results differ significantly from the budget and what went wrong.

The role of budgets in appraising a business

Budgets have the practical role of turning business objectives into practical plans. Strategic and other objectives can be somewhat vague, so that the discipline of setting a budget can force a business to be more systematic and logical in its forward planning and objective setting. Budgets then become the mechanism, through monitoring and analysing outcomes compared with budgets, for reviewing whether objectives have been met – a key part of business appraisal. In this way comparing a budget with actual outcomes will help the senior management see whether marketing objectives are being achieved, manpower planning is effective and so on. Budgets also help senior management in their overall control: departures from budgets are often only allowed after negotiation with, and approval from, senior management. Sometimes major stakeholders will be provided with budget information, so that budgets become a means of helping them assess their involvement in the business and its future plans.

However, the key thing about any budget is the extent to which it is realistic. There is a huge temptation to overstate positive aspects of a business and understate negative aspects. Unrealistic budgets can at best be misleading, at worst unrealistic. A good example is provided by Enron, one of the world's largest corporations which failed in 2001. Apart from some questionable accounting practices Enron failed as a result of overstating projections for budgets.

Key terms

Variance: the difference between budgeted and actual performance.
Adverse variance: where the variance contributes to a lower-than-budgeted profit.
Favourable variance: where the variance contributes to a greater-than-budgeted profit.
Variance analysis: the process of calculating and examining variances in order to improve business performance.

Getting it right

Variances are described as *favourable* or *adverse* rather than being described as positive or negative as "negative" would be confusing. A negative sales variance would reduce profits; a negative cost variance would increase profits!

Variances and variance analysis

For budgets to be useful, managers need to monitor actual performance compared with the target performance levels used in preparing the budget. The difference between the target performance and the actual performance is known as a variance.

So, for example, the budgeted expenditure on marketing for a small retail business might have been $500 for 2014, but in the event turned out to be $600. This is a variance of $100: calculated by subtracting "actual" from "budget". Because marketing expenditure is a cost, and businesses would like to minimise costs, this increase in marketing costs is an example of an adverse variance.

If, on the other hand, the business had forecast sales of $5000, but the sales turned out to be $6000, then this is a favourable variance of $1000: it is favourable because higher than planned sales is regarded as a good thing for most businesses.

By calculating and examining variances (known as variance analysis) businesses will be able to:

- Identify problems and take positive action so that further problems can be prevented
- Assess the budgeting process in order to make future improvements

- Assess the performance of departments and managers in achieving targets
- Understand present costs and revenues and control future events.

Calculation and interpretation of variances

Consider the information for a tractor manufacturer shown in Table 5.6.1.

Table 5.6.1 Calculation and interpretation of variances for the tractor manufacturer ▼

Activity	Budget ($m)	Actual ($m)	Variance ($m)	Description
Sales revenue	1500	1400	100	Adverse – sales are less than expected. This reduces profit.
Variable costs	500	450	50	Favourable – variable costs are not as high as expected. This increases profit.
Overhead costs	300	400	100	Adverse. Overheads are more than expected. This reduces profit.
Net profit	700	550	150	Adverse. The net result of favourable and unfavourable variances.

Getting it right

You will not be asked to disaggregate sales variances into price and volume components.

The position with this business is that the only activity that has performed better than planned is that of variable costs. The managers would need to research why this is the case. Have raw-material costs fallen? Has there been less waste? Has the business managed to increase production efficiency? Perhaps labour wage rates have changed. Are wage costs lower? Were fewer people employed? Were there fewer hours of overtime worked?

The adverse sales revenue variance (−$100 million) would need to be considered further. Is it due to falling sales volumes, falling sales prices or a combination of both?

The adverse overheads variance would also need to be researched. To what extent is it due to external factors (rents, taxes, heating and lighting costs etc.) and to what extent is it due to internal factors (office staff, marketing etc.)?

There are further techniques available to the analyst (for example, to disaggregate sales variances into price and volume variances). However, these are beyond the scope of this syllabus.

Exam-style questions

The owners of the Rex Cinema were concerned about falling profits so they decided to introduce a budgeting process. After the first six months they compared budgets with actual outcomes.

Activity	Budget ($)	Actual ($)
Ticket sales	25000	26000
Other sales	1000	800
Wages	8000	8100
Other variable costs	5000	6000
Overheads	4000	5000
Profits	9000	7700

1 Calculate the variances. [6 marks]
2 Indicate which variances are favourable and which are adverse. [3 marks]
3 Discuss how the management of the Rex Cinema could respond to these variances. [10 marks]
4 Evaluate the usefulness of budgets to the owners of the Rex Cinema. [16 marks]

Key concepts

- **Change** can be considered through factors influencing budgets and changes to those factors.
- **Management** can be considered through the use of budgets for monitoring and controlling.
- **Strategy** can be involved in the strategic response to adverse variances.

Progress check

You should now be able to:

- explain the purposes of budgets
- discuss the benefits and drawbacks of budgets
- produce budgets
- discuss the use of flexible budgets and zero budgeting
- analyse the use of budgets for allocating resources and for controlling and monitoring a business
- recognise the role of budgets in appraising a business
- explain the meaning and uses of variances
- calculate and interpret variances.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- A the contents of an income statement and a statement of financial position (balance sheet)
- A any amendments that need to be made to given data
- A the relationship between income statement items and those in the statement of financial position (balance sheet)
- A the methods of valuing inventory and the difficulties associated with such valuation
- A the impact of depreciation on the financial statements of a business

Link

Income statements and statements of financial position are covered in AS Level Chapter 5.4 Accounting fundamentals.

5.7 Contents of published accounts

In AS Level Chapter 5.4 Accounting fundamentals, the contents and the construction of income statements and statements of financial position (balance sheet) were outlined. This chapter will consider the effect of changes being made to the value of any of the items in either statement.

Income statement amendment

For example, if the price that a business had to pay to purchase products for sale increased, the cost of products sold would increase. If the price of the products sold to customers was not increased then the gross profit for the business would decrease.

Example

Guillaume plc
The trading section of an income statement for the year ended 30 September 2014

	Before change		After change	
	$000	**$000**	**$000**	**$000**
Sales revenue		996		996
Opening inventory	120		120	
Purchases	280		308	
	400		428	
Less closing inventory	95		95	
Cost of products sold		305		333
Gross profit		691		663

If the cost price of opening and closing inventory remained the same but the cost of purchases increased by 10 per cent, the purchases figure would then be $308. The effect would be to increase the cost of products sold to $333 and to reduce the gross profit to $663.

Progress question

1 Using the data above, if the price of products sold to customers was increased by 10 per cent and all other values were unchanged, calculate the new gross profit.

In the same way, changes might need to be made to the profit and loss section of the income statement. For example, if the wage rate was increased or there was an increase in the electricity bills or the rent, there would be an increase in the total of expenses that the business needed to pay. This would result in the profit for the year for the business decreasing.

In the following example, wages, rent and electricity are each increased by 10 per cent.

Example

Guillaume plc
Profit and loss section of an income statement for the year ended 30 September 2014

	Before change		After change	
	$000	$000	$000	$000
Gross profit		663		663
Rent	20		22	
Wages	160		176	
Electricity	10		11	
Office supplies	8		8	
Sundry expenses	2	200	2	219
Operating profit		463		444

Progress question

2 Using the "before change" data above, calculate the new operating profit if the wages and rent both increased by 25 per cent.

Statement of financial position amendment

The statement of financial position (balance sheet) can also be subject to change. For example, if a business sold some of its non-current assets (fixed assets) then the total value of non-current assets on the statement of financial position would reduce and the value of cash and cash equivalents (cash and bank accounts) would increase.

In the following example, Maradonna plc has sold a machine for cash $45 000 and a vehicle for $2000. Both assets were shown on the previous statement of financial position at these values.

Example

Maradonna plc
Extract from the statement of financial position at 30 September 2014

	Before change		After change	
	$000	$000	$000	$000
Non-current assets:				
Premises	450		450	
Machinery	125		80	
Vehicles	50	625	48	578
Current assets				
Inventory	96		96	
Trade receivables	468		468	
Cash and cash equivalents	112	676	159	723
Total assets		1301		1301
Non-current liabilities				
Long-term loan		130		130

	Before change		After change	
	$000	$000	$000	$000
Current liabilities				
Trade payables	248		248	
Overdraft	185	433	185	433
Total liabilities		563		563
Net assets		738		738
Shareholders' equity				
Ordinary shares		520		520
Retained earnings		218		218
		738		738

Progress questions

3 Using the "before change" data above, calculate the effects if a vehicle was purchased for $5000 using money from the bank account and credit customers owing $56 000 settle their debts.

4 Complete the "after change" section of the statement of financial position if machinery costing $35 000 was purchased using a long-term bank loan.

Remember that any increase in expenses recorded in the income statement will reduce the operating profit and the retained earnings shown on the statement of financial position. Therefore, changes affecting the income statement will also have an impact on the statement of financial position (balance sheet).

Valuation of inventory

Key term

Net realisable value: the value of an asset taking into account any expenses that have been incurred.

Inventory must be valued in order to be recorded in the statement of financial position (balance sheet) at the end of each financial period (usually one year). Accounting principles state that the value of inventory must not be under- or overstated and that the value must be as objective as possible. Inventory must be valued at the lower of cost or its net realisable value.

A business cannot value its inventory at what it thinks it might be worth; the value given must be factual. For these reasons inventory is ideally valued at its historical cost (what it originally cost to purchase). However, this is not always possible or sensible. For example, if a clothes retailer bought lots of T-shirts to sell and the fashion changed, this could leave it with unsold T-shirts. It is not likely that it would be able to sell the T-shirts as the same price that it could when they were fashionable. It would have to sell them at a lower price if it wanted to sell them now that they are no longer fashionable. If a T-shirt was bought for $4 and was to be sold for $8, that might have been possible when the items were fashionable, but when the fashion changes it might only be possible to sell them for $3. The net realisable value of the T-shirts is now only $3 and it is this value that must be used to record the inventory on the balance sheet.

Figure 5.7.1 Sale! ▶

If the T-shirts were still selling at $8 each then they would be valued at cost, i.e. $4 each.

There also times when inventory items are damaged whilst in storage. This will almost always reduce the price at which they can be sold. The damage might require some repairs to take place, which will add to the cost of the inventory.

Example

Piotr is an importer of sports shoes. He had 1000 pairs of sports shoes in storage when a fire broke out in the stockroom. The sports shoes were not destroyed but all of them were blackened by the smoke. They can be steam-cleaned at a cost of $1.50 per pair.

The original cost of purchasing the sports shoes was $9.00 and they were expected to sell for $20.00. Piotr expects that he can now sell the damaged shoes for $10.00.

Inventory must be valued at the lower of cost, $9.00 or net realisable value $8.50 ($10.00 − $1.50) and therefore the sports shoes would be valued at $8.50 per pair in this example.

Other difficulties in valuing inventory

- The value is taken on one day, which might not be representative of the other days of the year.
- It might not have been possible to complete a check on inventory on the actual date of the year end and therefore the valuation might be different from the one recorded on the statement of financial position. Products might have been sold or purchased during the time between those dates.
- Some inventory might never be sold and will therefore not be of financial benefit to the business.

Getting it right

LIFO and FIFO methods of inventory valuation are *not* examined in this syllabus.

Progress question

5 A business buys in wooden chairs at a cost of $15 each. They were to be sold for $25 each. The storeroom is flooded causing some minor damage to the chairs. The chairs can now only be sold for $12.

What figure should be used to value each chair for inventory purposes?

Key terms

Depreciation: spreading the cost of a non-current asset over its expected useful life.
Residual value: the estimated resale value of an asset at the end of its useful life.

Depreciation

Depreciation is the spreading of the cost of a non-current asset over its estimated useful life. The Cambridge International AS and A Level Business syllabus examines only the straight-line method of depreciation.

Depreciation is needed because most non-current assets decline in usefulness over their life, and therefore decline in value. So, for example, a lorry bought by a business is very expensive to buy, but after a long period of time it is virtually worthless because it keeps breaking down and may be unsafe.

Depreciation is calculated assuming that the cost is spread evenly throughout the expected lifetime of the item and that the equipment might have a resale value at the end of that time (residual value).

It is calculated as:

$$\text{Depreciation} = \frac{\text{Cost of equipment} - \text{Residual value}}{\text{Estimated lifetime of machinery}}$$

Example

A machine is purchased costing $20 000 and is expected to have a useful life of six years after which time it is believed that the machine can be sold for $2000.

Key term

Carrying amount: (net book value) the value of a non-current asset. It is calculated by: Purchase price – Accumulated depreciation.

The depreciation would be:

$$\frac{20\,000 - 2000}{6} = \$3000 \text{ per annum}$$

Therefore $3000 depreciation would be entered on the income statement as an expense. Three figures are entered on the statement of financial position: the original costs, the accumulated depreciation and the carrying amount (net book value), which after the first year would be:

	$	$	$
Equipment	20 000	3 000	17 000 (carrying amount)

Getting it right

Remember, depreciation is *not* money put aside to replace equipment, it is the spreading of the cost of the equipment over the estimated life of the equipment. It is a non-cash expense in the income statement.

This method of calculating depreciation is widely used due mainly to its simplicity. However, there are other methods that can be used and some businesses will choose to use an alternative method. This is one of the reasons why comparing the financial documents of different businesses can be difficult if they have used different methods in their calculations.

When the depreciation for the year is recorded in the income statement it has the effect of reducing the operating profit. For this reason, it is important that the accounting principle of "prudence" is applied when depreciating assets. If depreciation was overestimated, this would perhaps have the effect of reducing net profit too far.

Many countries have taxation policies that dictate how depreciation can be applied to various assets. This can be used to stimulate investment by businesses if they are allowed to write off part of the cost of assets purchased against profits, thus reducing their tax liability. Taxation policies related to depreciation are also used to prevent businesses from

being able to inappropriately reduce the profit that they declare to the tax authorities. For example, if a government wanted to encourage business investment in new technology, they might allow the cost of the equipment to be depreciated over a one- or two-year period, thus reducing taxable profits, rather than a more usual longer period.

It is difficult to be precise about the estimated useful life of an asset and this can make accurate depreciation difficult to determine. Some assets such as computers can have an extremely short useful life due to the rapid obsolescence of high-technology assets some of which will only be of use for two or three years.

Progress question

6 A machine is purchased costing $16000 and is estimated to have a useful life of three years after which time it is expected to be able to be sold for $1000.

Calculate the annual depreciation using the straight line method.

Exam-style questions

Altrayne plc. Income statement for the year ended 30 September 2014

	$000
Revenue	23
Cost of products sold	10
Gross profit	13
Overhead expenses	8
Operating profit (profit before tax)	5

The cost of products sold and overhead expenses are each forecast to increase by 10 per cent during the year ending 30 September 2015.

1 Prepare a forecast income statement for the year ending 30 September 2015. [6 marks]

Eladra plc

Eladra is a public limited company that manufactures electric sewing machines that sell for $150. Each machine costs $110 to make. A flood damages 100 completed machines that were in storage ready for sending out to a retail customer. The water damaged the electric motors but these can be repaired at a cost of $10 per machine. If the motors are not repaired it will not be possible to sell the machines and they will have to be scrapped.

Once the repair to the motors has been completed, it is estimated that Eladra plc will be able to sell the machines for $100 each.

2 **a** Calculate the cost to Eladra of the 100 machines. [4 marks]

b Calculate the recorded value of the inventory in the statement of financial position (balance sheet). [4 marks]

Ashoak Plastics plc. Statement of financial position (balance sheet) at 31 October 2014 (Extract)

	$000	$000
Non-current assets	584	
Current assets	185	
Total assets		769
Non-current liabilities	125	
Current liabilities	195	
Total liabilities		320
Net assets		449

In November 2014 Ashoak Plastics purchased a new factory at a cost of $350 000 and financed this with a long-term loan.

3 Prepare a statement of financial position (balance sheet) as at 30 November 2014 assuming that all other elements remain unchanged. [6 marks]

Key concepts

- **A** **Change** is involved in the amendment of income statements and statements of financial position in changed circumstances.
- **A** **Management** is viewed from the perspective of management accounting – using accounts to make management decisions.

Progress check

You should now be able to:

- **A** make amendments to an income statement and a statement of financial position from information given
- **A** understand the relationship between the information on an income statement and that in the statement of financial position
- **A** understand the net realisable value method of valuing inventory and appreciate the difficulties associated with valuing inventory
- **A** understand the role and impact of depreciation on the income statement and the statement of financial position.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- A the significance of return on capital employed, financial efficiency ratios and gearing
- A the calculation and importance of investor ratios
- A the value of using ratios to assess business performance including inter-business comparisons
- A the possible strategies that a business can employ to improve ratios
- A the potential limitations of using these ratios due to changes in accounting techniques and external influences

Key term

Return on capital employed (ROCE): a measure of the rate at which the assets of a business generate profit.
Capital employed: the total value of all share capital and reserves and loans of a business.

5.8 Analysis of published accounts

This chapter introduces some additional ratios that can be used to further analyse aspects of the financial statements of a business.

Profitability ratio

Return on capital employed (ROCE)

Return on capital employed (ROCE) is also known as the "primary ratio". This is a measure of the rate at which the assets of a business generate profit. It demonstrates the efficiency of the assets being used in a business with regard to profit generation. It is a ratio that might be used by potential shareholders who would want to assess the possible return they could expect to receive on any money invested in a business.

The calculation of ROCE is based on operating profit which is the profit of a business after all overhead expenses have been deducted. The capital employed is the shareholders' equity plus long-term loans, reserves and debentures.

The formula for the calculation of return on capital employed is:

$$\frac{\text{Profit before tax and interest (operating profit for the year)} \times 100}{\text{Capital employed}}$$

Example

A business has an operating profit of $644 000 and a capital employed of $5 850 000. The calculation of the return on capital employed would be:

$$\text{ROCE} = \frac{644\,000 \times 100}{5\,850\,000}$$

$$= 11\% \ (11.008547)$$

Is this a good return? It is not possible to say for sure whether 11 per cent is a good return.

- It depends on what return could have been received if the money had been placed in an interest-bearing bank account rather than being used to buy equipment.
- It also depends on what the return was in previous years. If the previous five years had yielded returns on capital employed of 15 per cent or more then the return of 11 per cent might not be acceptable.
- If the country was experiencing a recession then the business might consider 11 per cent to be a very good return even though higher returns had been experienced in earlier years.
- The return on capital employed can also be compared to other businesses in the industry. If the industry average for ROCE was 8 per cent then 11 per cent can be judged to be good. However, if the industry average is 15 per cent then 11 per cent might indicate that the business has some inefficiencies that need to be addressed.

Progress questions

Terranto plc had a profit before tax and interest (operating profit) of $400000 and capital employed of $2 800000.

1 Calculate the return on capital employed for Terranto plc.
2 Explain whether or not you think this is a good ROCE for Terranto plc.

The following information relates to Hale Harrison plc.

	2013	2014
Capital employed	$850m	$700m
Operating profit	$170m	$98m
Retained profits	$40m	$20m

3 Calculate the return on capital employed for both years.
4 Discuss the possible causes of the differences in the ratio between the two years.

Financial efficiency ratios

Inventory turnover

Key term

Inventory turnover: the rate at which inventory enters and leaves the business.

Inventory turnover is a measure of the rate at which inventory enters and leaves the business. The formula for the calculation of inventory turnover is:

$$\frac{\text{Cost of products sold}}{\text{Average inventory held}}$$

The inventory figure used is usually the average inventory figure for the year. This is the average of the opening inventory and the closing inventory.

The result tells us how many times, or on average in how many days, inventory is turned over (sold).

Example

Exemplar Wholesalers has the following information.

	$
Opening inventory	60000
Purchases	580000
	640000
Closing stock	80000
Cost of products sold	560000

$$\text{The inventory turnover} = \frac{560000}{70000 \text{ (average of \$60000 and \$80000)}}$$

$$= 8 \text{ times or every 46 days (i.e. 365 divided by 8 = 45.625)}$$

Is this business efficient if inventory is turned over every 46 days or eight times each year? It is difficult to say without knowing what type of products the business deals in.

Progress questions

Mowertron is a business manufacturing blades for agricultural equipment. The following information is an extract from the latest income statement for Mowertron.

	$
Opening inventory	125 000
Purchases	850 000
	975 000
Closing inventory	75 000
Cost of products sold	900 000

5 Calculate the rate of inventory turnover for Mowertron both in terms of times per year and days.
6 Discuss whether or not this is an acceptable rate of inventory turnover for Mowertron.

Figure 5.8.1 Food items for sale in a local market ▲

Key terms

Days' sales in receivables: the average time taken by trade receivables (debtors) to settle their debts with a business.
Debt: an amount owed by a business to a third party.

- If the business is a wholesaler of electronic equipment such as radios then having an inventory turnover of eight times per year might be very acceptable
- If the business sold food then the figure might not be acceptable because this might indicate that inventory is staying in the business too long before being sold and therefore the quality of the products might be compromised.

As with other ratios, this must also be compared to rates from previous years and also with those of other businesses in the industry.

Example

Colly Stroll is a private limited company that has been baking and selling cakes to supermarkets for many years. The following is an extract from the latest income statement for Colly Stroll.

	$
Opening inventory	45 000
Purchases	210 000
	255 000
Closing inventory	37 000
Cost of products sold	218 000

$$\text{The rate of inventory turnover} = \frac{218\,000}{41\,000\ [(45\,000 + 37\,000) \div 2]}$$
$$= 5.3 \text{ times per year or on average every 69 days}$$

Is this a good rate of inventory turnover? Not for cakes! Imagine what a cake might be like to eat if it had been stored for 69 days! You might expect the inventory turnover of a business making and selling fresh food to be more in the order of 150 times per year, or 2.4 days.

So clearly whether or not the inventory turnover rate is an acceptable one will depend heavily on the type of business and the kind of products involved.

Days' sales in receivables

Days' sales in receivables calculates the average time that debtors (trade receivables) take to settle their debts with a business. As seen in an earlier chapter it is important that businesses keep money flowing in so that they are able to settle their own debts with their suppliers.

Days' sales in receivables is calculated by:

$$\frac{\text{Trade receivables (debtors)} \times 365}{\text{Credit sales}}$$

Example

A business has credit sales for the year of $594 600 and debtors (trade receivables) at the end of the year of $86 000.

Link

See also AS Level Chapter 5.5. Forecasting cash flows and managing working capital.

Days' sales in receivables would be:

$$= \frac{86\,000 \times 365}{594\,000}$$

$$= 52.845$$

$$= 53 \text{ days (rounded up)}$$

This means that the debtors of this business are settling their debts on average after 53 days. Is this satisfactory?

- If the business itself is required to settle its debts with its suppliers after 30 days then it is in danger of experiencing a negative cash flow situation
- However, if its suppliers require that debts be paid within 60 days then the business will not be in a negative cash flow situation
- This figure may be distorted by one very large credit customer owing a big proportion of the total amount outstanding.

Progress question

Treebo plc produces and sells sweets to retailers. Most of their sales are on credit terms. The credit sales for the year ended 30 November 2014 were $786 000 and the trade receivables (debtors) at 30 November 2014 were $64 500.

7 Calculate the debtor days for Treebo plc and comment on whether or not the result is likely to be acceptable to Treebo.

The figure must also be taken in the context of what proportion of the sales of a business are credit sales and what proportion are cash sales. If a business mainly sells on cash terms then the debtors that do take a long time to settle their debts might have less of a negative effect on the liquidity of the business.

Gearing

Gearing is a measure of the proportion of the company's capital that is from fixed interest-bearing sources.

Gearing is calculated by:

$$\frac{\text{Debt}}{\text{Equity + Debt}}$$

$$\frac{\text{Fixed interest bearing finance} \times 100}{\text{Shareholders' equity + Preference shares + Long-term loans}}$$

Key term

Gearing ratio: measures the percentage of the capital of a company that is from fixed interest-bearing sources.

The gearing ratio shows the relationship between the proportion of capital that has been provided by the owners of a business and that which has been supplied by others and which requires interest payments to be made. It indicates the level of dependence of a business on fixed interest finance.

The gearing ratio is calculated by:

$$\frac{\text{Non-current liabilities (Long-term loans)} \times 100}{\text{Shareholders' equity + Long-term loans}}$$

A business that has a gearing ratio above 50 per cent is usually judged to be highly geared. The lower the ratio the lower the risk to the business is. The interest on loans must be paid whether or not a profit is made by the business. A ratio below 50 per cent is usually classed as low gearing.

Key term

Dividend: the return paid to shareholders for each share that they hold.

The gearing ratio might be used by potential shareholders to assess the likelihood of the business being able to afford to pay dividends to its shareholders. If the business is highly geared then a large amount of money will be needed to pay the interest on the loans and to repay the amount borrowed.

Getting it right

There are various methods of calculating gearing and you should use the one indicated in a question. One alternative is

$$\frac{\text{Debt}}{\text{Equity}} \times 100$$

You should also be aware that it is the interpretation and understanding of the result that is important.

Link

See also AS Level Chapter 5.2 Business finance and its sources.

Even a highly geared company might not experience any problems in paying the interest on loans at times when it is generating a high level of profit, but if it then experiences difficulties and its profits reduce substantially, it might no longer be able to service the debts. This can be a serious threat to the liquidity of the business.

An alternative method of calculation is to not use the "× 100" element of the calculation above. This would give an answer between 0 and 1 rather than a percentage. Either method is acceptable. In the example above this would mean that gearing of 50 per cent would be shown as 0.5.

As well as the gearing ratio, the current rate of interest payable must also be considered.

The usual interpretation is:

- High gearing in times of high interest rates = high risk
- Low gearing and low rate of interest = low risk.

The gearing ratio of a business can be important when seeking additional finance. For example, if a business has a gearing ratio of 15 per cent and is seeking a long-term loan from a bank in order to finance expansion within the business, the bank is unlikely to be worried about the ability of the business to repay the loan. However, if the business had a gearing ratio of 58 per cent the bank may fear that the business could become illiquid and therefore be unable to service the debt. The bank might be even more cautious if interest rates in the economy were on an upward trend because this would increase the interest payments that the business would be required to make.

The gearing ratio would be considered in the context of all of the financial information that a potential lender might request from a business that is seeking to increase its borrowing.

Key terms

Investor ratios: calculations used by shareholders and potential shareholders to determine whether or not to retain their shares in that company.

Dividend yield: the rate of return that a holder of ordinary shares receives based on the market price of each share held.

Dividend cover: measures the number of times that the total dividend could be paid out of the company's profit after tax and interest.

Price/earnings ratio: shows the relationship between the earnings per share and the market price of the share.

Investor ratios

Investor ratios are used by existing shareholders in a business to assess whether or not to retain their shares in that company or whether to sell them and to purchase shares in a different company. They are also used by potential shareholders who use them to assess the potential dividends that they might receive if they purchased shares in a particular company.

The three investor ratios that are assessed in the Cambridge International AS and A Level Business syllabus are the dividend yield, the dividend cover and the price/earnings ratio.

All of the ratios are concerned with dividends paid on ordinary shares.

Dividend yield

This is the rate of return that a holder of ordinary shares receives for each share held. It is calculated by:

$$\frac{\text{Dividend per share} \times 100}{\text{Market price per share}}$$

Progress questions

Business X has shareholders' equity of $496 000 and long-term loans of $154 000. Business Y has shareholders' equity of $450 000 and long-term loans of $369 000.

8 Calculate the gearing ratio for business X and business Y.

9 Discuss in which of the two businesses investors are likely to prefer to buy shares.

Getting it right

It is likely that if you are asked to calculate a gearing ratio you will also be asked to analyse the importance of your result. Make sure that you are able to analyse the significance of your result to the business in the question/case study.

The dividend per share is calculated by dividing the total amount of dividends by the number of issued shares.

Example

Prelent Express plc has issued 700 000 ordinary shares of $1 each and has total dividend for the year of $175 000. The current market price of the shares is $5.50.

The dividend yield would be calculated as follows.

First find the dividend per share which is calculated by:

Total dividend divided by the number of shares, i.e.

$$\frac{175\,000}{700\,000} = 0.25$$

This is then used in the calculation for dividend yield as follows:

$$\text{Dividend yield} = \frac{\text{Dividend per share} \times 100}{\text{Market price per share}} = \frac{0.25 \times 100}{5.50}$$
$$= 4.55\%$$

Shareholders would then compare 4.55 per cent to other returns that they might be able to achieve if they invested their money in some other way. For example, if they could place the money on deposit in an interest-bearing bank account that was paying 5 per cent per annum they might prefer to put the money in the bank rather than take up the riskier option of share ownership.

This return would also be compared to the dividend yield obtainable if they purchased shares in a different business. The dividend yield must be considered along with the degree of risk involved in owning shares in a particular company. If the company was deemed to be a higher risk investment than an alternative company then 4.55 per cent might not be sufficient reward for a high-risk investment.

Dividend cover

This ratio measures how many times the total dividend could be paid out of the company's profit after tax and interest. This can give an indication of the "quality" of the dividend cover and how likely it is that the level of dividends being paid can be maintained in future years.

Dividend cover is calculated by:

$$\frac{\text{Profit after tax and interest}}{\text{Dividend paid}}$$

Example

Sleepers plc, a manufacturer of beds, has paid a total dividend of $112 500 to holders of ordinary shares. The profit for the year after tax and interest was $450 000.

$$\text{Dividend cover} = \frac{\text{Profit after tax and interest}}{\text{Dividend paid}} = \frac{450\,000}{112\,500}$$
$$= 4 \text{ times}$$

Progress questions

A company pays a total dividend of $225 000 and has 600 000 ordinary shares. The current market price of the company's shares is $4.20.

10 Calculate the dividend yield for the business.

11 Explain how a potential shareholder might judge whether or not this is a satisfactory return.

Progress question

Yakuba is a public limited company and has a profit after tax and interest of $532 000 and a total dividend paid to holders of ordinary shares of $152 000.

12 Calculate the dividend cover for Yakuba.

Price/earnings ratio

The price/earnings ratio shows the relationship between the earnings per share and the current market price. The higher the ratio, the higher the confidence of shareholders is likely to be. Although, as with all judgments about share ownership, this ratio will be considered along with other financial information.

The price/earnings ratio is calculated by:

$$\frac{\text{Current market price per share}}{\text{Earnings per share}}$$

The earnings per share is calculated by:

$$\frac{\text{Profit after tax}}{\text{Number of ordinary shares}}$$

Progress question

Ribery, a public limited company, has a profit after tax for the current year of $520 000 and has 800 000 issued ordinary shares of $1 each. The current market price of ordinary shares in Ribery is $7.80.

13 Calculate the price/earnings ratio for Ribery.

Extreme Heat plc has a profit after tax for the current year of $450 000 and has 500 000 issued ordinary shares. The current market price of the ordinary shares is $6.30.

The earnings per share is: $\frac{450\,000}{500\,000} = \$0.90$

Therefore the price earnings ratios is: $\frac{\$6.30}{\$0.90} = 7$ times

This indicates that the current market price is 7 times greater than the earnings per share.

The accuracy and usefulness of all of the investor ratios can be influenced by the way in which the profit for the business has been calculated. Any changes in accounting procedures can change the outcome of the calculation of any of the investor ratios. For example, if a business changed the way in which it calculated the depreciation on its non-current assets, this would change the declared profit for the year. Any change to the calculation of profit would automatically increase or decrease the result of any of the investor ratios.

The market price of ordinary shares, in many countries, can be subject to sudden and large changes. This can be as a reaction to changes in the world economy rather than to internal issues within the business. For example, the uncertainty about some of the countries within the Eurozone in Europe caused shares prices in several countries to fall following the global financial crisis which began in 2008. The businesses whose share price fell had not taken any action that would justify the fall in the value of their ordinary shares. The fall in market price was due solely to a lack of confidence in the economies as a whole rather than in a particular company. This type of change will also affect the outcome of any calculation of investors' ratios.

Figure 5.8.2 Public unrest following a financial crisis ▲

Link

See also AS Level Chapter 5.4 Accounting fundamentals where the income statement and profitability ratios are discussed.

Strategies that businesses might adopt to improve ratio results

Improve profitability

Companies must strive to satisfy their shareholders because dissatisfied shareholders will be likely to sell their shares. A large sell-off of shares can reduce the market price and can then leave the company more vulnerable to a take over by another business.

Strategies to improve investor ratios will inevitably be linked to the profitability of the company.

The declared dividend to be awarded to shareholders will be influenced by the level of profitability of the business together with the aims and objectives of the business. For example, if the directors of a company want to follow a programme of growth requiring substantial financial investment then it is likely that lower dividends will be given to shareholders to allow more money to be available for the growth plans.

Delay expenditure

If a company wanted to improve the investor ratios, then a decision might be made to delay any large expenditure so that more profit can be assigned to be used as dividends to shareholders.

Increase general confidence in the company

Some ratios such as the price/earnings ratio can be affected by the level of confidence in the stock market in a country as mentioned above. Confidence in a particular company can be affected by a general optimism in the financial market. This is outside the direct control of the company itself. Changes in confidence levels can also be caused by actions taken by the company itself. The impact on the market price of the shares and therefore on investor ratios depends on whether or not investors feel that actions taken by a company will result in an increase in future profitability. In 2014 Barclays plc announced that it was to close much of the investment section of the bank and that approximately 19 000 jobs would be shed over the following few years. The share price for Barclays rose following this news. This would indicate that investors believed that the changes would result in a future increase in profits and therefore returns to investors.

In May 2014 Mondalez International (formerly Kraft Foods Inc.) announced a restructuring of the business involving the divesting of the coffee section of the business. Immediately after the announcement there was a limited rise in the market price of shares which might have indicated that investors were unsure about the longer-term impact of the changes but that there was at least some optimism about future profitability.

Increase/improve marketing of the company

By raising the profile of a company, its sales and hopefully its profitability can be increased.

All of the above factors will impact on either the market price of shares and/or the profitability of a company, both of which are integral to the calculation of investor ratios.

Comparison of ratio results between businesses

Link

See also AS Level Chapter 1.5 Stakeholders in a business and A Level Chapter 1.6a External influences on business activity: economic constraints and enablers.

Many stakeholder groups will compare the results of ratio calculations. Managers and owners (including shareholders) of a business would compare the results to those of previous years. They would hope that the current year's results are an improvement on previous years. If not, this might be explained by factors outside the control of the business such as a national or global recession.

If the worsened results are not the cause of an external factor then the managers must investigate the factors inside the business that are responsible for the deterioration. For example, if the return on capital employed is lower than in previous years is this due to a fall in demand or to an increase in overheads? The cause must also be assessed in terms of: is this indicating a trend or is it an event that is unlikely to occur again? The answer to this question will determine what, if any, action should be taken.

Existing and potential investors will also make comparisons over a few years as well as between businesses. They will be looking to identify where they might get the highest possible return on any money invested.

However, when judging the ratios of different businesses, stakeholders need to be aware of the differences that occur between businesses that are in different industries. For example, it should not be surprising if the ratios of a retail business are very different to those of a business in the manufacturing or primary industry sector.

Limitations of accounting ratios

All of the ratios explained in this chapter can be used to assess any changes in the performance of a company over a period of years. They can also be used to compare the performance of one company with another. However, any comparisons must be done with caution.

Difficulties with comparisons can arise due to the following:

- Different accounting techniques might have been applied when producing the financial statements for earlier years
- Different companies might be using different methods to calculate items such as depreciation
- Comparisons with companies in a different industry are unlikely to be of value
- Comparing the ratios of businesses of different sizes can be misleading
- Ratios are calculated based on published financial information and a company might have adjusted its financial statements to present a particular financial condition to any stakeholders
- Ratios and the financial statements from which they are derived are quantitative and therefore do not reflect any non-quantitative aspects of the business.

Progress questions

14 Explain two possible limitations of comparing the investor ratios of two businesses.

15 Explain why potential shareholders might want to know the dividend cover of a company.

Considering this last point in a little more detail, does the business act in an ethical manner at all times? Does the business source all of its raw materials from sustainable sources? Does the business always consider the consequences of its actions on the local community? Issues such as these would be considered by a socially responsible business, but this would not be reflected in any financial ratios. However, there is a possibility that because a business is seen by all stakeholders to be conducting business activities in a socially responsible manner, customers would be attracted to the business and therefore this could result in favourable financial statements.

Exam-style questions

1 Elliott Mining is a public limited company and the following information is for the year 2014.

Ordinary shares of $1 each	$135m
Market price of shares	$4.00 each
Dividend per share	$0.43
Profit before tax and interest	$24.3m
Non-current liabilities	
(7% long-term bank loan)	$12m

a Calculate the dividend yield for 2014. [3 marks]

b Calculate the return on capital employed for 2014. [3 marks]

c Calculate the gearing ratio for 2014. [3 marks]

d Advise the managers of Elliott Mining whether they should consider financing further expansion by increasing their long-term loans or by issuing more shares. [16 marks]

2 The following information is given for Dansell, a public limited company, for 2014.

	2014	2013
Ordinary shares of $1 each	$800m	$1000m
Total dividends paid	$30m	$43.75m
Dividend per share	$0.375	$0.4375
Retained earnings	$34m	$44m
Market price of share	$6.00	$0.25

a Calculate the dividend yield for Dansell plc for 2013. [3 marks]

b It has been proposed that the dividend per share for 2015 be reduced to $0.35 per share. Discuss the possible effect this might have on the shareholders of Dansell plc. [8 marks]

c Dansell plc intends to expand its production facilities and would require additional finance of $150 million. Assess the potential sources of finance that the business might use to finance this project. [12 marks]

Key concepts

- **Change** can be explored through the impact of change on financial statements.
- **Management** can be explored through the concept of management accounting.
- **Strategy** can be explored through the use of accounts in making strategic decisions.

Progress check

You should now be able to:

- calculate and comment on the importance of the return on capital employed, inventory turnover, days' sales in receivables and the gearing ratio of a given business
- calculate and assess the significance of investor ratios, i.e. dividend yield, dividend cover and price/earnings ratio
- discuss how each of these ratios might be used and the reasons for the results of any calculations
- discuss the value and limitations of comparing ratios between businesses
- discuss the limitations of using accounting ratios in given situations
- discuss ways in which businesses might improve ratio results.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **A** the need for investment appraisal
- **A** the significance of risk in investment decisions
- **A** the meaning, calculation and interpretation of payback and average accounting rate of return (ARR)
- **A** the meaning, calculation and interpretation of discounted payback and net present value (NPV)
- **A** the meaning and interpretation (but not the calculation) of internal rate of return (IRR)
- **A** qualitative factors that might influence an investment decision in a given situation
- **A** comparison of the investment appraisal methods, including their limitations

5.9 Investment appraisal

The concept of investment appraisal

Case Study

Ryan Restaurants (RR)

RR is a successful chain of restaurants. Growth remains the key objective for the business. RR wants to expand. RR has identified three options:

- Open a chain of restaurants in another country
- Takeover an existing restaurant business in the other country
- Open more businesses in RR's own country.

RR can only choose one of the options.

1. Why is it important that RR makes the right decision?
2. What are the key factors that are likely to affect the decision?
3. Should RR consider a fourth option – do nothing?

The need for investment appraisal

The idea of an investment is to spend money now with the aim of getting a return in the future. In the business sense it usually means capital expenditure – spending money on capital goods such as equipment, vehicles, new buildings, IT systems – but it can include other types of non-current spending such as on a marketing campaign.

The basic question that needs answering in an investment situation is: "Is it worth spending the money now, will I get a large enough return in the future?" If the answer is "No" then the money could probably be put to better use elsewhere. If the answer is "Yes" then from a financial point of view the investment is worthwhile, but there will be a range of other factors to be examined.

Investment appraisal is using a set of tools to help make investment decisions. These tools are very important to businesses as often the decisions are major strategic decisions concerning issues such as new types of production lines, new factories, different locations and possibly takeovers. Often large amounts of finance are involved.

One factor that will need to be considered is risk. The cost of the investment should be known with some degree of confidence. However, the return will not happen until the future. In some instances this may be a long way into the future. For example, a new power station or refinery could last for 50 years; a new building even longer. It is difficult to be confident about what could happen next year, let alone in 2050! Decision-makers need to be constantly aware of the role of uncertainty and risk in an investment decision. Even with the very best planning and decision-making there will many factors beyond the control of the business influencing the success or otherwise of an investment.

Key terms

Investment: the process of spending money now with the aim of getting a return in the future that is larger than the original spending. In the business sense it usually means spending money on a major project.

Investment appraisal: a range of techniques used to help make business investment decisions.

Risk: the chance the events will not turn out as planned. Risk may involve uncertainty about potential gains or losses.

Figure 5.9.1 It is difficult to make predictions about the future, and more difficult the further into the future you try to predict ▲

Key term

Net cash flow forecast: a forecast relating to an investment project that shows, for each time period, cash inflows, cash outflows and the difference between the two.

Getting it right

Cash flow in this context refers to the project rather than the business as a whole. The project is "ring-fenced" – that is, it is considered in isolation from other cash inflows/outflow. It is useful to distinguish cash flow in this context from other cash flows by calling it "net cash flow forecast".

Link

See AS Level Chapter 5.5 Forecasting cash flows and managing working capital for more on cash flow forecasts.

Progress questions

1 What distinguishes an investment from other sorts of spending?
2 Why are investment decisions subject to risk?

Forecasting cash flows

In order to see whether spending money now brings a better return in the future we need to examine future returns. This means we have to forecast:

- Future cash inflows
- Future cash outflows.

So, for example, if we spend $20 000 on a new piece of machinery we need to know what contribution it is going to make to the business's profits by looking at the value of the production, the running costs and maintenance costs in order to compare these with the initial capital costs.

This means producing a cash flow forecast *for the project*. This is distinguishable from the cash flow forecasts we have met before (see Chapter 5.5) which are for the business as a whole. It is usual to combine cash inflows for the project with cash outflows and to call the result the "net cash flow forecast".

To illustrate this idea consider a piece of machinery that costs $600. Each year it is forecast to earn the business $300 and cost $100 to operate and maintain. Suppose the machine has a useful life of five years after which it is sold for scrap for $50, the net cash flow can be calculated as shown in Table 5.9.1.

Table 5.9.1 Forecast net cash flow ($) ▼

Year	Forecast cash outflow	Forecast cash inflow	Net cash flow forecast
Initial investment	600		−600
1	100	300	200
2	100	300	200
3	100	300	200
4	100	300	200
5	100	350	250

This net cash flow forecast then forms the basis for the investment appraisal analysis.

However, it is important to remember that none of the figures in Table 5.9.1 can be predicted with certainty – indeed the further into the future they go, the greater the degree of uncertainty.

Progress question

3 What distinguishes a net cash flow forecast from cash flow forecasts?

The significance of risk in investment decisions

Any investment, by its nature, must involve risk. It involves spending money now for a return in the future, and the future will never be completely predictable.

Taking the elements of an investment in a typical project:

- The original investment: in many instances a business will only be able to estimate the cost of the investment. So, for example, the investment might involve building a new factory. With major projects like this, things seldom go according to plan. Projects take longer than planned, costs of materials etc. change, there may have to be a major change in the plan due to some difficulty that is discovered. An example could be that when the builders are digging the foundations for the new factory they discover some important archaeological remains. They would have to stop their building work while the archaeologists do a major excavation of the site. Another example is weather delays that increase the costs.
- Future costs in the cash flow (outflows) are higher than expected. The future costs are likely to be operating costs, wages, maintenance and raw materials. Any one of these could turn out to be higher than predicted (or, less likely, lower).
- Future incomes from the project (inflows) could be less than expected. The business could have been optimistic in predicting future demand or future prices. Fashions might change or competitors might prove to be more effective than anticipated.

In each of these situations, there is a chance that the investment is not as good as it originally seemed.

Basic methods of investment appraisal

Payback

Key term

Payback: the length of time it will take, in terms of net cash flows, to pay back the capital cost of an investment.

The simplest form of investment appraisal is the concept of payback.

This technique examines the question: How long does it take to pay back the original investment?

Looking at Table 5.9.1 above, the business wants to find out how long it takes to earn the $600 that the machine cost. It is forecast to earn a net $200 a year for the first year. After three years it has earned the $600 needed. **So the payback is three years.**

In our example, the payback finished as a convenient whole number of years. Often that does not happen. Suppose, for example, the initial cost of the investment in Table 5.9.1 was $650 rather than $600. After three years the project earns a net $600 and after four years it earns a net $800. So the project will earn the necessary $650 sometime during the fourth year.

But when precisely? We cannot say for certain but we can estimate. At the beginning of the fourth year it has earned $600 so it needs to earn another $50. In the fourth year it earns a net $200. So assuming it earns constantly through the year it will have earned $50 a quarter of the way through the year, i.e. after three months.

So our estimate of payback becomes three years and three months.

Although very simple in concept, this technique is useful:

- If the business has several feasible projects to choose from, this technique can easily be used to reduce the shortlist – long payback projects can be eliminated early on.
- The technique lends itself to "What if?" analysis – e.g. how much would the payback change if the inflows were overestimated by 10 per cent? This helps clarify thinking about the risks involved.
- If there is a long payback period the success of the project is subject to a great deal of uncertainty. Risk averse managers and businesses may choose to reject the project on the grounds of the high level of uncertainty.
- If there is a short payback period there can be more confidence in the project as the risk is less.
- If the project is paid for using a loan, it gives the lender an idea how quickly the loan could be repaid.

The main strength of this technique is its simplicity. This makes it easy to use, easy to understand by managers and potential investors, and it fits in well with trying to achieve short-term objectives.

On the other hand it takes no account of the overall profitability of the project. So, for example, if we had a similar project to that in Table 5.9.1, but the only difference was it lasted ten years not five years, both projects would give a payback of three years. Clearly, however, the ten-year project would generate more profits for the business over its life.

Of greatest concern is the fact that the technique takes no account of cash flows after the payback is forecast to have been achieved. For this reason payback is normally used in conjunction with other investment appraisal methods.

Link

See AS Level Chapter 1.1 Enterprise for more on opportunity cost.

Accounting rate of return (ARR)

Accounting rate of return (ARR) is a technique that does take account of cash flows throughout the life of a project. In some textbooks ARR is known as "average rate of return".

Key term

Accounting rate of return (ARR): measures the average annual profit of an investment as a percentage of the initial investment. It can be compared with prevailing interest rates.

The idea behind ARR is that of opportunity cost. If the investment was not made in a capital project it would probably be put in a bank to earn interest. The ARR calculation produces a rate of return that can be compared with the prevailing interest rate. This provides a useful comparison for decision-making.

The bank interest rate tells the saver what return, *per year*, expressed as a percentage, the saver will get per $100 invested. So an interest rate of 7 per cent says that for each $100 saved, the interest will be $7 per year.

The same ideas are applied to the investment project.

Using the example in Table 5.9.1, the amount invested is $600. Over the five-year life of the project the business anticipates receiving the net amount of $450 (−600 + 200 + 200 + 200 + 200 + 250):

This averages $\frac{\$450}{5} = \$90$ per year.

So the business has earned a net £90 per year on average for an investment of $600. So the return in a year *per $100 invested* is $90/6 = $15.

The ARR is the annual average net return per $100 invested, so in this instance is 15 per cent. This is very high and, if the forecasts are realistic, is much better, in most countries, than the interest on the original $600 if it were saved in the bank.

ARR can be calculated using a formula:

$$\text{ARR} = \frac{\text{Average annual net cash flow} \times 100 \text{ and is expressed as "\%"}}{\text{Original investment}}$$

Often businesses have a predetermined criterion rate of return for evaluating projects. Any project falling below this criterion rate will be rejected. For practical purposes the criterion rate is usually chosen as the prevailing interest rate for business borrowing as this is a useful measure of opportunity cost. Sometimes the criterion rate is chosen at a convenient rate, e.g. 10 per cent. Any project falling below the criterion rate may be rejected as not achieving sufficient return.

ARR has strengths and weaknesses.

Table 5.9.2 Strengths and weaknesses of ARR ▼

Strengths	Weaknesses
• The concept of interest rates is familiar to most people so that the comparison between ARR and interest rates is easy to understand. • It uses all the cash flows over the life of the project – unlike payback. • It is easy to compare with a criterion rate of return. • It is easy to compare projects.	• There is more uncertainty with the result than for payback because all cash flows are used, and the further into the future they are the greater the uncertainty. • The calculation takes no account of the timing of net cash inflows. A project that earns well at the beginning but not at the end could have the same ARR as one that builds up slowly over its life. Intuitively the one that earns earliest will be preferred – and will have a quicker payback. • It takes no account of "the time value of money" – see below. This is a major weakness.

The greatest weakness of ARR is that it assumes that cash flows in the future would have the same value no matter when they occur.

Getting it right

A common mistake in calculating ARR is to forget to deduct the original cost of the investment when calculating the average net cash flow for the top line of the formula.

Key term

Criterion rate: a predetermined rate of return that a business needs projects to exceed if they are to be accepted.

Progress questions

4 Give one disadvantage of using payback as a method of investment appraisal.
5 Give one advantage of using ARR.
6 A business plans to borrow for an investment. Why would the bank be interested in the project payback?
7 Calculate the payback and ARR for the project in Table 5.9.1 if the initial investment is $700.

Discounted cash flow methods

Discounting

Key term

Discounting: the process of recognising that money in the future has less value than the same amount today.

To overcome the major weakness of ARR we will need to consider discounting.

If you were asked the question: "I have $100 dollars to give you. Would you like it now or this time next year?" you would say, without doubt, "I'd like it now." Why? The reasons are:

- **The time preference for money** (and other personal possessions): As human beings we prefer things now rather than waiting for them. Things now give us greater perceived value.
- **The opportunity cost**: If you were given the $100 now, you could put it in the bank and earn interest over the year, so you would have more than $100 in a year's time.
- **Inflation**: The impact of inflation is to increase prices of products and services. The $100 will buy more today than the $100 will in 12 months' time. However, most cash flow forecasts are constructed in "real" rather than "money" terms, so inflation is not usually a factor to be considered.
- **Risk**: The further we go into the future the less certain we are.

This means that to compare future cash flows (money in the future) with an investment now, the money values in the future have to be converted into what they are worth to us today.

This can be illustrated by just using the one factor, the opportunity cost of an investment decision.

Let us suppose you want to invest $100 in a friend's business. The foregone opportunity might be:

- The opportunity to earn interest on it if you saved it
- The return from a "safe" investment in, say a large, stable business
- The return from investing in government securities.

The expected returns from these are all likely to be at least the prevailing rate of interest. So if, for example, the interest rate is 5 per cent then the minimum return you would expect from this investment would be $105 after the first year. If your friend's

business could earn you more than $5 over the year you would prefer, provided the risk was low, to invest it in your friend's business rather than save it. If your friend's business earned less than $5 you would prefer to save your money. The other way of looking at this is to say that if the business gives you $105 in a years' time it has the same value as $100 today. This process of reducing the future value of money to today's value is called discounting the future. In this case we have discounted the future by 5 per cent.

So the question we asked, "Would you prefer $100 now or $100 in a year's time?" can be answered by discounting $100 in a year's time to $100/1.05 = $95.23. Therefore, $100 in 12 months' time is worth the equivalent of $95.23 today.

If we now look at $100 in two years' time, this will be discounted to $100/1.05 = $95.23 in one year's time. Which, in turn, will then be worth $95.23/1.05 = $86.58 today. This is the same as $100/(1.05)^2$.

Key terms

Discount rate: the percentage rate at which each future year is discounted.

Present value: the value today of a given amount of money in the future.

What this means is that if you were asked, "Would you like $86.58 now or $100 in two years' time?" your logical reply would be, "I don't mind." However, at that stage the acquisitive side of your nature would probably start working and you would take the $86.58. But what if you were offered $70 or $100 in two years' time? Would you take the risk of waiting two years? That is where your attitude to risk comes in!

In our example 5 per cent is called the discount rate. The value of $86.58 is called the present value of $100 in two years' time.

Figure 5.9.2 The opportunity cost of an investment decision will always include the opportunity to earn interest from saving the money instead ▶

Discounted payback

Key term

Discounted payback: the discounted payback period is the amount of time that it takes to cover the cost of a project, by adding positive discounted cash flow coming from the profits of the project. This contrasts with payback, which uses unadjusted net cash flows.

We saw, earlier, the simplicity of payback as an investment appraisal technique. Discounted payback takes that simple idea one stage further by discounting the net cash flows before calculating how long the original investment will take to pay back. The discounted payback period is the amount of time that it takes to cover the cost of a project, by adding positive discounted cash flow coming from the profits of the project.

Using the data from above, and assuming that we discount the future at 10 per cent, the results are as shown in Table 5.9.3.

Table 5.9.3 Comparing payback with discounted payback ▼

	Net cash flow ($)	Discount factor at 10%	Net cash flow ($) discounted at 10% *
Original investment	600	1.00	600
End year 1	200	0.91	182
End year 2	200	0.82	164
End year 3	200	0.75	150
End year 4	200	0.68	136
End year 5	250	0.62	155

* Net cash flow discounted at 10% = Net cash flow × Relevant discount factor
Note: the discount factors have been rounded.

Getting it right

In our example it is easy to make the mistake of saying that the discounted payback is after four years. It is not, it is *during* the fourth year, i.e. after three years nine months.

From the payback method, the $600 is paid back after three years using net cash flow.

However, using discounted net cash flow, after three years the discounted net cash inflows add up to $496 ($182 + $164 + $150).

- A further $104 in net cash inflows is needed to bring the total back to the original figure of $600.
- In the fourth year there is an additional nine months (104/136 × 12 months).
- So discounted payback is three years and nine months.

Discounted payback is less well known than other investment appraisal methods. It benefits from the fact that it does take account of the time preference for money, unlike simple payback, but it still suffers from the disadvantage that it takes no account of cash flows beyond the payback period. It is also less intuitive than payback.

Net present value (NPV)

Key term

Net present value (NPV): the value today of future cash inflows and outflows net of the cost of the original investment.

NPV takes discounted payback a stage further, by considering all the cash flows over the life of a project and then applying discount factors.

If we compare the discounted net cash inflows for a project with the original investment we will get a measure of the project's worth *taking account of the time value of money*. The total of the present value of the net cash flows less the cost of the investment (in this case $600) is known as the net present value (NPV) of the project.

In our example from above this is:

($)
182
+164
+150
+136
+155
−600
= 187

Getting it right

In a question you will be given the discount factors to use.

The $600 cost of the investment is not discounted because it is expenditure *now*.

The NPV of the project is $187, positive.

A positive NPV tells us that the proposed investment gives a higher return than the next best alternative and is worth considering further.

Therefore, in our example, the NPV tells us that the value to us today of the project is positive and so is worth undertaking even making allowances for the time preference of money, risk and opportunity cost.

The net present value (NPV) also enables quick comparisons between different projects – **the larger the NPV, the better**.

In some ways NPV has benefits over Payback and ARR. NPV does take account of the time value of money and the timing of cash flows. It takes some account of factors such as inflation and risk. It also has opportunity cost built in. Many businesses will use the predetermined discount rate – known as the criterion rate – against which all projects are analysed. It is often related to the prevailing interest rate or chosen as 10 per cent for convenience.

One criticism of NPV is that the result is highly dependent on the discount rate that is chosen. As we have seen this will be dependent on several factors (risk, inflation, time preference, opportunity cost) which are all difficult to quantify. In addition NPV is not an intuitive method to people who are not comfortable with mathematics.

Progress question

8 Recalculate the NPV of our project above if the discount rate is 5 per cent rather than 10 per cent. What does this tell you?

The technique does allow "What if?" analysis to be undertaken, particularly examining the impact of different discount rates, to some extent reducing the concerns arising from the difficulties of choosing the rate in the first place.

Key term

Internal rate of return (IRR): the discount rate that gives a net present value of zero for a particular project.

Internal Rate of Return (IRR)

As we have seen, NPV is highly dependent on the discount rate that is chosen. One way of avoiding having to choose a discount rate is to use the technique called internal rate of return (IRR).

This techniques relies on the fact that if the NPV = 0 then the investor will be indifferent (they will not mind) as to whether they undertake the investment or not. If the NPV is above zero the project is worth doing, below zero the project is not worth doing.

Internal Rate of Return (IRR) takes this idea further by asking the question: "What would the discount rate have to be to produce an NPV = 0?"

The investor would then have to resolve the question as to whether this rate of return is acceptable or not, probably an easier task than deciding on a discount rate.

Taking the example from Table 5.9.1 the net present value for the project at different discount rates is as shown in Table 5.9.4.

Table 5.9.4 Present value of project at different discount rates ▼

Discount rate	10%	20%	25%	30%
Net present value ($)	187	18	−46	−99

So the NPV = 0 at a discount rate between 20 per cent and 25 per cent. A more accurate result can found by trying discount rates around 21–22 per cent or drawing a graph (Figure 5.9.3).

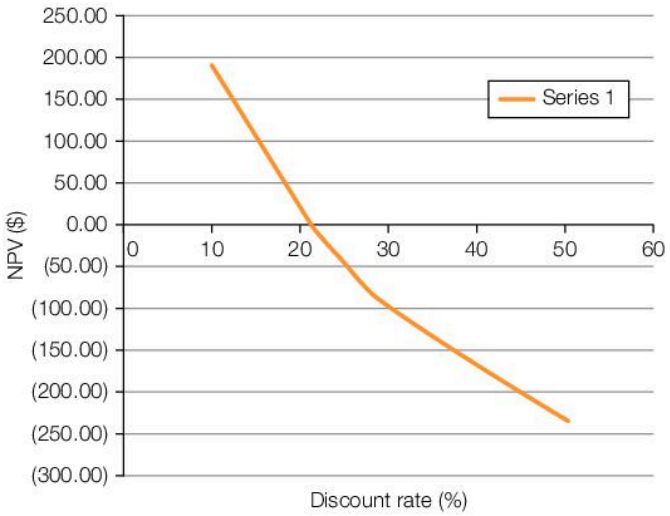


Figure 5.9.3 NPV plotted against discount rate ▲

This shows the IRR to be approximately 22 per cent, i.e. the discount rate that gives NPV = 0.

The business now has to decide whether this an acceptable rate, based on factors such as real interest rates (i.e. interest rates adjusted for inflation) and criterion rates.

IRR has all the benefits of NPV as a decision-making tool, but its greatest benefit is that it avoids the need to decide on a discount rate.

The only significant disadvantage is that the concept is challenging to people with poor mathematical skills. However, with the use of spreadsheets or other ICT applications the user can concentrate on the results rather than the calculation.

Getting it right

You will not be required to calculate the IRR but you may have to interpret the results of the calculations.

A simple way of getting an estimate of IRR is to take the reciprocal of the payback period in years and multiply it by 100. In our example the payback was approximately four years and so the estimate of IRR $1/4 \times 100 = 25\%$.

Progress questions

9 Give three reasons why you should discount the future when carrying out an investment appraisal.

10 Why is the NPV for a project always smaller than the undiscounted net cash flow for a project?

11 Why is it difficult to choose a discount rate?

12 Distinguish between discounted payback and payback.

Qualitative factors in investment appraisal

Used effectively, the investment appraisal techniques should help investment decision-making. Initial use of the techniques will help to eliminate less attractive projects and make comparisons between alternative projects. The techniques are all quantitative, in other words they are based on numbers that can be calculated or estimated. So "What if?" variations in assumptions can be explored through further calculations, strengthening the messages that come out of the analysis.

However, there are other issues, which cannot necessarily be measured or estimated in numerical terms. These are known as qualitative factors. These also need to be considered by the decision-makers.

What is the business's attitude to risk?

The attitude of the owner(s) is certainly important here, but so too are the attitudes of the managers and other employees. It is even possible that the customers might have a view – customers might choose a particular bank, for example, because it is "safe". They may move elsewhere if it starts taking large risks. Some people and businesses are "risk takers", other are "risk averse".

What is the impact of the project on various stakeholders?

If a major investment has a big impact on the local community – perhaps through environmental considerations – a business might decide to reject an investment even if the investment appraisal analysis suggests otherwise. The lost public goodwill may do more damage to the business than the financial benefits of the project. The reaction of the workforce will be critical to the project's success.

What about factors outside the control of the business?

Business decisions cannot be made based only on the factors under the control of the business. The success of an investment can depend on the state of the economy, the developments within an industry, the behaviour of competitors, and the demands of customers.

Does the business have access to suitable finance?

Although a project may look good from the calculations, unless the business can afford it, or get access to sufficient finance, it is not a realistic option. It is particularly important to consider the legal structure of the business to assess the likely finance available. It is also important to consider the attitude of those stakeholders likely to finance a project.

Does the proposed project fit in well with the business's objectives and strategies?

For example, a new factory may mean a reduction in marketing activity, jeopardising a growth target.

Comparison of investment appraisal methods including their limitations

For any particular project it would be unwise to rely on any one investment appraisal technique. Indeed it would be unwise to rely on investment appraisal alone – it is most important to consider the qualitative factors surrounding the decision.

What is important is to look at the whole of the evidence before making a judgment.

However, there are circumstances in which more weight may be given to one technique than another:

- If the business is relying on a loan for the investment, the lenders may be very interested in payback.
- If the project has a long life, discounting the future may be essential.
- If the forecasts cannot be made with confidence, qualitative factors may become more important.
- If economic conditions are uncertain, especially interest rates and inflation, IRR may be preferable to NPV since a discount rate will not need to be chosen. Simpler techniques such as payback ignore the opportunity cost of the investment altogether.
- A small business, with limited skills, may want techniques that are easy to use and simple to understand.
- If the decision involves only one project (rather than a comparison between two or more projects) a greater degree of confidence may be required in the technique.
- Using a technique for shortlisting projects may allow a different approach than that needed in the final decision.

Activity

Using the information in this chapter, draw a table showing the strengths and limitations of each of the investment appraisal techniques.

Progress questions

13 If a project is high risk, why might an investor want a quick payback?
14 Why is payback useful for a project involving a loan?
15 Give two reasons why the agreement of the employees might be important to the success of a project.
16 Give one disadvantage of IRR as a method of investment appraisal.

Exam-style questions

Ryan Restaurants

Ryan Restaurants (RR) is investigating two possible countries for a new chain of restaurants, X and Y.

RR has prepared estimates for investment in country X. RR estimates the capital cost of the project to be $700,000. Cash inflows (not including capital cost) and discount factors are estimated to be as follows.

$000	Year 1	Year 2	Year 3	Year 4	Year 5
Expected cash inflows	500	500	600	800	900

Cash outflows are 60 per cent of cash inflows.

1 For this project, calculate:
- **a** average rate of return (ARR) [3 marks]
- **b** payback period [2 marks]
- **c** net present value (NPV) using the discount factors. [4 marks]

	Year 1	Year 2	Year 3	Year 4	Year 5
Discount factors	0.91	0.83	0.75	0.68	0.62

RR's investment appraisal has the following results for country Y:

ARR = 65%

Payback = 1 year 8 months

NPV = $2.8 million

Capital cost = $150,000

The following information is available for the two countries, X and Y.

Country X	Country Y
Growing economy	Not much growth last year
Good industrial relations	Poor industrial relations
Flexible labour laws	Rigid labour laws
Many competitors	Few competitors
High income per head	Average income per head

2 Using financial and non-financial information recommend whether RR should choose country X or country Y. Justify your decision. [20 marks]

3 Evaluate discounted payback as an investment appraisal technique. [10 marks]

Key concepts

- **Change** can be explored through considering the role of major projects in bringing about change and how changes to relevant factors can influence those decisions.
- **Management** will be involved in implementing decisions about major projects.
- **Strategy** relating to growth can influence decisions.

Progress check

You should now be able to.

- define investment appraisal and recognise the need for it
- discuss the significance of risk in an investment decision
- explain, calculate and interpret payback and ARR
- explain calculate and interpret discounted payback and NPV
- explain and interpret IRR
- discuss quantitative factors that might influence an investment decision
- evaluate investment appraisal methods and make recommendations based on them.

You should be able to relate these to a range of businesses in different situations.

6 Strategic management

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- **A** what is meant by corporate strategy, tactics and strategic management
- **A** the need for strategic management
- **A** how strategy determines organisational structure
- **A** how strategy determines competitive advantage

Key term

Strategic management: the analysis, decisions and actions an organisation undertakes in order to create and sustain competitive advantages.

6.1 What is strategic management?

Corporate strategy and strategic management

Businesses of all sizes operate in a market environment that is constantly changing. They are managed by individuals who have particular reasons for holding the positions they do. Their owners are looking for specific results. In order to achieve success businesses have to be prepared to have some idea of what they are trying to achieve. Strategic management tries to give a framework for success. It starts with setting objectives for the business and then deals with these three questions that will be considered in detail in A Level Chapters 6.2–6.4:

- **Where are we now?** The analysis of the current situation in terms of resources and the market environment including competition, economic factors and government policies.
- **Where do we want to be?** The choice between various options given the results of the analysis.
- **How are we going to get there?** The implementation of the chosen actions.

Components of strategic management

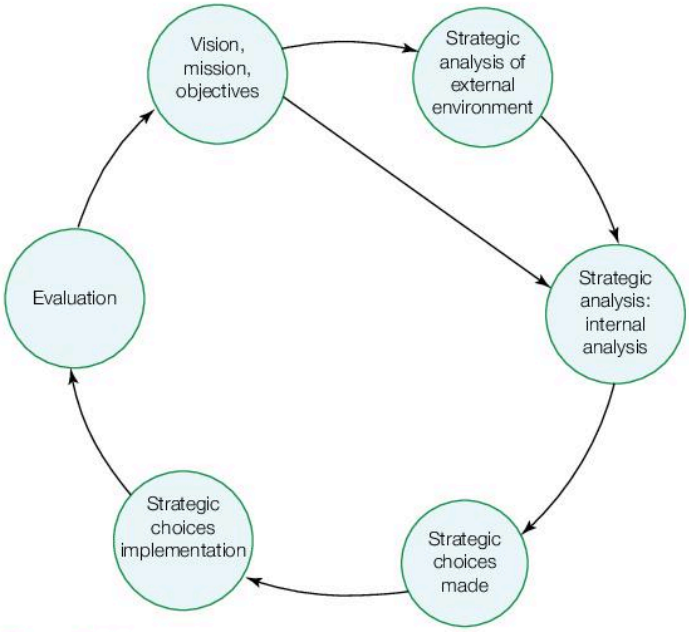


Figure 6.1.1 The components of strategic management ▲

Strategic management takes place at three different levels: the whole business (corporate), particular areas such as divisions (business) and functional areas (functional). A business has to make sure that these levels communicate with each other and that the strategies all integrate and work towards the corporate objective.

Key term

Corporate strategy: sets out the direction a business should take in order to achieve objectives.

Activities

1 Research three businesses and find out their vision and/or mission statements and examples of their objectives.
2 Compare these and discuss how the businesses might use them to act in different ways.

Getting it right

It is important when answering strategy questions to link possible strategies to objectives. Avoid confusing strategies with tactics.

Key term

Tactic: a short-term course of action for the day-to-day management of a business or for trying to meet part of an overall strategy.

Link

Tactics are covered in AS Level Chapter 1.4 Business objectives.

- Corporate strategy deals with the overall purpose and concerns of a business. It deals with issues like "Which markets should we be in?", "Should we outsource the whole of our distribution system?" and "How can we improve the way our production systems make us competitive?"
- **Business strategy** is the strategy for a particular part of a large business. This may be a strategic business unit like the paint division of a large chemical business. Decisions will focus on the role the particular part of the business plays within the strategic management programme.
- **Functional strategy** is strategy for a particular functional area such as marketing, production or human resource management (HRM). Decisions will focus on choice of products, production methods and meeting customers' needs.

Business and functional strategies have to fit within the framework of the overarching corporate strategy.

Strategic management thus integrates the key objectives and the plans for achieving these. It analyses the key strengths and weaknesses of a business, the opportunities and threats in the marketplace and takes into account the possible actions of competitors before setting out actions using available resources to achieve the objectives.

Strategic management and tactics

Strategic management sets out the direction a business should move to reach set objectives. A strategy is usually for the long term. Tactics are the short-term methods used to support the strategy and make sure it is successful. For instance an objective may be fast growth to be achieved by a strategy of entering information technology services with a tactic of matching the competition's prices. Strategies are usually very difficult and costly to change or implement; tactics may be changed much more easily and cheaply.

Case Study

Strategy and tactics – Arm and Hammer

Arm and Hammer was a very successful business making and selling baking and washing soda in the USA. By 1970 sales of these old-fashioned products were falling. Arm and Hammer had to produce a new strategy or the business would fail. The strategy was first to produce new reasons for buying the product and the tactic was to market baking soda as a chemical for making fridges smell sweet. This was partially successful but not enough to guarantee continued business, so Arm and Hammer extended its idea for diversification into all kinds of household chemical products. In order to do this the business had to thoroughly research the reasons for falling sales, the competition in the new markets, the customers' attitudes, the finance available and the expertise in the production department.

1 Explain what Arm and Hammer's strategy for survival was.
2 What tactics did Arm and Hammer use to implement the strategy?
3 What contributed to making this strategy successful?

Corporate strategy	Functional strategy	Product tactic	Marketing tactic
Diversify into household chemical products	Produce environmentally friendly products Market products to specified segments	Manufacture toothpaste, cat litter, detergent etc.	TV and magazine ads, retail promotions, distinctive logo

Case Study

Metro

Metro is a newspaper that is available in over 100 cities in 18 countries. It is distributed free on the street and in transport locations like rail and bus stations. Its content is specific to the country and city it is placed in. It receives its revenue from advertisements not sales. It is given out free to customers. It has general formulas to balance the ratio of articles, news and advertisement space. It makes choices about printing the paper itself and getting the printing outsourced. These are all strategic choices. The tactical choices it faces are what to charge advertisers, the number of pages, the places and methods of distribution (e.g. handing out or news-stands?) and which articles to print. *Metro* has been extremely successful.

1 Explain the difference between strategy and tactics for the functions of marketing, product, production and finance, using *Metro* as an example.

Figure 6.1.2 ▲

Link

AS Level Chapter 1.4 on Business objectives has more information on objectives, vision and mission statements and how these might be related.

Activity

Research appropriate media to find businesses that have a strategy with tactics. Use one of these examples to write a case study similar to Metro on this page.

Progress questions

1 Explain the difference between a strategy and a tactic.
2 Give one example of a corporate strategy and an appropriate tactic that might be linked to it.

The need for strategic management

Strategic management is a key tool for achieving success. It is extremely difficult for a business to survive if it does not set out the reasons it is in business, the situation it finds itself in, what resources it has and some idea of what it will be doing in the future. If it is failing to plan it is planning to fail. A business operating like that would be at the mercy of change and its competition. Most companies, charities and government institutions have a strategic plan that enables them to move into the future on a secure basis.

Link

AS Level Chapter 1.4 on Business objectives has more information on objectives, vision and mission statements and how these might be related.

Table 6.1.1 Importance of strategic management ▼

Stages of strategy	Results of carrying out stage			
• Vision, mission, objectives	• Defines reason for existence	• Enables measurement of progress	• Gives employees purpose	• Clearly sets out goals
• External market analysis	• Gives information on competitors' actions	• Gives information on legal, economic and political changes	• Gives information on customers	• Enables informed decisions
• Internal analysis	• Gives information on business strengths and weaknesses	• Gives information on resources available	• Pinpoints factors the business can control and change	• Enables informed decisions
• Strategic choice	• Generates possible actions	• Enables advantages and disadvantages of actions to be considered	• Relates actions to resources available	• Enables informed decisions
• Strategic implementation	• Enables planned implementation	• Enables plans to match market reality		• Enables planned actions
• Evaluation	• Provides measure of success	• Enables adjustments as environment changes	• Provides continuous feedback	• Enables better decision-making

Getting it right

Strategic management is the process of setting objectives, analysis, choice, implementation and review. It may involve using some tools or techniques such as SWOT analysis or Ansoff's Matrix. An answer to a question on strategic management must focus on the process. If the techniques are mentioned they must be placed in the framework of strategic management.

This process of strategic management enables a business to gather essential information on all the factors that will influence the progress and success of its business. This includes the external environment and the internal resources and problems. The attitudes and behaviour of stakeholders can also be included. This information will be critical in detecting market opportunities, avoiding threats, and choosing strategies to achieve objectives and meet customers' needs.

Deciding on a strategic management plan will ensure that business activities are co-ordinated and supported by everyone involved. Larger businesses will find it very difficult to function without such co-ordination and the motivation provided to employees could be invaluable. Market conditions change rapidly in the complex selling environments, and strategic management will enable rapid flexible responses to change as well as providing a rational system for decision-making. Strategic management is about planning for the future and setting a particular course or direction for a business. This means it will become more efficient and its employees will be less frustrated and more committed to the organisation.

However, strategic management is only effective if the people involved in carrying it out fully understand the process and techniques used. They must also have reliable information. In today's changing world it requires constant evaluation and updating to maintain its usefulness and this has implications for organisation structure and HRM.

Progress questions

3 Outline two reasons why a business might engage in strategic management.

4 Explain the benefits to each of these functional areas of carrying out strategic management:
- **a** Marketing
- **b** Human resource management
- **c** Production.

5 Outline the possible consequences to a business of not carrying out strategic management.

"Structure follows strategy" – Chandler's assertion

Alfred Chandler studied the growth of large businesses and how their strategies to achieve growth and expansion led to a change in their structure and organisation. He thought that management strategy is "the determination of the basic long-term goals and objectives of an enterprise, and the adoption of courses of action and the allocation of resources necessary for carrying out the goals", while structure is "the design of organisation through which the enterprise is administered". He considered that managers did not merely respond to changes but are active in devising new strategies and thus new structures. He felt that management strategy should be decided at the centre or the top and the decision communicated to managers lower down the business structure. Individual business units would then be free to decide their own tactics within the strategy.

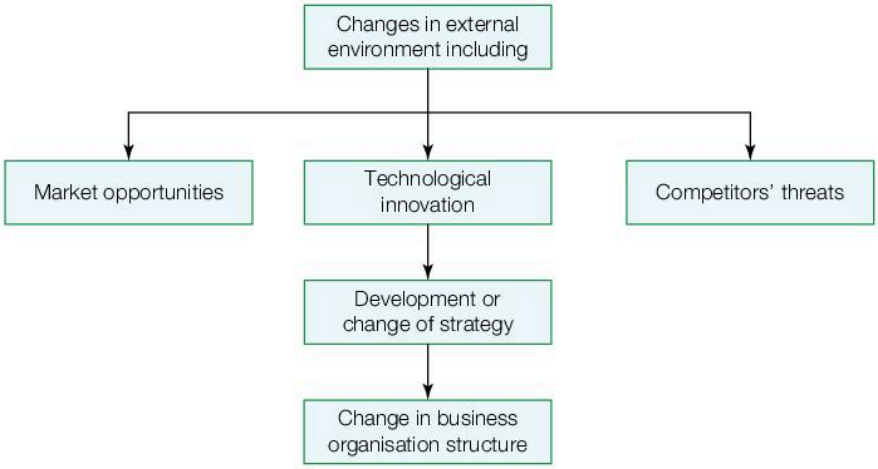


Figure 6.1.3 Chandler's model ▲

His studies showed that a selection of large US conglomerate companies had grown by diversifying into different product markets and in each case adopted a structure (the M form) in which semi-independent product or geographic business units were co-ordinated by a central headquarters that set strategy for the whole corporation. His belief that the strategic management decisions lead to the way a business was structured is still a fundamental part of business theory.

Case Study

The Virgin Group

The Virgin Group of businesses is a collection of over 100 private companies, operating in a variety of unrelated industries and markets. They all use the Virgin brand. Each one has the central Virgin Group as a major shareholder. The central Group encourages individuals and companies to research and enter new markets with new products and gives a large degree of flexibility and autonomy to them. The setting of specific objectives

for the whole group supports this overall strategy. These objectives are then translated for each division of the Group and in turn each company. The objectives will be different for each company and specific to its market and its situation. Each company has to maintain its commitment to the Virgin brand and has a large degree of control over how it does this. For instance, each company can have a different marketing strategy and a different way of structuring the roles of employees. Virgin stresses the commitment to the brand and the transformational leadership style, with managers setting an example, being innovative and encouraging employees to be the same.

1 Using the above as a starting point research the objectives, strategy and structure of the Virgin Group of companies.
2 To what extent does the Virgin Group confirm Chandler's assertion that "structure follows strategy"?

Business strategy and competitive advantage

Link

Globalisation and marketing is considered in detail in A Level Chapter 3.5 Globalisation and international marketing.

The markets in the world are becoming ever more competitive as globalisation continues. Businesses can now operate outside their starting country and the Internet has opened up opportunities for even small operations. Businesses selling in domestic markets also face increased competition from new start-ups and competition from abroad. It is increasingly realised that successful businesses generate wealth for the whole of a society and this has led to more interest in entrepreneurial, management and marketing skills. In this environment a business has to offer something unique in order to attract interest, customers and sales revenue.

There is no definitive single strategy that will bring success. Some businesses have specialised in one product or a single approach to selling. Others diversify and sell a range of products in a range of markets. Examples of different approaches are:

- Nike specialises in design and marketing, outsourcing its production and retailing
- Coco-Cola has focused on specialising in being a soft-drinks supplier
- Hitachi has diversified into producing a wide range of products in different markets.

Strategic management offers such a competitive advantage if carried out efficiently and accurately with the active involvement of employees. Lack of a strategy can mean a business is drifting, uncertain and unable to compete effectively as it will not know its markets, its strengths and weaknesses, nor will it be able to provide a focus for meeting changing customer needs.

Case Study

Unilever – case study in strategic management

Unilever, a large transnational corporation with a focus on food, home care and personal care products, has always operated in competitive markets with major rivals including Procter & Gamble. Since 2002 these rivals have been more successful in terms of introducing new products and in percentage increase in sales and profits per year. Unilever realised that a different approach was needed. Initial research led the business to focus on personal care product markets as a priority. It identified competition as a key difficulty in an economic context of rising raw-material costs, poor exchange rates and low economic growth in key markets. In 2009 Unilever produced The Compass – a document setting out a new strategy.

The vision and mission is to "develop new ways of doing business with the aim of doubling the size of the company while reducing our environmental impact" and inspire people to take small, everyday actions that can add up to a big difference for the world.

Objectives

Unilever has a range of objectives relating to sales, costs and profits. These include 50 contained within the Unilever Sustainable Living Plan. These include:

- We will help 1 billion people improve their health
- We will halve the environmental footprint of our products
- We will source 100 per cent of agricultural raw materials sustainably by 2020

The business has "put the Unilever Sustainable Living Plan at the heart of our business strategy".

Analysis

Unilever carried out detailed studies of the markets it operated in, the production and supply processes it uses and what customers thought of its brands. It identified an increasing unhappiness with multinationals only seeking profits and saw an opportunity for its unique commitment to sustainability to also act as a marketing tool.

Strategy

From this Unilever formulated a strategy focusing on building great brands that deliver superior performance so customers will prefer them to others. These brands are built on innovation from R&D and continuous market research to see exactly what customers desire.

Developing economies like Vietnam and Thailand were identified as areas with high market growth. Products would be varied, from "trading up" premium brands in more beauty markets, "reaching down" in developed countries to shoppers with less income and "reaching wide" through expansion into new markets (Africa, male grooming and e-commerce), sometimes facilitated by buying existing businesses – acquiring Alberto Culver made it easier to enter the large Brazil hair care market in 2010.

Consistent global marketing for each brand is tailored to individual countries – e.g. using small shops in India.

The strands of this strategy are underpinned by a commitment to growing sustainably and this key value appeals to consumers. Unilever was one of the first large multinationals to use sustainability and an "environmental approach" to business in a significant way. This gave it a head start over its competitors and a direct appeal to an increasing number of consumers. This head start over competitors has been consolidated and built into the brand image, increasing its appeal.

- Examples include working with retailers in Mexico to improve distribution, and the Shakti programme in India expanded direct distribution via very small businesses at village level.
- Production is increasingly sustainable; examples include the Indonsa factory in South Africa that will halve gas emissions, be water neutral and produce no landfill waste.

The strategy also streamlines the structure of Unilever, reducing 11 product categories to four and 22 geographical units to eight, with six focusing on developing economies where markets are growing faster.

HRM policy has become focused on training, leadership and developing a "performance culture" with employees working together for the values of the business.

Figure 6.1.4 Unilever headquarters in Mumbai, India ▲

Evaluation

Some targets have been met (100 per cent electricity from renewable sources in Europe), others partially.

Personal care products have become the largest category.

In 2013 sales revenue grew by 4.3 per cent, higher than any of its competitors.

All product categories show increased sales revenue in developing countries as increasing numbers of consumers become conscious of the need for sustainability.

For more detailed information and examples look at www.unilever.com.

1 How does the vision and mission of Unilever relate to its business methods? Illustrate with examples.
2 Explain why Unilever has made sustainability such a feature of its strategy.
3 Strategic planning involves the whole of a business. Show how this applies to Unilever.
4 Investigate www.pg.com. Identify the strategy Procter & Gamble is using. Compare this with Unilever to find similarities and differences.

Source: Partly based on information in annual report www.unilever.com

This next case study shows what can happen when there is no strategy.

Case Study

A Danish orchestra

Orchestral music is costly to produce. Many musicians have to be employed and in Denmark the money to pay them is difficult to find. Fewer people are interested in going to orchestral concerts and when they do they want to hear popular pieces, not experimental modern music. The change in recorded music to CDs and downloads has led to a fall in recorded music being sold. The orchestra found it was increasingly unable to find the money to go on playing. A major funder (Danish government), a new chief executive and the new principal conductor all agreed something had to be done.

However, nobody had responsibility for developing a strategy – the CEO ran the day-to-day business, the conductor ran the music, the orchestra played it, the funders supplied money and the artistic director decided on the programmes.

When they did talk about it there was no agreement as to the cause of the crisis. The artistic director wanted certain pieces played but had no control over ticket prices. The business managers complained that the product (the music played) was not suitable to attract audiences. The result was that no sustainable strategy was made and the orchestra struggled on from one artistic and financial crisis to another, with a high turnover of key employees and a reduced number of players.

1 Outline the problems in the market environment facing the orchestra.
2 What difference might a strategic approach have made to the success of this orchestra?

The Unilever case study indicates that developing a strategy may be extremely important for success in an increasingly competitive world. Unilever will face competition not only from other large transnationals in developing economies but also from domestic businesses that will have good local knowledge and consumer links. This next case study shows an entirely different approach to strategic planning.

Case Study

Semco – strategic management or not?

Semco is a large company based in Brazil but operating in other countries in South America and elsewhere through subsidiaries. It produces a range of products including minerals, foods, chemicals, steel and software services. Since being set up in 1953 there has been steady and sustained expansion. Ricardo Semler took over as a 21-year-old and introduced rapid changes. He sacked 60 per cent of the senior managers, stopped clocking in when employees started work and let employees choose when and how long they worked. There is no official structure or organisation chart, no goal or mission statement and no long-term budget. Supervision of employees is very limited. Employees decide when they take holidays and can choose how they are paid – wages, share options, commission and eight other ways. Employees decide what training they want to take and can have time away for this. Ricardo sees his role as

being disruptive and making people think. "Ask why" is a constant theme in the business. There are hardly any written plans. Every six months he asked employees to start again by justifying their functional area and their work. Executives were asked to resign and reapply for jobs, to be interviewed by other employees. The stress is on performance, not on working methods. New proposals can come from any employee and are fast tracked through a committee made up of employees from all business areas and types of work. The business often enters markets which involve complexity and that are difficult to enter but provide opportunities for profits. A major way Semco does this is by forming partnerships with suitable businesses, often overseas, for limited length projects or permanently. Semco has been described as a "framework for negotiated hierarchies", rather than a pyramid of command and control.

There are ten principles, including being "dependable and reliable", providing customers with "differentiated services" and "responsibility before profit" and offering "products and services at fair prices". The "Survival Manual" sets out expectations about working in Semco. Points it makes include: leaders are "situational", that is, a leader is someone who acts like a leader, not someone with a title. Jobs are rotated frequently and hours are flexible and decided by each person, but there are usually three to five people who act as strategic decision-makers. The way Semco operates arises from ideas generated from anybody in the company.

Indicators of the success of this approach for Semco are that since 2008 revenues have grown six times and the company is valued at about $9 bn. Its partnership that offers joint ventures, partnerships and advice on entering markets is one of the world's top two.

Semco seems to be unique in the way it has applied strategic management.

1 Outline the ways its method of strategic management is different from that of Unilever and most other businesses.
2 Assess the extent to which Semco really does have a strategic plan.
3 Examine three reasons why Semco has been so successful over a long period of time.

Progress questions

6 Explain the difference between corporate strategy and tactics.
7 Outline the key components of strategic management.
8 Analyse why strategic management is so important for business success.

Exam-style questions

The future of Jackson Limited

Jackson Limited has developed a new way of engineering brake components for cars and lorries. The business uses a new material and its own unique machine processes. Its products are not cheap and are bought by vehicle manufacturers that sell expensive products to higher-income consumers and businesses in its own country. Its workforce is motivated, skilled and well paid. Managers encourage employees to offer ideas and take responsibility. However, Jackson Limited lacks the finance and economies of scale to expand production for export. The chief executive officer is aware that competitors are developing similar products that will offer significant advantages in a competitive market. The directors have had a good offer from a large multinational corporation to buy the business, but none of them wish to sell at the current price offered. They are exploring the possibility of linking up with other producers to enable marketing in a number of different countries. Recently the small R&D team have been developing a range of materials that may be effectively used in cooking pots and boat hulls. Two of the directors are keen to continue with the business's brake products, focusing on its existing strengths. Others are not so sure.

1 Discuss how an understanding of strategic management might be of value to Jackson Limited as it faces an uncertain future. [8 marks]

Key concepts

- **Change** can be viewed from the perspective of strategies in a changing, competitive world.
- **Management** will need to understand and implement strategies.

Progress check

You should now be able to:

- apply your understanding of strategic management so that you can analyse the way particular businesses strategically manage and evaluate how effective their processes are
- make recommendations for strategic management for a given business in a particular situation.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- SWOT analysis
- PEST analysis
- using vision/mission/objectives
- Boston Matrix analysis
- Porter's Five Forces analysis
- core competency analysis

6.2 Strategic analysis

Strategic analysis is the second stage in management strategy, following setting a vision/mission statement and objectives. A possible alternative use of the strategic analysis techniques in this chapter is to use them to clarify and refine business objectives. Strategic analysis answers the question – where are we now?

Analysis is the process of considering:

- The internal resources a business may use
- The external environment and its influence – this includes market structure, the behaviour of the competition, legal and political factors
- The forces and factors acting on a business and its products which derive from the internal and external situations.

In this chapter we study some of the important tools available to us for strategic analysis.

SWOT analysis

Key term

SWOT analysis: an examination of the strengths and weaknesses (internal) a business has and the opportunities and threats (external) it faces.

SWOT analysis is an exploration of the strengths and weaknesses (internal) a business has and the opportunities and threats (external) it faces.

- Strengths and weaknesses are largely under the control of a business and can act to build on strengths and remove weaknesses
- Opportunities are outside the control of a business and may be taken advantage of
- Threats are also not controllable, but actions can be taken to minimise them.

SWOT analysis is an important mechanism for identifying actions that a business can undertake to make it more competitive or to develop an appropriate strategy.

A SWOT analysis must fit into a strategic framework – there is no point in doing one unless the business has a purpose which will lead to actions. Before a SWOT analysis is attempted a business must have considered the reasons for carrying one out and what will be done with the analysis.

Getting it right

A very common misunderstanding relates to opportunities and threats. You should make it clear that these relate to influences that are *external* to the business. Any internal factors can be expressed as a strength or a weakness.

- Strengths are those things a business is good at. It can use these to gain competitive advantage. They might include skilled and motivated employees, brand loyalty, good location, good relations with suppliers and access to finance. Strengths are internal to the business.
- Weaknesses are those things a business is not good at. Weaknesses can lead to loss of competitiveness. They might include high labour turnover, outdated products, poor after-sales service, communication

problems and high fixed costs. Weaknesses are internal to the business and may include internal opportunities not yet taken.

- Opportunities are there for a business to take advantage of. They might include a new expanding market segment, a competitor closing or government subsidies becoming available. Opportunities are external to the business.
- Threats are likely to bring problems for a business. They might include a likely recession, a competitors marketing campaign, a new tax or technology changes making a product obsolete. Threats are external to the business.

Undertaking a SWOT analysis

SWOT analysis is usually shown in a matrix, with each identified factor entered into the appropriate section. The case study illustrates how this might be done.

Case Study

Skoda – a SWOT example

Skoda, a car business from the Czech Republic, sold cars at relatively low prices and there was a market perception of low quality. Skoda entered a partnership with Volkswagen to try and survive and then expand in a competitive market. The quality improved but selling price was still low. After a short time this SWOT analysis was carried out in one of the countries Skoda cars were sold in.

Strengths (internal)	Weaknesses (internal)
• Good customer satisfaction • Customers recommended Skoda • Low price mark • Well-trained workforce • Volkswagen link • Good after-sales service	• Non-Skoda buyers' perception was one of low price/low quality • Low market share • Limited finance available
Opportunities (external)	**Threats (external)**
• Competitors focused on the product • Skoda could focus on owners' experience • Volkswagen link with quality • Market segment identified to sell to	• Lots of competition from big businesses • Big advertising/promotion budgets of competitors • Increasing imports of cars • New environmental legislation

Skoda used this SWOT analysis to develop specific objectives related to market share, and in particular to increase customer awareness and interest. This enabled Skoda to successfully engage in a promotional strategy to stress the excellent experience of people who bought its cars. Its marketing campaigns focused on this customer experience in order to overcome negative perceptions.

1 How did the SWOT analysis assist SKODA in identifying a new marketing objective?
2 To what extent did the SWOT analysis contribute to the change in promotion activity?

Figure 6.2.1 ▲

Activity

Choose a local business. It may be your school or college. Identify an issue it faces and carry out a SWOT analysis in relation to that issue.

Using SWOT analysis to develop objectives

A SWOT analysis is carried out when there is a problem or a decision to be made. Once the SWOT factors in relation to the problem/decision have been identified a business can identify which of the factors are most important. If it is an internal factor the business can then set out relevant objectives based on this. For example, consider a business seeking to increase profits. If an important factor is the weakness or lack of staff training leading to inefficiency, this weakness can be directly addressed by setting an objective relating to increased training. The business can then decide how to do this, perhaps by a training programme or mentoring. If the factor is external, for example the threat of competition, then an objective of maintaining or increasing market share may be set. The business can then decide how to do this, perhaps by changing the distribution method.

The specific SWOTs within each factor can be identified and addressed in a similar way. For example, a business with a strong threat from a new competitor might develop a focus on maintaining market share, or a business with a strength in innovation might focus on producing a new product each year.

Table 6.2.1 Advantages and disadvantages of SWOT analysis ▼

Advantages	Disadvantages
• SWOT analysis is relatively quick, cheap and is easy to present. • By highlighting the four characteristics it enables a business to build on its strengths, take action on its weaknesses, and offer insights into taking advantage of opportunities and combating threats.	• It deals with a particular, time, and markets and businesses may change quickly, making the SWOT analysis outdated. • Its simplicity may lead to wrong conclusions, e.g. it is not the numbers of factors in each section that are important but the potential impact of each factor on the business. • SWOT also has an element of subjectivity about it, in particular the relative importance of the various SWOTs identified in the analysis.

Progress questions

1 What must a business do before it carries out a SWOT analysis?
2 How might a SWOT analysis be used in relation to:
   a Setting objectives
   b Deciding on a change in tactics.
3 Identify two weaknesses in using SWOT analysis.

Key term

PEST analysis: an examination of the external environment that a business works in by considering the political, legal, economic, social and technological factors facing the business.

PEST or external environment analysis

PEST analysis is an examination of the external environment (political and legal, economic, social and technological) within which a business works. The factors involved are all outside the control of the business and PEST analysis will analyse their impact on business planning and success.

P is the political and legal dimension: government policies, decisions and actions will form the legal and regulatory framework within which businesses work. Laws on employing people, competition policy, advertising rules and health campaigns are examples.

Link

PESTLE factors are fully discussed in A Level Chapters 1.6a External influences on business activity: economic constraints and enablers and 1.6b External influences on business activity: additional external constraints and enablers.

Getting it right

Make it clear that you are using SWOT or PEST. Explain why. Link the analysis clearly to the situation and explain how the business may act on the analysis.

E is the economic dimension: taxes, monetary policy, unemployment levels and exchange rates are examples.

S is the social dimension: demographic changes, attitudes to drugs, family size and community needs are examples.

T is the technological dimension: increasing Internet use, cellphones, developments in biotechnology and nanotechnology are examples.

Some books use the acronym PESTLE, making legal and environmental factors separate. Environmental factors may also be important and these can be included in the social dimension.

Undertaking a PEST analysis

PEST is often undertaken by a business when a change of direction is being considered. This is because it is important to establish the setting and context of the business. The change of direction may not be possible given existing PEST factors. For example, a business may be well placed for carrying out an activity, but if it is illegal it is a non-starter.

The most important factors relating to a business under each of the PEST headings are identified and outlined, either in a list or a matrix. This will enable a business to take these into account when planning a strategy. For example, the CleanOff case study looks at a business considering expanding.

Case Study

CleanOff – a PEST example

CleanOff is a small limited company providing a service cleaning office buildings of IT businesses. It has been very successful in the large city it is located in and is thinking of expanding to offer a wider range of services to a bigger area. This would mean becoming a public company and issuing shares to raise the finance for expansion.

Political and legal	Economic
• Cost and legal implications of becoming a public company • New health and safety laws will increase costs • Strong competition from larger and established companies make it difficult to expand • Stricter employment regulations for larger size of business will increase costs	• GDP of country is growing – more offices likely to open • Tax on profits likely to fall – profit levels rise • Unemployment falling – more difficult to find employees • Government investment subsidies being removed – no incentives • Continued growth in services/office work
Social	**Technological**
• Office employees expect clean working environment – likely to lead to more contracts • Cleaning company employees expect more breaks, safer chemicals – higher costs • Society expects use of more environmentally friendly products – higher costs	• New cleaning machines available – higher cost but work quicker • Better and safer cleaning products available – higher cost, work quicker, good selling point • Electric vehicles for transport to and from jobs – higher cost but less time taken, good selling point • Disposable overalls and gloves – higher cost but no laundry bills

The matrix indicates some of the important PEST factors and the possible impact these might have on CleanOff. These impacts will enable CleanOff to focus on which are the most important. CleanOff can then research these in more detail and produce possible financial data on these in order to help make the decision on whether to expand.

1 Using the PEST analysis recommend whether CleanOff should expand.

Activity

Choose a business you know locally (it could be your school or college) that is facing a decision, perhaps it wishes to expand. Carry out a PEST analysis in relation to the decision.

Advantages and disadvantages of PEST analysis

PEST analysis is relatively quick and cheap as it uses secondary research. It is easy to present. It provides an understanding of the wider business environment and encourages managers to engage in strategic thinking. If used with a SWOT analysis it can highlight and explain opportunities or threats and indicate ways to exploit these or take avoiding action.

However, it deals with a particular time, and markets and businesses may change quickly, making the PEST analysis outdated. Its simplicity may lead to wrong conclusions, e.g. it is much more difficult to assess the real impact of PEST factors on the business and its plans than it is to simply identify them. The large amounts of information about PEST factors that will be generated may mean it is difficult to analyse it concisely. Dealing with PEST factors involves making assumptions about future change which may turn out to be incorrect or inappropriate.

PEST can also be subjective, which may be a significant problem as it relates to the external environment, one which is very broad for the analyser to make judgments about.

In the end the usefulness of PEST depends on judgments about the relative importance of factors. These judgments may be very difficult to make.

Progress questions

4 Explain the difference between SWOT and PEST analysis.
5 Identify an example of a situation where each of these analyses might be appropriate.

The role of vision/mission statements and objectives

Vision statements and mission statements are very similar in that they set out what the business is really about. Vision statements set out what the business wants to be in the future and are inspirational. A mission statement is set out with the customer's view in mind and explains how the business is trying to achieve its vision. The mission statement deals with what the business does every day, the vision is what the future will be like because the mission statement has been delivered. Not all businesses use the terms "vision" and "mission statement". Some only have one of these, some refer to purpose, aim or goal.

Procter & Gamble's vision, for example, is to "be recognised as the best consumer products and services company in the world" and in order to achieve this its mission is to "provide branded products and services of superior quality and value that improve the lives of the world's consumers".

Link

AS Level Chapter 1.4 Business objectives also considers vision statements and mission statements.

Table 6.2.2 Vision and mission statement examples ▼

Business	Vision statement	Mission statement
Coal India Ltd	To emerge from the position of domestic leader to leading global player in the energy sector by adopting best practices from mine to market with due care to environmental and social sustenance.	Produce the planned quantity of coal efficiently and economically with due regard to safety, conservation and quality.
Chinese University of Hong Kong	To be acknowledged ... internationally as a first class comprehensive research university whose ... dimensions of student education, scholarly output and contribution to the community ... consistently meet standards of excellence.	To assist in the preservation, creation, application and dissemination of knowledge by teaching, research and public service in a comprehensive range of disciplines, thereby serving the needs and enhancing the well-being of the citizens of Hong Kong, China ... and the wider world community.
Ministry for Education and Sports, Uganda	Quality education and sports for all	To provide for, support, guide, co-ordinate, regulate and promote quality education and sports to all persons in Uganda for national integration, individual and national development.
Ford	To become the world's leading consumer company for automotive products and services.	We are a global family with a proud heritage passionately committed to providing personal mobility for people around the world.

Setting the vision/mission statements then defines what the real purpose of the organisation is. All the objectives in strategic planning then follow on from this.

For instance, in the case of Coal India Ltd, its vision statement clearly sets out where it wishes to go: to become an international global business. The mission statement sets out what field it will operate in. This will enable Coal India to set specific objectives in relation to market share in India, countries to set up selling or producing in, and particular targets for production, health and safety and costs. Such clear vision/mission statements are really helpful in the process of setting a strategic approach to planning. However, Coal India appears to have limited itself to the coal market area of the global energy market. Its current mission statement will prevent it from exploring alternative energy sources. Compare with the Ugandan Ministry statements. They are more general and lead on to the specific objectives which include "universal primary education for children from 6 years to 12 years" and to ensure "pass rates in literacy and numeracy levels".

Strategic analysis is about determining where a business is at the moment. Vision statements are really about where a business wishes to be in the future. They therefore act as a framework for setting objectives in relation to achieving the vision. However, setting out a vision is based on where the business is now and must relate to the current position and develop from it. It gives very little guidance about how to achieve the vision, but it makes it easier to develop objectives and strategies to achieve it.

A mission statement is more descriptive of where the business is now. Mission statements are generally not very detailed and set out the current position in a way that will enable a business to understand exactly where it is. Knowing this makes it easier to develop objectives that take the business on further.

Activity

Research some more business vision and mission statements. Use these and the statements in Table 6.2.2 to comment on how effective they might be in setting objectives for a business.

Although potentially a useful tool, many of these statements are very general in what they say and it is sometimes difficult to understand exactly how useful they are and to see how they will lead on to developing specific objectives. Consider the statement in the progress question. Their nature is to give an initial guiding framework rather than to be specific in what they are describing.

Progress questions

The Mozambique Eyecare Project aims to provide a sustainable solution to the problem of avoidable blindness in developing nations by addressing the significant barrier of local human resource capacity development through optometric education.

6 Compare this mission statement with those in Table 6.2.2. Identify differences between them.

7 Comment on how effective this statement is as a vision or mission statement as part of strategic planning.

Boston Matrix analysis

Key term

Boston Matrix: a matrix that places products from a business in one of four categories, based on market share and market growth.

The Boston Matrix is a tool for carrying out portfolio analysis of the existing range of products being sold. It is most suitable for businesses that have a relatively large number of products. Products can be placed in one of four categories, relating to combinations of low or high market share and fast- or slow-growing markets. This enables a business to consider its range of products and assess its position.

- Too many "problem children" products might mean they are all new products or that insufficient promotion is being carried out. But it might mean that the future prospect for sales is very good.
- Too many "rising star" products might mean difficulties if for some reason high competition causes slowing sales, but it might mean that the company is likely to earn high profits soon and maintain market leadership.
- Too many "cash cow" products might mean that there are no newer products coming to replace the existing ones, but it might mean that there is a steady reliable income and profit stream.
- Too many "dog" products might mean that very soon the company will have very little sales revenue, but it might mean that the company can continue with very little promotion expense.

Link

Portfolio analysis is discussed in AS Level Chapter 3.3a The marketing mix: elements and product.

It is important to realise that the Boston Matrix gives a range of possibilities for the products in each of the sections. It is not an exact predictor and does not give preset prescribed analyses. It is important to consider other factors when using the Boston Matrix. It does not give programmed specific answers about what businesses should do, but it does highlight possibilities.

If a business has products in each of the categories then it is likely that there will be products nearing the end of their selling lives but possibly

Link

AS Level Chapter 3.3b
The marketing mix: price, promotion and place considers portfolio analysis as a part of using the product life cycle.

Getting it right

The Boston Matrix is a tool for analysis – it cannot give a single definite unique answer as to what a company should do about its product range.

still generating profits before they finish (dogs), others producing high profits and revenue (cash cows), others beginning to achieve market leadership and be well set for future profits (rising stars) and others with the real prospect for success (problem children). Generally it is recommended for a business with a wide range of products to have a balance, with products in all categories.

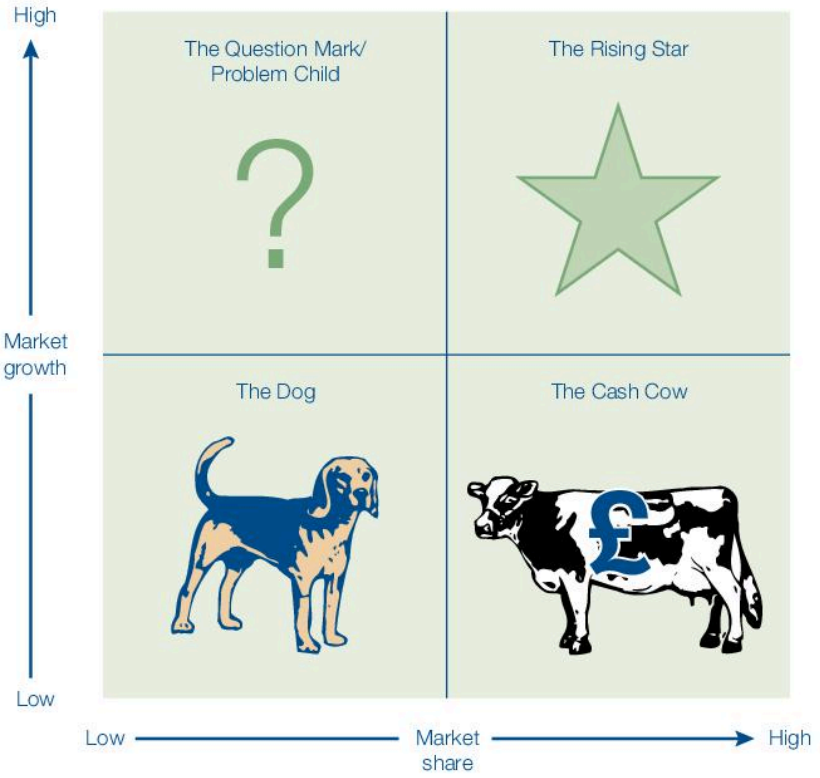


Figure 6.2.1 Boston Matrix ▲

Problem child – a low market share in a fast-growing market

These are products which have a low market share but a big and growing market potential. They are often new products, just introduced, or maybe products that have not received appropriate marketing investment. They may be making a loss but will have a lot of potential for expanding sales, but they may well need significant investment in order for their sales to grow. This investment is aimed at adjusting or refining the product in order to increase its acceptability in the market. It may be that a business decides that the growth in the market will almost automatically increase sales and if this level of growth is in line with the business objectives there is no need to increase spending to ensure that the potential of these products can be realised and disasters avoided. There is a high chance that there are competitors and it is also likely to be a new market, where investment at the start will secure long-lasting advantages in terms of reputation, goodwill and consumer loyalty. There may be costs to be recovered, such as research and development, launch and advertising costs. Low sales volume means lower unit costs from

economies of scale may not be possible. Businesses will have to decide how much to invest in order to make sure that the product moves away from loss-making. The process of investing is often referred to as building. An example of a problem child is Apple's iCloud because it has a low market share in a fast-growing market. This reflects the fact that there is a lot of competition.

Rising star – a high market share in a fast-growing market

These products have either been introduced early into a new market and thus gained high market share or have built up their high market share as the market grows. They will be generating profits but may be open to a lot of competition unless they have managed to combat this by establishing their dominant position. Marketing costs are likely to be high as they will have been necessary to gain the position or to safeguard against possible competition. Unit costs are low or falling as output rises. Assuming all goes well these products have the possibility of generating large revenues and profits for some time, but there is the possibility that the attractive growth means competition may lead to more costs or a falling market share. The process of continuing to spend on marketing is often referred to as holding. An example of a rising star is Amazon's Internet selling business because selling via the Internet is rapidly expanding and Amazon has the highest market share in this area.

Cash cows – a high market share in a slow-growing market

These products are very often in mature markets in which consumers who are likely to buy the product are already doing so. The high market share reflects past spending on marketing, and the research and development and launch costs have usually been recovered some time ago. The only way to get future growth is to take more of the small share that competitors have and this is likely to be very expensive for only a small increase in sales. Consumers are loyal to the product and marketing spending does not have to be significant as it is aimed at maintaining sales rather than making them grow. It will be necessary to make sure costs do not rise. These products should then be generating profit that can be used to develop and market other products. This process is often referred to as milking. An example of a cash cow is the Mars bar because it has a high market share in a slow-growing market that has been in existence for a long time.

Dogs – a low market share in a low-growth or declining market

These products are likely to be in markets for products that are becoming outdated. Alternatively competitors might have eroded market share to a low point. A dog product may still be generating profit with few marketing or overhead costs. The distribution arrangements will be in place, the production facilities will be running smoothly and there may be customer loyalty from consumers who still buy. In this case it may be worthwhile still producing the product with minimal marketing until it moves into loss making. However, there is

often little point in trying to develop products in these markets and there is a strong argument for discontinuing these products as they offer no future. This is often referred to as divesting. An example of a dog is a hand-pushed carpet sweeper because this product has falling sales.

Key term

Product portfolio: the range of products sold by a business.

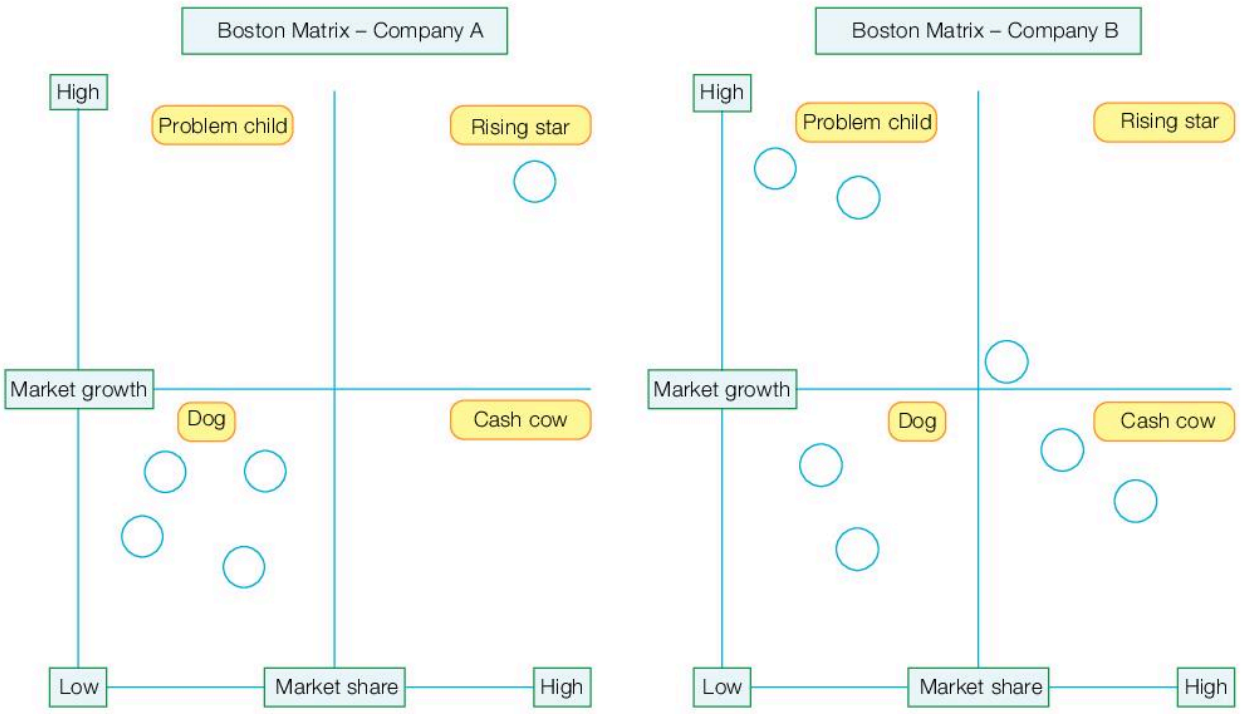
Getting it right

Do not describe a product as, e.g., a dog without referring to the Boston Matrix to show you understand the term. Give explanations for exactly how each of the types of product are defined and how a business might use this information.

Advantages and disadvantages of using the Boston Matrix

The Boston Matrix is simple to use and easy to present. It pinpoints the variety in the product portfolio and indicates possible strategies. For instance, if all the products are cash cows the business may be advised to use some money in research and development to generate new products to ensure future growth. If most of the products are rising stars the business needs to invest properly in marketing to ensure that at least some of them succeed. If they all fail the business will be in trouble.

However, the model must be used carefully. It is simple to produce and this simplicity can be misleading in complex market situations. It encourages managers to think simplistically. For instance, a high market share might not be associated with high profits. There might be very high promotion costs to maintain the level of market share. There might be very high costs in changing to a strategy identified by the matrix. Managers must be aware of assumptions that are made, interpret their analysis carefully and not allow the model to determine decisions without thought. Technological developments are rapid and markets may change very quickly, as can competition.



Circles indicate position of products and sale revenue of each.

Figure 6.2.2 Boston Matrices for Company A and Company B ▲

Progress questions

8 Consider the Boston Matrix diagrams for these two businesses (Figure 6.2.2). Comment on what they might mean for:
   a The current position of the business.
   b Developing a strategy for the business.

9 All the products of a company are dogs. What are the advantages and the disadvantages of this for the company?

10 All the products of a company are problem children. What are the advantages and the disadvantages of this for the company?

11 Assess the advantages and disadvantages of using the Boston Matrix for a business.

12 How might Boston Matrix analysis be linked to the concepts of product differentiation and market segmentation?

Activity

Find a business which has a number of products. Classify them according to the Boston Matrix.

Porter's Five Forces analysis

Key terms

Porter's Five Forces analysis: sets out five external influences that determine the intensity of the competition in a market.
Differentiation: using promotion to make consumers feel that a product is unique and different from other products in the same market.

Porter's Five Forces analysis deals with five external influences on a business that determine how intense the competition in a market is. These influences act on a business as forces that make it more difficult for a business to be successful. From this a business can assess how attractive the market is in terms of possible long-term profits. Markets where the forces from competition are strong will be less attractive to enter and more difficult to succeed in. Considering the strength of each of the forces allows a business to prepare a strategy to focus on weakening one or more factors that are making the market very competitive or are about to do this. It can also lead to suggestions that increase competitive advantage either by focusing on lowering costs (cost advantage) or by making the product stand out from the competition (differentiation). Figure 6.2.3 shows the five forces.

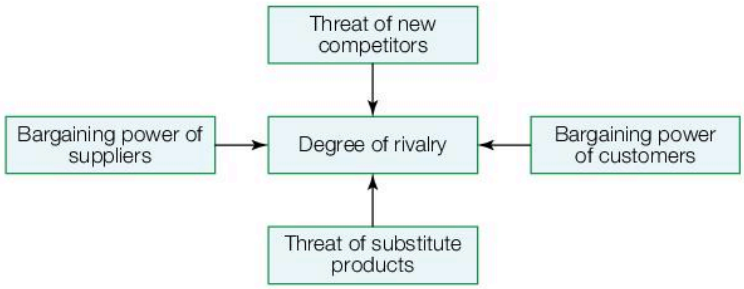


Figure 6.2.3 Porter's Five Forces ▲

Key term

Barriers to entry: these make it difficult or expensive for new businesses to enter a market. They include patents, customer/brand loyalty, high start-up costs and limited access to distribution channels.

Threat of new competitors/entrants

Markets that are profitable will attract new businesses. If a market is difficult for new businesses to enter there are likely to be high profits for businesses already selling. The threat or actual entry of new businesses will mean that the extra competition will make it more difficult for existing businesses to sell and will drive prices down and marketing costs up. Profits will therefore fall and the market will become less attractive. Markets with barriers to entry that make it

difficult or expensive to enter will have less threat of new competition. Barriers to entry include high capital costs needed to start up (e.g. for steel plants), legal barriers (patents, copyright), brand loyalty (high marketing costs needed to overcome this), and not having distribution channels set up.

Businesses must assess how much of a threat of new competition there is. If the threat is low the market is attractive to stay in or enter. If high, a business must consider trying to reduce the threat by developing brand loyalty, setting up exclusive distribution networks or new products to sidestep the competition threat.

As an example: airlines face a low threat from the entry of new competitors as the capital costs of setting up are high, and potential new airlines may find it difficult to hire licensed trained staff and to obtain airport flight slots.

Threat of substitute products

Key term

Substitute products: products that may be bought in place of another, e.g. margarine and butter.

If a market has few substitute products it is likely to be attractive, with high profits for businesses already selling. If more substitutes from a different industry become available it is likely that prices will be driven down as there are now more alternatives. The price elasticity of demand for products will rise. Examples include a new hot drink threatening the market for tea or coffee, cartons threatening the bottling industry, and Internet TV threatening cable or broadcast TV.

Link

Price elasticity of demand is covered in AS Level Chapter 3.3b The marketing mix: price, promotion and place.

Businesses must assess how much of a threat of new products there is. If low, the market is attractive to stay in or enter. If high, a business must consider trying to reduce the threat by developing existing or new products to sidestep the competition threat.

For instance, Starbucks faces a high threat from competition because there are many other products available that compete with coffee, tea and cake-based snacks.

Bargaining power of customers

Customers in different markets may have different amounts of power. If there are many customers each one is likely to have little influence as the sellers can simply decide not to sell to them as there many other people likely to buy. This makes the market more attractive with higher profits than if there were only a few buyers, each of whom are important. A small farmer selling to supermarkets faces a strong buyer who has the power to dictate some of the terms to the seller. The supermarket may well be able to determine the price and delivery times. This means that supplying supermarket chains is not always attractive to many businesses. Similarly, businesses selling defence products often face powerful customers (governments), as do tyre businesses supplying large car manufacturers.

Businesses must assess how much buying power customers have. If low, the market is attractive to stay in or enter. If high, a business must consider trying to reduce the threat by developing indispensable

products (e.g. high-speed microchips for PCs), engaging in forward vertical integration (e.g. movie-making businesses buy theatres) or unique products which customers feel they really have to buy.

Customers of banks, for example, have high bargaining power as it is easy to switch to a different bank. However, it may be argued that this power is lessened by the possible difficulties of switching and customer loyalty.

Bargaining power of suppliers

If suppliers to businesses in a market have power they will be able to raise prices and thus costs to those businesses. This power may be achieved by legal means, e.g. when Microsoft became the main supplier of operating systems to PC manufacturers, or methods such as cartels (illegal in most countries). An example of an international cartel is that formed by the main oil-producing countries (OPEC). If there are many suppliers their power is likely to be weak as the buyers can obtain supplies from a variety of sources and not be reliant on a few.

Link

The topic of integration and its different types is covered in AS Level Chapter 1.3 Size of business.

Businesses must assess how much buying power their suppliers have. If low, the market is attractive to stay in or enter. If high, a business must consider trying to reduce the threat by backward vertical integration (e.g. paper makers take over timber suppliers), acting together with other similar businesses to buy in bulk or diversifying into other markets.

As an example, General Electric makes electrical products and power-generating equipment. Their suppliers have low bargaining power because most could not survive without GE contracts.

Degree of rivalry between existing competitors

Markets feature competition and the level of competition is usually positively related to the number of businesses in the market. But a market dominated by only two businesses may be highly competitive (Procter & Gamble and Unilever have 90 per cent of the UK market for household cleaning products and compete vigorously, for example). Rivalry is expressed in price competition, product differentiation, marketing budgets and competition via different distribution channels. It may be related to changes in market growth or external economic factors.

Businesses must assess the degree of rivalry and competition in their market. If this is low the market may well be attractive to stay in or enter because it will be easier to gain market share and profit. If high, a business must consider trying to reduce the rivalry or win by producing differentiated products targeted at particular segments, building up brand values to gain premium prices or exclusive distribution channels.

For example, Ralph Lauren sells its luxury lifestyle clothes, shoes and handbags from retail stores. RL faces significant competition from similar branded businesses, as well as from Internet-based businesses.

Porter's Five Forces: the pharmaceutical industry

Businesses manufacturing medical drugs are among the most profitable and richest in the world. They include Pfizer, Novartis and AstraZeneca. Their business relies on expensive research projects to test new drugs, licences from governments, wide distribution networks and branding.

Threat of new entrants

Start-up costs are high, but it is possible to obtain licences and organise research labs relatively cheaply on a smaller scale. A new business only needs to discover one or two significant new drugs to become highly profitable and expand from a low position.

The threat to the major manufacturers is low to medium.

Threat of substitute products

Substitutes for pharmaceutical drugs include "alternative" medicines and more healthy lifestyles. However, there are often few substitutes for medication as part of treatment for particular conditions.

The threat of these substitutes to the major manufacturers is medium to low.

Bargaining power of customers

Customers with ethical beliefs are placing increasing importance on drugs not tested on animals and safe drugs proved by proper medical research. These customers are often large (nationwide health services or chain stores) and are interested in results not branding.

Their bargaining power is high.

Power of suppliers

Raw materials and equipment are readily available and production can be located almost anywhere. Therefore the power of suppliers is weak.

Competitive rivalry in the industry

There is a relatively small number of major businesses all striving to use research and development to produce new drugs, then branding them to make sure that customers will prefer their own product.

Competitive rivalry is high.

Summary

- Threat of new entrants: Low/medium
- Threat of substitutes: Medium/low
- Bargaining power of customers: High/medium
- Bargaining power of suppliers: Low
- Competitive rivalry: High.

This shows that a business considering entering the pharmaceutical industry will find it very difficult to do so. Businesses already in the industry will have to base their strategy on finding new products and

putting an emphasis on marketing to customers, making research and development and marketing costs high.

Case Study

Shoes to handbags

Jay runs a small business making shoes for local shops. She is finding that competition from large manufacturers is increasing and she thinks she might be better off switching to making leather handbags instead. She carries out a Porter's Five Forces analysis to help with the decision.

Threat of new competitors is high

- Lots of competition and products.
- Low customer loyalty.
- Easy to enter mass market.

Bargaining power of customers depends on who she sells to

- Depends on who she sells to. Large shops have high power, smaller designer shops less power.
- Large shops have large power. Small power if she can develop a brand image and sell to designer shops.

Bargaining power of suppliers is low

- Use existing ones mainly. Low bargaining power as suppliers are small.
- Low as she can change to another supplier easily.

Threat of substitute products is high or low

- High if producing bags similar to mass-produced ones, low if producing one-off exclusive bags.
- Low if uses good-quality production methods.

1 Using the results of Jay's Five Forces analysis, recommend to Jay a direction for her business to take.

Activity

Investigate two markets for different products. Use Porter's Five Forces to analyse the differences between these markets to assess which is the most attractive to businesses.

Advantages and disadvantages of Porter's Five Forces analysis

Table 6.2.3 Advantages and disadvantages of Porter's Five Forces analysis ▼

Advantages	Disadvantages
• Enables a business to assess its position in a market or the potential for entry to a market. • Considering the forces acting on a business, together with their strength and direction, enables a business to assess its chances of survival, growth or profitability. • It indicates possible actions that might be taken to reduce threats or take advantage of opportunities. • It might also highlight internal strengths and weaknesses.	• It is best for simple markets. • A more complicated market structure with many related businesses is difficult to reduce to the five forces. • In a complex market, competition is not simple and the model is too simple to take account of all the possible relationships that might exist between suppliers and distributors. • Markets change quickly and the forces operating in them do as well. • The analysis will become out of date very quickly.

Progress questions

13 Identify the forces in Porter's Five Forces analysis.
14 Outline one strength and one limitation of using this technique.

Prahalad and Hamel's core competencies analysis

Key term

Core competencies: the capabilities essential for a business to gain competitive advantage.

Core competencies are the capabilities that are essential for a business to gain competitive advantage. They most likely develop in the central activities that add the most value to products. They tend to focus on cementing and co-ordinating different functional areas and working groups together and may be in any functional area. They may act to give some coherence between products and provide a common theme or link between them. They represent common skills, techniques or relationships that can be applied successfully in a range of appropriate products and industries.

Examples include:

- Sony – core competence is miniaturisation leading to small electronic components and circuit boards and pocket-sized products
- Federal Express – core competence is logistics management leading to on-time delivery
- Woodpecker Addiction Centre – core competency is customised client case management leading to changed behaviour.

The three factors used in deciding the core competencies are how much the organisation and its products:

- Provide potential access to a wide variety of markets, e.g. Saga is a leading supplier of insurance and holiday products to the over-50s based on its core competencies of a focused brand identity, direct marketing skills and good customer relationships, all related to the target market
- Make a real contribution to the positive customer perception of the product, e.g. Tesco is a leading Internet retailer based on its core competencies of customer-friendly website, and efficient and quick delivery
- Are unique and this makes it difficult for competitors to compete, e.g. Lenovo has a high percentage of the PC market based on high-quality products, fast distribution and lean production methods.

Core competencies can be used to help generate a business strategy as considering them may suggest other areas a business could successfully operate in. If a retail business has core competencies in managing and motivating staff, good customer relations and training programmes it may be successful in providing care homes. If a business fails to develop its core competencies this may lead to poor performance, as US TV manufacturers found when they relied on the new cheap Japanese TV technology for screens and circuit boards in the 1970s, losing their core competency in R&D, meaning they were not well placed for the new digital products.

However, many strategists think that this idea of core competencies is difficult to apply to many businesses and valuable time and resources

might be wasted when there are simpler analyses available. For example, a SWOT analysis could highlight what a business is good at and where it might need to focus on a weakness.

Core competencies and products

The core competencies are also linked to planning product strategy. They will lead to the production of core products which can then be used to produce end products. The core products may not be directly sold to customers and will be used in the end products.

For example, Honda has core competencies in design and low-cost production, particularly in producing petrol-driven engines as a core product. These are used in Honda's end products such as cars, boats, motorbikes, lawnmowers and generators. Canon has core competencies in optics, which has led to the product range of photocopiers, cameras and medical imaging.

Using core competencies

Applying core competencies means:

- A business can focus its efforts on the things that really matter to customers
- A business can develop skills that reinforce the core competencies.

To do this a business needs to:

- Identify the reasons behind purchasing decisions by customers in its industry, e.g. if small size is an important factor in buying electrical products like cellphones then what it might value is integration and miniaturisation
- Identify existing core competencies in the business.

Then it needs compare the two lists and to develop the core competencies that relate to the needs of the customers. If there are none, then it must change the way the business works to develop relevant core competencies. If this is not possible the business should consider changing to a different market that more closely matches the existing core competencies.

Very often an analysis of core competencies results in identifying activities that could be outsourced, enabling a real focus on the core business. For example, accounts, payroll, cleaning and transport can often be better provided by buying these services from another business.

Strengths of using core competencies analysis

This analysis enables a business to develop and strengthen competitive advantage through differentiating the products to provide a unique selling point (USP) that customers see as important to them.

It also enables a business to develop training programmes to make sure the skills of its staff continue to meet customers' needs.

Getting it right

When writing about the techniques of strategic analysis it is important to do more than simply describe them. They must be applied and used to generate possible solutions to problems or to indicate ways forward. They are only effective if used well.

Limitations of using core competencies analysis

This analysis may be accurate, but only in the short term. If a business does not keep updating its core competencies it can lose the good relationship with customers and allow other businesses to gain competitive advantage.

It is possible for a business to be mistaken in what it thinks are its core competencies and base a strategy on a misleading analysis.

Progress questions

15 Explain what core competencies are, giving some examples.

16 What are the three criteria for deciding what a core competency in a business might be?

Exam-style questions

Rajah plc

Rajah plc operates a chain of department stores in eight major cities and 13 smaller ones. It sells a wide range of furniture, clothing, kitchen equipment, leisure gear and books but its product portfolio is much wider than this.

Its objectives are firmly focused on maximising profits. Over the last few years it has begun to lose sales revenue. The managing director (MD) thinks this is for two reasons: firstly the increased use of the Internet for shopping and secondly the effects of the global recession which have badly affected incomes and employment in the country. All his competitor stores are suffering in the same way though he has heard that one of them is about to open up an Internet shopping service.

The staff at Rajah are all highly trained and flexible and the business has considerable customer loyalty, but price is now of real importance and Rajah's prices are high. The IT systems in use are dated and need considerable investment. The business has considerable overheads in the form of distribution centres and large stores.

The marketing manager has said that the recession shows signs of ending but that the business can no longer carry on without a significant change of strategic direction.

The MD presents the board with a report setting out two options for Rajah. Both are affordable and both will yield approximately the same profits over the next three years. After that there is uncertainty.

- Set up and develop an Internet shopping service in addition to scaling down spending on the high street and mall stores.
- Continue with the stores, reduce prices and aim at a lower-income target market using less-expensive displays and take over some of the wholesaler suppliers in order to cut costs.

1 Evaluate the usefulness to Rajah of strategic analysis techniques in helping the business decide between the two options. [16 marks]

Key concepts

- **Change** is a central theme of analysis.
- **Management** can be studied through the use of management tools.
- **Innovation** can be addressed through identifying opportunities and studying risk.
- **Strategy** is central to deciding on the needs for strategic information.

Progress check

You should now be able to:

- understand and carry out SWOT and PEST analyses, Porter's Five Forces analysis and core competencies analysis in situations a particular business might find itself in
- select the most appropriate and relevant model in relation to a given business situation and apply it
- consider options facing that business and make justified recommendations regarding possible strategies that may be adopted, based on one or more of the models
- evaluate the way that vision and mission statements can lead to setting objectives as part of strategic analysis for a given business situation.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- using Ansoff's Matrix to analyse and evaluate different market strategies and risk
- using force field analysis to make strategic choices
- constructing decision trees and use the calculations to select an appropriate strategy
- the usefulness of decision trees including assessing the accuracy of their data

Key terms

Ansoff's Matrix: a decision tool for assessing risk. It sets out four combinations of possible types of products and markets that can be used as a tool for making strategic decisions.

Force field analysis: compares forces acting to make a change happen and forces acting against a change.

Decision trees: a quantitative technique that takes a systematic approach to decision-making. It uses probability and predicted outcomes in profits or sales to estimate the likely monetary outcome of taking a particular decision. It can be used to distinguish the likely outcomes of different decisions.

6.3 Strategic choice

Tools for strategic choices

This chapter deals with three tools a business might use to make a choice between possible strategies. These tools are the next step on from the use of the analytical tools dealt with in Chapter 6.2. These will provide a platform of understanding about the position of the business. Ansoff's Matrix, force field analysis and decision trees can then be used to help make the choice about which strategy to follow.

- **Ansoff's Matrix** is a tool used for decision-making and strategic planning when a business is considering ways it might grow. The matrix is particularly applicable to marketing as it considers combinations of types of products and markets, but the analysis has implications for all functional areas. It indicates how risky various options might be and this enables choices to be made that take account of business objectives.
- **Force field analysis** considers the forces that influence a business as it considers change. It indicates the forces that are driving movement towards a goal and those that are restraining movement towards that goal.
- **Decision trees** are a quantitative method that takes a systematic approach to taking decisions.

Ansoff's Matrix – strategic choice and risk

Ansoff's Matrix is useful in assessing risk when a business is looking to expand. Every business in this situation will have products and markets and the matrix uses this to set out four options for a growth strategy, each with a certain degree of risk.

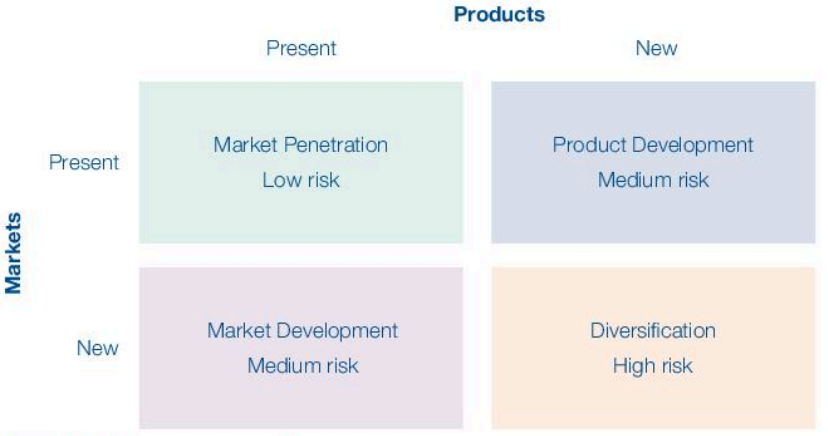


Figure 6.3.1 Ansoff's Matrix ▲

Market penetration – existing products, existing markets

This strategy involves operating in a market the business already knows and understands. This means it is likely to be low risk. However, there will still be risk attached because growth may incur costs and may lead

Key term

Market penetration: marketing existing products in existing markets (low risk).

to competitors reacting and becoming more aggressively competitive. Market penetration strategy will focus on increasing sales in the existing market by:

- Increasing brand loyalty and repeat purchases
- Increasing frequency of purchase
- Increasing sales at the expense of competitors
- Increasing sales to new customers in the market.

A marketing strategy must identify one or more of these as the objective, followed by selection of appropriate methods to achieve growth. More advertising, promotional offers, more sales staff, larger pack sizes, more direct selling and wider distribution are typical methods used in market penetration. An example is the expansion of Pakistan Oil gaining an increase in market share from 40 per cent to 65 per cent between 2001 and 2005 by opening more sales points.

Market penetration is more likely to succeed if the market is not saturated, competition is not high and the market size is growing.

Market penetration also offers the options of consolidation (by focusing activities on maintaining sales or market share), no change (by continuing with the same strategy) or even withdrawing from the market. These options will not involve the objective of growth.

Getting it right

Do not confuse Ansoff's market penetration (existing product in existing market) with penetration pricing, which is low prices to launch a new product.

Progress questions

1 How might the following businesses increase sales by market penetration?
   - **a** An online newspaper
   - **b** A car showroom
   - **c** A hairdresser

Market development – existing products, new markets

Key term

Market development: marketing existing products in new markets (medium risk).

Market development often carries a medium risk. The business knows and understands its products but it must adapt its marketing to a new situation, with different competitors and customers. A new market may involve promoting a new use for a product, a new geographical area or a different target market segment. For example, Pakistan Oil not only supplies buyers in Pakistan but has started to export its products to Afghanistan.

Link

Core competencies are considered in A Level Chapter 6.2 Strategic analysis.

Market development is most likely to succeed if the strengths and core competencies of the business are linked to the product. It can then successfully transfer to a new market based on this strength. Extensive market research is often needed as part of this strategy.

Progress questions

2 How might the following businesses increase sales by market development?
   - **a** An accountant
   - **b** A taxi business
   - **c** A manufacturer of farm tractors

Product development – existing markets, new products

Product development usually carries a medium risk. The business knows and understands its market and has a clear knowledge of its products. It will need to either modify these products to offer something different to customers in its market or it must develop new products to appeal to the same market. For example, Google introduced a new web browser (Chrome) for Internet users, McDonald's introduces new food products.

Link

Product development is discussed in AS Level Chapter 3.3 The marketing mix: elements and product.

Product development is likely to succeed if the strengths and core competencies of the business are linked to customers. It can then successfully use these to sell the new product. Extensive research and development based on market research is often needed as part of this strategy.

Progress questions

3 How might the following businesses increase sales by product development?
   a A sports magazine
   b An iron works
   c A clothes shop
4 Explain market development.

Diversification – new products, new markets

Key term

Diversification: marketing new products in new markets (high risk).

Diversification tends to carry a high risk. The business has to produce a new product and sell it in a new market. It will not have experience of either the product or the market to draw on. Diversification is often achieved by integrating with another business in the target product and market to take advantage of their existing strengths. The Virgin Group bases its growth on diversification, always seeking new products and markets for its next venture. It now produces a wide range of products, each one entering a new market. Canon has moved from being a company making cameras to one that produces a wide range of office machinery.

Diversification is likely to succeed if there is a real reason for adopting it, for instance if the existing market or product is failing, with forecast falling sales and profits. Tobacco businesses in developed countries have diversified away from their core product as it becomes harder to sell tobacco products due to legislation and changing consumer tastes. Diversification also requires a business to obtain expert advice about the new market and base its expansion on solid extensive research. There will almost certainly have to be a new or rearranged organisation structure.

Ansoff's Matrix and reducing risk

A business that uses Ansoff's Matrix will have an understanding of its possible product and market possibilities. This will enable it to reduce the risk for whatever strategy it chooses. Knowing the various levels of risk that the analysis predicts will help a business design an appropriate

strategy to maximise the chances of success. Using Ansoff's Matrix does not guarantee success, it prepares the way for it. For example, knowing that diversification is a high-risk strategy will make a business research very carefully into the possible new market in relation to its chosen product. Again, a business thinking of going for product development will focus on exactly why its new product will be suitable for the existing market. Ansoff's Matrix points up the key areas a business needs to focus on.

Progress questions

5 What levels of risk do the four sectors of Ansoff's Matrix have?
6 Explain the difference in these levels of risk.

How useful is Ansoff's Matrix?

Ansoff's Matrix provides a useful tool for a business considering expansion or changing its products or markets. It clearly sets out four strategies for success and relates these to the core competencies of the business and to the level of risk. It helps in indicating what might be necessary for success in each strategy. It is relatively simple and quick to use and easy to explain.

At best, Ansoff is a useful starting point for strategic decisions. Much more analysis is needed before decsions can be taken. In addition it is not always easy to define what a market is and this complicates the analysis. The level of risk indicated is very simplistic and depends on many more factors than just the new/existing product and market. Investigating the options may be very expensive, a cost that must be recovered.

Getting it right

Ansoff's Matrix is a useful starting point to give decision-makers an idea of the likely level of risk involved in a strategy. It is a guide, and further analysis is needed to assess probabilities (decision trees), likely returns (investment appraisal) and market research before decisions can be effectively made.

Activity

Choose a local business – it could be your school or college. Research its products. You could suggest a new product it could market. Now prepare an Ansoff's Matrix for the business.

Using Ansoff's Matrix to evaluate possible strategies

Advantages

Ansoff's Matrix is simple to construct and present. It clearly sets out the current position of a business and its market and indicates possibilities for future strategy. It indicates the level of risk likely to be found for each possibility. It does this best when set within a strategic framework. It is most successfully used when business objectives have been set and it follows an analysis of the current position of a business using the models discussed in A Level Chapter 6.2. The matrix will suggest possible strategies and their riskiness. The business must then weigh up the advantages and disadvantages of these strategies, bearing in mind the strategic analysis of its position. It must then develop the methods needed to implement the strategy. These may include designing a marketing strategy, changing the organisation structure, research and development or new financial arrangements. Ansoff's Matrix will enable a business to evaluate strategy in relation to its products and markets but this is only the start of implementing the chosen course of action.

Disadvantages

Placing a business in relation to its markets is much more complex than Ansoff's Matrix suggests. It is simplistic and a business that relies on it may be ignoring many other factors, especially the external environment and possible demand for products. The risk assessments are formulaic and simplistic and only provide an indication, not an exact assessment.

Case Study

BP and the Deepwater Horizon oil spill

BP is a large oil producer operating in many countries. It has drilling operations in many countries. In 2010 one of its wells in the Gulf of Mexico suffered a blow-out. This resulted in millions of gallons of oil escaping into the ocean and causing damage to sea life, beaches and the tourism industry in countries near the Gulf. BP had to pay for capping the well and also millions of dollars in compensation. It faced the prospect of problems getting new licences for drilling and increasing customer perception that it did not care about the environment. In order to resume growth BP had to make some strategic decisions.

Market penetration – continuing to drill for oil

A major activity of BP is deep-water exploration to find oil and then drill for it. Choosing this strategy would mean BP continues with these activities in the USA. This would match the company's objectives and strengths. BP is a major business in a market with high capital costs to new entrants. Its product is increasingly demanded and it has key core competencies related to oil exploration. It has competitors, but these have similar market strengths to BP. BP has massive investments in the USA, in terms of capital and in relationships with government. The risks of continuing to drill for oil are low. Once suitable oil deposits are found oil can be sold at a profit.

Market development – drilling elsewhere or new markets for oil

BP already successfully locates oil and drills it in many locations throughout the world. It can use all the arguments for market penetration to extend its drilling operations outside the USA, which is what it is doing now. Oil is a major raw material and fuel product for every country in the world with very few alternatives to its use. BP is already a major supplier of oil. Finding new uses for oil would involve very high research costs that BP does not need to undertake. It is profitable operating in its own markets and the Deepwater Horizon spill is a temporary setback. The risks of trying to find new markets are significant.

Product development – new fuels and chemical raw materials to existing markets

BP is in the fuel and raw-material industry. It sells its products to people who need them for business or personal use. New products to these markets would mean selling bio fuels like ethanol, or producing other raw materials. Both these would involve considerable spending on buying the commodities or in setting up extractive and processing facilities. The global market for bio fuels is currently small but has the prospect of significant growth with lots of competition. BP has core competencies in oil extraction, not minerals or bio fuels, and the competition in these industries is high. The risk involved in this strategy is significant.

Figure 6.3.2 ▲

Diversification – new products in new markets

BP is a very large business with good profits and excellent forecasts. It is not facing declining demand for its products and there is no prospect of any extra competition. Diversifying might involve the business being distracted from its core activities. This strategy would be very risky for BP.

This case illustrates how Ansoff's Matrix might be used to make a strategic choice.

1 Using Ansoff's Matrix, recommend an appropriate strategy for BP to follow after the Deepwater oil spill.

Progress question

7 Explain the usefulness of Ansoff's Matrix to managers of a large computer manufacturing business in your country that is considering different growth strategies.

Force field analysis

Force field analysis is used when a business is considering a change or a plan and has to make a decision to go ahead or not. It is a way of weighing up the advantages and disadvantages of the change by considering the forces that act on the planned change. It can also highlight ways the business can reduce forces against the change and strengthen forces acting for the change.

Force field analysis method

Below are the seven steps needed to carry out a force field analysis. Care must be taken to identify the relevant forces and estimate their importance.

- Draw up three columns
- Set the proposal for change in the middle column
- List in the left column all the forces that are for the change and that drive it
- List in the right column all the forces that are against the change and that restrain it
- Give each force a score, from 1 (weak) to 5 (strong)
- Add up the total scores
- Use the total to help make the decision.

Example

A manufacturing business is considering whether to install some expensive computer-controlled equipment that will reduce the cost of production and enable new products to be produced. Figure 6.3.3 shows the force field analysis the business carried out.

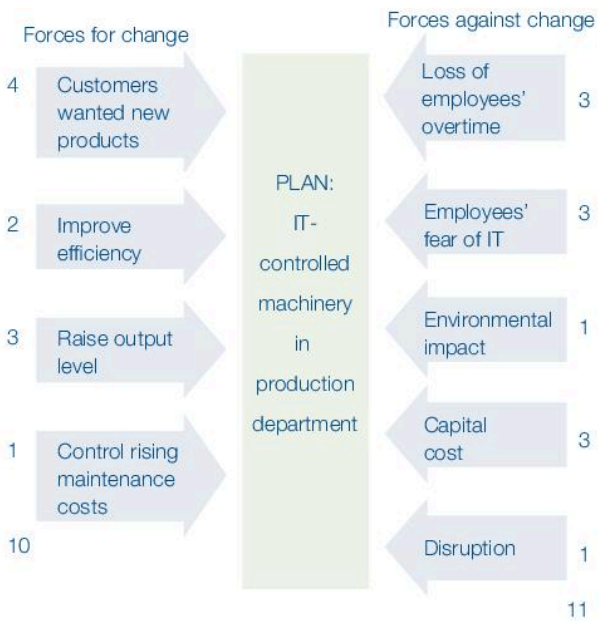


Figure 6.3.3 Force field analysis ▲

The numerical scores, 10 for and 11 against, indicate that the forces against the change are larger than the forces for the change and therefore the project should not go ahead.

In addition, the analysis can be used to identify ways to alter the strength of the forces involved. The forces for change can be strengthened and the forces against change can be weakened. In this example more training could be given to employees. This may reduce the employees' fear of IT by −2, increase costs by +1, giving a net gain of +1. Similarly, better planning may reduce the disruption and staff could be consulted in a meaningful way or offered a higher wage in order to reduce their upset at the loss of overtime. These will also reduce the forces acting against the change.

Evaluation of the use of force field analysis

Advantages

Force field analysis is simple to understand and apply and easy to present. It is a useful technique as it makes a business identify the forces acting on a change. This can be used to strengthen the forces acting for change and minimise the forces acting against change. This will enable a business to successfully bring about a desired change.

Disadvantages

Not all the forces may be identified. Any omissions my severely affect the outcome. In addition, the scores given to each force have to be based on a subjective judgment which may be little more than opinion. The overall outcome of the analysis may therefore not be based on real evidence and so may not be very reliable. Force field analysis must be used with care and alongside other techniques.

Activities

1. Find an example of a change that is being proposed in your school/college or where you work or in an organisation you know of.
2. Carry out a force field analysis by identifying four forces acting for the change and four forces acting against the change.
3. Does the analysis make you think the change should go ahead?
4. Suggest one way that the organisation could reduce forces against the change or strengthen forces for the change.

Progress questions

8. When might a business use force field analysis?
9. Outline two advantages and two disadvantages of force field analysis.
10. Explain how force field analysis could be used to assess forces driving and constraining a major decision to relocate a call centre business to another country.

Decision trees

Ansoff's Matrix and force field analysis are useful when considering the direction of a possible change or new strategy. Decision trees are a different tool. They aim to help make a choice between several possible courses of action. They are particularly useful when the choices are clear cut and estimates of numerical costs and benefits are available to be entered onto the decision tree. This then allows the probabilities of success or failure to be factored in and a calculation carried out to determine the highest yielding course of action. "What if?" analysis can be used to check the different outcomes that appear if different assumptions and forecasts are made. This is especially useful when outcomes are not so clear cut, when "What if?" analysis can be used to "test" the impact that differing assumptions have on a decision.

Key term

"What if?" analysis: explores the impact on a decision of changing one or more of the parameters in the decision tree, for example probabilities and estimates of costs and benefits. This enables decision-makers to see how robust a decision is.

Constructing a simple decision tree

Decision trees are started on the left by setting out the decision to be taken, indicated by a small square representing a decision node. Each possible option is then represented by a labelled line drawn rightwards. The end of each line will either be another decision or an uncertain result/outcome. If it is another decision a small square is drawn, with the options indicated on rightward lines. If the result is uncertain the line ends in a small circle representing a chance node. Lines drawn rightwards from this show the possible outcomes and indicate this in numerical terms. Figure 6.3.4 shows an example of the structure of a decision tree.

Getting it right

In a decision tree squares show decision points, circles show points from which different results or outcomes are possible. Always show the possibility and result of no change where appropriate.

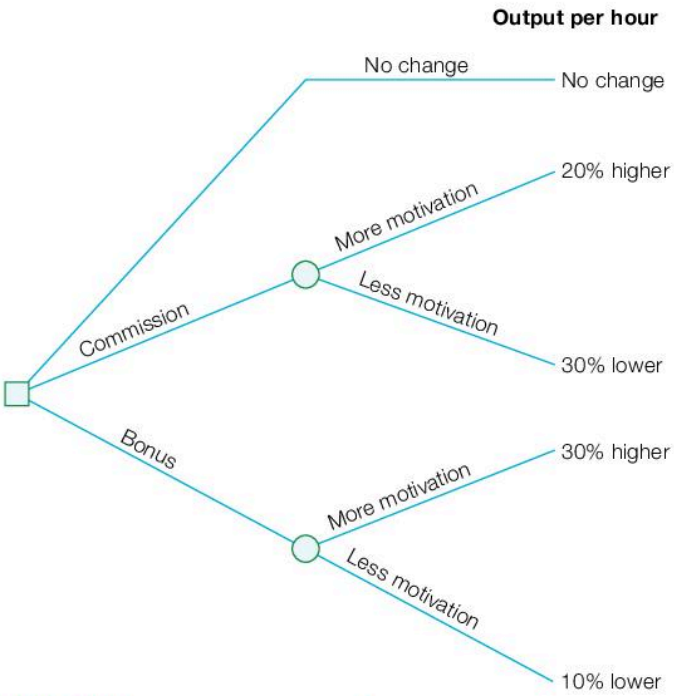


Figure 6.3.4 Decision tree structure ▲

Make sure that a branch showing the effect of not making a change is included where appropriate.

Calculation of expected monetary values

The decision tree in Figure 6.3.4 is a simple one that provides the framework for analysis. It needs to show the estimated costs or final benefits of the choices being considered before analysis can be undertaken.

A business in Thailand is thinking of exporting for the first time. It can only afford to export to one country. It has a choice of Singapore or Japan. In Singapore it has a number of contacts and will set up its own sales network. The level of sales will depend on the economic conditions in the country, i.e. whether it is expanding or in a recession. In Japan the business would have to sell through an existing local distributor. If the business does not export at all it is expected to continue producing revenues of $2 million at a cost of $1.8 million and will continue to do this as long as a profit is being produced. All the expected revenues are estimates based on market research and are therefore not certain. They therefore have a probability of taking place. The probabilities for each option must add up to 100 per cent.

Table 6.3.1 shows the costs and possible revenues of these choices in monetary terms.

Table 6.3.1 An exporting decision ▼

Destination	Distributor	Cost	Revenues	Probability
Singapore	Own network	$200000	$400000 in recession	0.6
			$1.2 million in boom	0.4
Japan	Existing local	$100000	$600000 in recession	0.7
			$1 million in boom	0.3

1 First draw the decision tree showing the decisions and outcomes that apply.

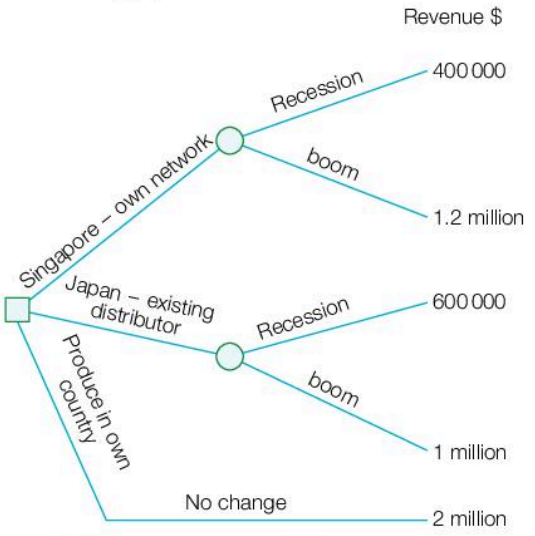


Figure 6.3.5 ▶

2 Now incorporate the costs for each option under the line showing that option and the probabilities of each result under the line showing that result.

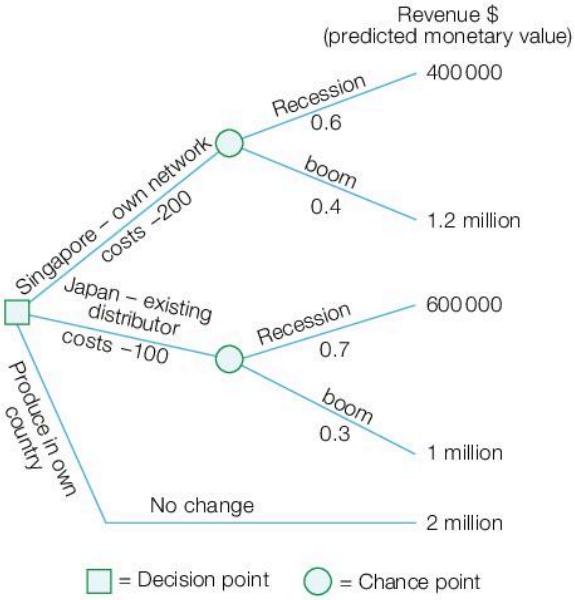


Figure 6.3.6 ▶

Key term

Expected monetary value: the value in money terms of a possible outcome, taking into account forecast returns and the probability of these happening. It represents the average value of the outcome if the decision was repeated a large number of times.

3 Now calculate the expected monetary values for each of the possible results. Expected monetary values are what you might expect to get back from a situation where probabilities occur. For example, a coin tossing game. If it is heads you win $5 (probability 0.5), if it is tails you lose $2 (probability 0.5). On average if you toss the coin many times you can expect to win $1.50. This is obtained from adding the outcomes of the two possibilities, i.e 0.5 times $5 plus 0.5 times minus $2 = $1.50 – the expected monetary value. Start at the right-hand side. For each outcome multiply the predicted monetary value of the outcome by the probability of it happening. For each option add all these expected values and take away any costs for each option. This figure will be the benefit for that option taking into account the expected returns and the probability associated with them and their costs. Show the expected value under each option. Use two diagonal lines to cross through all the options except the one with the highest expected monetary value.

Expected monetary values

Singapore:

Local distributor in recession = $400 000 × 0.6 = $240 000

Local distributor in boom = $1 200 000 × 0.4 = $480 000

Total = $720 000

Minus cost of $200 000 = expected monetary value of $520 000

Are these better?

Japan

Local distributor in recession = $600 000 × 0.7 = $420 000

Local distributor in boom = $1 000 000 × 0.3 = $300 000

Total = $720 000

Minus cost of $100 000 = expected monetary value of $620 000

No change

Revenues of $2 000 000 minus costs of $1 800 000 = expected monetary value of $200 000

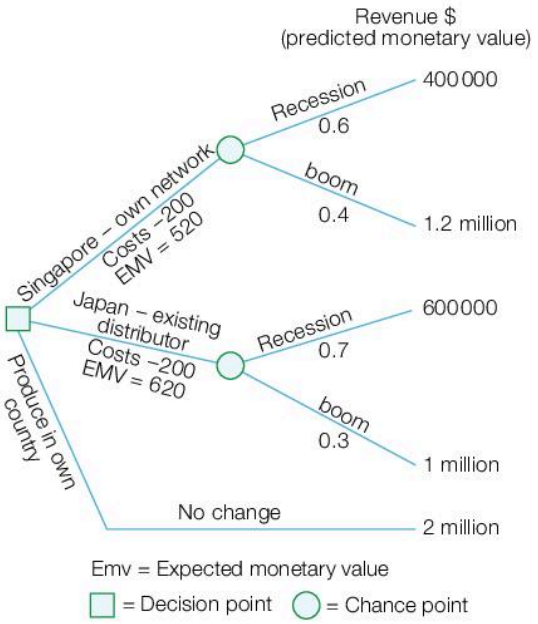


Figure 6.3.7 Expected monetary values ▶

4 Using quantitative values only, the chosen option will be the one with the highest expected monetary value. Therefore the business will choose to export to Japan on the basis of this decision tree as the expected monetary value of this option is $100 000 more than exporting to Singapore (see Figure 6.3.7). It will continue to produce in Thailand as it is continuing to make a profit.

Evaluating the usefulness of decision trees

Table 6.3.2 Advantages and disadvantages of decision trees ▼

Strengths	Limitations
• They clearly set out options and their associated costs and benefits • They give a quantitative analysis that takes account of the level of risk and the probability of the outcomes occurring • The decision is based on more positive factors than just a hunch or a feeling • The work carried out in investigating the costs, benefits and probabilities means that many details will have to be researched, not just estimated quickly • The analyst has to carefully think through the decision process, clarifying what is involved in the decision and the factors influencing it • They provide the opportunity to investigate the impact on decisions of factors and assumptions based on a "What if?" analysis	• Used inappropriately decision trees may lead to poor decision-making • The fact that a quantitative result is obtained may disguise poor research • Successful decision tree analysis relies on the data and assumptions used being realistic and this may not be the case • The research methods may have been rushed or flawed • The research may be out of date and the probabilities used may be unrealistic as conditions may change quickly • There may be other factors that affect the decision which have not been taken into account. For example: new competitors, sudden changes in inflation, customer tastes or employee reactions to new work methods • "Expected values" are averages, they may never actually happen (in our example of tossing a coin you will never win $1.50 which is an average, you will either win $5 or lose $2)

Getting it right

It is likely that you will be presented with a decision tree already drawn. You may possibly be asked to complete sections which are missing or make some calculations based on the information in the tree.

Getting it right

Ansoff's Matrix, force field analysis and decision trees can be very useful, but decision-makers must be aware of their limitations and also use other methods to decide strategic choices, particularly where market conditions are changing rapidly.

Sensitivity of "What if?" analysis

Decision tree analysis can be made more useful by assigning a range of probabilities to each possible result by asking the question "What if?" For example, sales are forecast to rise by 40 per cent with a probability of 20 per cent. What if a competitor unexpectedly appeared? This might reduce the probability of the forecast increase to 10 per cent. This adjustment will enable a business to see the effect of different scenarios on the forecast expected monetary values. This will increase the chances of a decision based on decision tree analysis being a good one.

Progress questions

11 When might a business decide to use a decision tree?
12 What does the expected monetary value mean?
13 Outline two advantages and two disavantages of decision trees.
14 Explain "What if?" analysis.
15 Explain the usefulness of decision trees to the managers of a publishing company who need to take strategic decisions to survive.
16 Explain the factors that the directors of a business should consider before making the strategic choice between two alternative growth strategies.

Exam-style questions

Gino's Coffee Bar thinks of expanding

Gino's coffee bar is interested in expanding its customer base as a start to further expansion and as a defence against any more competition. Gino, the manager, has asked his assistant, Hera, to produce some background information on the options available. Hera's report set out three options with her forecast changes to revenues:

- Carry on with the same marketing strategy. Result: no change in predicted revenue and costs.
- Spend $10 000 on an advertising campaign aimed at 18–25-year-olds. Result: an 80 per cent chance of success bringing in an additional $10 000 but a 20 per cent chance the advertising will increase revenue by $5 000.
- Alter the furniture and decorations in the coffee bar to give more space for soft chairs. This will cost $20 000. Result: a 60 per cent chance of additional revenue of $15 but 40 per cent chance that revenue will fall by $6 000.

1 a Draw a decision tree to illustrate the options, their predicted money values, the probabilities of success and the expected monetary values. [8 marks]
b Using the decision tree and the calculations you have carried out recommend one of the three options to the manager of Gino's. [14 marks]
c Discuss the usefulness of strategic choice tools analysis in making this recommendation. [16 marks]

Key concepts

- **Change** is central to strategic choices and is the main driving force.
- **Management** will need to make choices between ways of developing businesses.
- **Strategy** is the consequence of making strategic decisions.

Progress check

You should now be able to:

- use Ansoff's Matrix to analyse and evaluate different business strategies in relation to risk
- use force field analysis as a means of making strategic choices
- construct simple decision trees using calculated expected monetary values
- use decision tree results to assist in selecting the most appropriate strategy
- understand the usefulness of decision trees including an assessment of the accuracy of the data used.

You should be able to relate these to a range of businesses in different situations.

This chapter will develop your knowledge, understanding and ability to analyse and evaluate:

- A business plans
- A corporate culture and strategic implementation
- A developing a change culture
- A managing and controlling strategic change: change management strategies
- A contingency planning and crisis management

6.4 Strategic implementation

Strategic implementation is a process that turns strategies and plans into actions so that business objectives and goals can be achieved. Strategic implementation focuses on the who, when, where and how of reaching the business objectives. A business plan will contain all these things but it has to be implemented for the strategies to be effective. Implementation must take account of where the business is now (strategic analysis), the resources the business has, the business context (market conditions), and forecasts for the future. It must involve the whole of the organisation and its staff and will mean change for employees and the organisation.

Business plans

A business plan is a document that sets out in practical terms what a business is about. It will contain objectives, strategic and tactical plans, information about the market and financial forecasts. It is like a roadmap, setting out the way forward to reach objectives. Unlike strategic management plans that are designed to be used internally, the business plan has an external audience. The business will use this plan to obtain backing and finance when starting up or when changing its operations, e.g. expanding, or entering new markets. The audience for a business plan will include banks, suppliers of venture capital, grant awarders, and potential purchasers or business partners. These people will be very interested in how the business is intended to develop, the timescale, and how finance will be handled. Their focus is on whether money invested in the business will be returned and/or what level of return or profit is likely. A business plan can be any length, from the back of an envelope to a 100-page document. Most are several pages long.

Key term

Business plan: a document setting out the objectives of a business and exactly how the business intends to achieve them in practical terms. It contains, objectives, strategic and tactical plans, market information and budgets.

The elements of a business plan

There is no set layout for a business plan though banks and government provide forms which give specific guidance. However it is set out, a plan should contain these elements, even if different headings are used.

Link

Venture capital is discussed in AS Level Chapter 5.2 Business finance and its sources.

Executive summary or basic information

This is short and contains the business name, a brief history, the legal structure, the product or service being sold, the resources needed and where these will come from, and a quick statement about hopes for the future. It will contain a brief statement of the purpose and the objectives of the business.

Product or service

A detailed outline of what will be sold and what market it will be placed in. The focus should be on how the product/service meets a market need and how this is different from any competition. It might include any patents, copyrights or trademarks.

Market analysis

An account of the market that might include details of the size, the competition, the target customer, market trends and future developments. Some indication of market research might be present.

Activities

1 Think of an idea for a small business, for example selling sweets or making cushions. Produce a business plan for setting up and operating this business. It may be difficult to obtain some of the information needed, e.g. precise costs of materials or exact numbers of employees, so use estimates where you need to.

2 Your business has gone well for two years and you are thinking of expanding, e.g. by opening another shop, extending the product range or taking over another business. Draw up a business plan for the expansion.

Marketing plan

This is often an account of the marketing mix the business will use. This will tell interested people where the product/service will be positioned in the market. It will include detail about the price, the promotion methods to be used, the way the product/service will be distributed to the target customer and what selling methods will be used. This section will focus on how the business will meet the needs of its customers.

Production plan

This section will tell readers how the product/service will be produced. It will include any patents held, the premises and equipment needed, details of suppliers and how quality will be maintained.

Organisational plan

This section deals with the people in the business. It might include names, abilities and experience. It will show how people will be organised and managed and include training arrangements. There might be an organisation structure diagram.

Financial plan

The key part of this section will be a monthly cash flow forecast for one to two years, using information drawn from all the other areas of the plan. There will also be a profit and loss forecast. This will enable the financing needs to be clearly identified.

Conclusion

This will summarise all the above and give some idea of the longer-term plan for the business.

The value of business plans

Business plans have a value for all kinds of businesss, whether large or small, established or about to start. For all types of business a plan will set out the detail needed to implement strategic choices because it contains a detailed listing of how the resources of the business must be organised in order to meet objectives.

A business plan is particularly valuable for businesses starting up as it provides a focus for all the activities needed to operate and makes a business consider all the details involved, especially as the plan is often used to get finance from hard-headed banks or venture capitalists who need to be convinced that the business is financially sound.

For established larger businesses a business plan is valuble for setting out how to implement a new project, including obtaining finance. This will also apply to a change of direction. Larger or well-established businesses have a tendency to just carry on with the same procedures year after year and a business plan will make sure that the business reviews what it is doing at regular intervals. A business plan may apply to the whole business or part of it.

Getting it right

A good business plan answers four simple questions:

- Why does your business exist? (Purpose or mission statement)
- Where do you want to take it? (Objectives)
- How will it get there? (Strategy)
- What will it cost? (Budget)

A business plan should enable a business to:

- Successfully apply for a loan, a grant or other finance as the plan clearly sets out how the money will be used and repaid.
- Examine the business idea and future prospects in detail and in realistic practical terms. This will highlight any potential problems and make it difficult for managers to dismiss threats.
- Fully examine whether a particular idea is commercially viable. The research required for the plan will discover whether the market will be suitable for the product or whether the proposed investment in equipment will really generate enough cost savings.
- Have a sense of direction matched by a practical plan. This will give focus and enable problems to be identified early and action taken to overcome these.
- Determine whether the business has enough internal resources (money, expertise, equipment) for what is planned.
- Continually review progress in the areas set out in the plan.

However, there is a cost to a business plan. It takes time and involves forecasts that may turn out to be inaccurate. It might be very difficult to be precise about future developments. The plan may be rigid and inflexible and employees may follow it even though conditions have changed. A business may come to rely on the plan rather than communicate with suppliers, customers and staff.

Case Study

At Home Store

Ria and Tom Thenin had always wanted to run a business. An opportunity arose when a long-established furniture store went bankrupt. They were able to obtain the lease on the store building but they had to start with no furniture to sell. In order to start up they had to borrow some money from a bank. The bank required a business plan The Thenins saw this as being a waste of time; after all they had a business to get going. It was only when they were writing it that they realised the process had made them think of all sorts of things they would have ignored.

"We thought the business plan was for the benefit of the bank and was paperwork we had to do to get the loan. However, it made us think about what we really wanted from the business and exactly how we were going to manage money, advertising and employing staff in the store. It made us research the market in our town and it showed us that people had more money for furniture and home products than we thought. This influenced our whole approach to what we sold. It even made us focus on the name for the business. Having a longer-term view meant we called it At Home, rather than just restricting the name to furniture."

"The business plan set out all the things we wanted to achieve – our objectives – and made us think not only about the next month but into the future. We stuck to it in the first year and kept referring to it. Things had gone so well we decided to continue with the plan and rewrote it for the second year and we still do this every year."

"This is one of the reasons we have started a household consultancy business which runs alongside the store. We advise customers on how to make their houses attractive and arrange for painters, builders and joiners to do the work. We are able to supply furniture and a whole range of electrical products as well. We wrote another business plan for this expansion and are on track to reach the objectives we set. The bank loan is nearly paid back and we are looking for new ventures. A business plan is a must for us."

1 Explain why the Thenins felt making a business plan was not a good use of their time.
2 Analyse the reasons why they came to see the benefits of drawing up business plan.
3 Discuss why they are continuing with business planning.

Link

Corporate culture is related to the way an organisation is structured. It is worth making sure you can see the connections between this chapter and A Level Chapter 2.4 Organisational structure.

Key term

Corporate culture: the values, beliefs and behaviours that determine how a company's employees interact to get tasks done.

Getting it right

There are other types of corporate culture apart from power, task and entrepreneurial, but these are the ones specifically mentioned in the Cambridge International AS and A Level Business syllabus as examples.

Progress questions

1 Outline the elements of a business plan.
2 Explain three advantages of a business plan for:
   a A new business about to start up
   b A well-established large business.

Corporate culture and strategic implementation

Corporate culture

Corporate culture is sometimes said to be "the way we do things around here" or to be the "personality" of an organisation. It is the values, beliefs and behaviours that determine how a company's employees interact to get tasks done. It is not defined and develops over time as attitudes of employees develop. Corporate culture may be seen in things like dress codes, hours of work, the way an office is set up, employee benefits, communication channels, leadership styles, organisation structure and attitudes to work.

For example, there is an obvious difference between the two organisations in Table 6.4.1.

Table 6.4.1 Two different corporate cultures ▼

Organisation A, e.g. a typical bank	Organisation B, e.g. Google
• Dress code is suits • Narrow hierarchy • Meetings need scheduling via a diary system • Small room office space • Set defined hours • Autocratic leadership	• Dress code is relaxed • Flat organisation structure • Meetings set up when needed • Open-plan office • Flexitime working • Democratic leadership

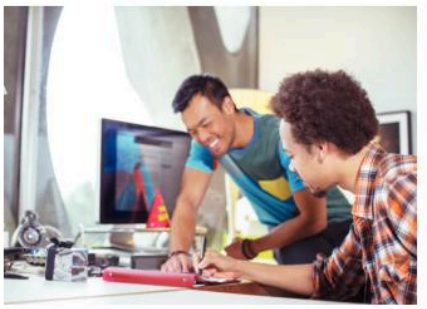


Figure 6.4.1 Two different corporate cultures ▲

Neither business is better than the other, but there will be reasons for the differences. These reasons may be related to the philosophy of the top managers or founders, the type of industry the business operates in or for historical reasons. Corporate cultures can be classified into several types and three are considered here.

Types of corporate culture

Power culture

A power culture has decision-making concentrated in the centre of the organisation, with only a few people responsible for making decisions. It is likely to be associated with an autocratic leadership style, centralised decision-making and a narrow tall organisation structure with clearly defined quick communication channels. Consultation and group work will be minimal.

This means decisions can be made quickly and implemented precisely. The organisation can react quickly to changes that happen. However, there is little scope for creativity and employees may feel dissatisfied as they have little control.

Task culture

A task culture is based on a team approach. Groups of employees are formed to complete particular tasks. Power comes from expertise not position in the organisation. These groups may be long term or short "project teams". Task culture is likely to be associated with an empowering democratic leadership style and a matrix or flat organisation structure with delegated decision-making. Creativity is valued and employees become motivated. However, decision-making can be slow and there may be destructive rivalry between teams and high costs in setting up and breaking up teams.

Entrepreneurial culture

An entrepreneurial culture embraces change and takes risks. Employees come up with new ideas and are listened to. Entrepreneurial culture is likely to be associated with a democratic empowering or a laissez-faire leadership style and a flat structure with quick communication channels between employees at different levels. However, resources may be wasted in ideas that do not work and it will be difficult to control what employees are doing.

It is important to remember that any of these cultures may be appropriate for a successful business. There is no one best culture. There are advantages and disadvantages to all of them but these are always in relation to the way a business is structured. For example, quick communicaiton channels may be an advantage in a business where market conditions change quickly but a disadvantage in a research-based business where decisions must be carefully made by weighing up evidence from a range of sources.

Strong or weak cultures

Whatever the type of culture there is in an organisation, there is another dimension to culture. This is whether the culture in the organisation is strong or weak.

Strong cultures are where the employees understand the culture so there is little need for procedures setting out how to behave. Employees will behave consistently and the type of culture in the business is clear and followed by everyone. Employees all agree on the existing beliefs

Key terms

Power culture: concentrates decision-making at the top or centre of the organisation, with autocratic leadership and quick communciation channels.
Task culture: uses a team-based approach, with groups formed to complete particular tasks, a democratic leadership style and delegated decision-making.
Entrepreneurial culture: has risk-taking embedded within it, with all staff able to contribute ideas, a democratic or laissez-faire leadership style and quick communication channels.

Link

See A Level Chapter 4.5 Lean production and quality management for links between culture and lean production, and AS Level Chapter 2.1 Management and leadership and A Level Chapter 2.4 Organisational structure for links between culture and organisation structure.

Activity

The specification gives three types of culture as examples. Two other possible corporate cultures are role and person cultures. Research these and assess their advantages and disadvantages

Key terms

Strong culture: employees all understand the existing culture and agree on existing beliefs and behaviour.

Activity

Choose an organisation you know well. Discuss what type of corporate culture exists in it.

Key terms

Weak culture: employees do not all understand the existing culture and have different ideas about its values and how to behave.

and values and the way the business operates. A strong culture is often linked to power cultures.

Weak cultures are where the employees do not really understand the culture and so behave inconsistently. This means there will be a need for set procedures and rules to follow to make sure that employees do not waste resources by behaving differently. Employees have different ideas about the existing beliefs and values and the way the business operates. This will encourage individual thought and contributions. A weak culture is often linked to task and entrepreneurial cultures.

Progress questions

3 Explain the meaning of corporate culture.

4 Explain the differences between power, task and entrepreneurial corporate cultures. You could refer to differences in leadership style, communication channels, teamwork and organisation structure.

5 **a** Explain the difference between a strong culture and a weak culture.
b Outline why this difference may be important.

Case Study

RiteCut Machine Tools

RiteCut Machine Tools is a medium sized manufacturer of power tools and machines that it sells to other businesses. It make a range of saws, drills, milling machines and cutters. For many years its market had been stable, it had a number of loyal customers and the sales staff were not used to having to really sell the products. Contracts were often renewed almost automatically. The employees were highly skilled and regarded working as enjoyable. The owners encouraged a culture of "friendliness", with managers acting as advisers rather than supervisors. The suppliers it used for raw materials and components had been built up over years. Contracts were often renewed without any exploration of other possibilities. However, the market began to change as computer-operated machines and automated production processes were increasingly introduced by its customers. Its products looked old fashioned, there was very little interest in developing new ones and the sales staff lacked the skills for selling in a more competitive environment. Sales and profits fell rapidly. Before RiteCut failed the owners sold out to two new graduates in Technology and Business.

The new owners saw the weaknesses in RiteCut but felt that with a different approach the strengths were enough for success. They saw that changing the culture was the key. They immediately arranged for two managers to take early retirement and hired younger people with a track record of improving efficiency. Targets for sales were set and the sales staff were given training. A research and development team was brought in. Production employees were also given targets for waste and quality as well as quantity. Instead of employees being paid a set wage, pay was now related to performance in meeting the targets. The suppliers were told that unless they reduced prices they would lose the contract arrangements with RiteCut, and several of them refused. A number of employees left, complaining that the business had changed and it was more like being in a prison than at work.

1 Explain how the organisational culture at RiteCut might have contributed to the fall in sales and profits.
2 Analyse the different culture the new owners introduced at RiteCut.
3 Explain how the new owners might have managed the change in culture more effectively.
4 To what extent will a change in culture contribute to RiteCut's future success?

Corporate culture and implementing a strategy

Implementing a strategy always takes place in particular social, economic and market situations. A business with one corporate culture may be better placed for success in one context than in another. Table 6.4.2 sets out how this might apply to a variety of selected situations.

Table 6.4.2 Suitability of culture types ▼

Situation	Culture type		
	Power	**Task**	**Entrepreneurial**
High-technology new products	• Less suitable, inflexible, decision-makers not in touch	• Very suitable, can develop new products	• Very suitable, new ideas developed
Growing market	• Suitable, clear decision-making	• Suitable, new ideas worked on	• Very suitable, new ideas encouraged and developed
Highly competitive brands	• Suitable, quick reactions to competitors	• Suitable, new ideas worked on but slow to react	• Very suitable, new ideas encouraged and developed, but weak culture leads to differing views
Long-lived products	• Very suitable, stable market environment needs clear positive leadership	• Less suitable, teams can clash with objectives	• Less suitable, new ideas tend to divert from core activities
International expansion	• Very suitable, clear direction	• Suitable, teams work on specific aspects but room for argument	• Suitable, new ideas, but lack of guidance may make these inappropriate for new markets

Getting it right

When analysing the way a business implements a strategy remember to refer to the role that corporate culture plays in achieving success.

A business that is attempting to implement a strategic plan must have the support of an appropriate corporate culture. Leaders of a business must take an active part in shaping the culture of their business.

The following two case studies illustrate two different approaches to matching corporate culture to strategic implementation. Both show how important the right match is. They also demonstrate possible weaknesses because each of the cultures has disadvantages as well as advantages. Any strategic planning will involve change and it is vital that businesses also consider the possibility of changing their own culture so as to support the changes inherent in moving forward.

Case Study

Google – a successful high-technology company

Google has grown and expanded in line with a strategic plan to produce high-technology solutions to computing problems. There are now 46,000 employees. It actively encourages innovation by setting up project project teams (e.g. Google Chrome) and allowing individuals 20 per cent of their work time to develop their own ideas. Google Wave (dropped in 2010) was developed by a team who chose to work from Sydney Australia and would not share their ideas until the project neared completion. Street View was first developed by random employees using some of their 20 per cent free time before it was taken on by a formal Street View group. Google hires on ability not experience and encourages employees to follow out-of-work interests like frisbee and mountain biking, providing work-based facilities for these. Workspaces are shared and all employees are encouraged to communicate with each other, whatever level of the organisation they are on. The focus at Google is on product development, not marketing strategy that rarely goes beyond an impressive launch of a product.

1 What is the corporate culture at Google?
2 To what extent has it contributed to the success of Google?
3 What disadvantages does this type of corporate culture have for Google?

Case Study

BJL Electrical – a growing business

Beri and Jack Leveson started BJL Electrical, an electrical contracting business, in a large city with a lot of competition. To start with they did not think about corporate culture – the business just grew as they hired more employees. They have successfully expanded, even though their industry has suffered a downturn and many competitors have made employees redundant. Beri and Jack have now developed a strong corporate culture, with themselves making the decisions and communicating these to the 46 employees. Each new employee starts with an hour-long seminar which sets out the culture in the business. Employees are expected to deliver a high-quality customer-focused service along lines laid down by the two owners. Any problems which are not covered in the work guidelines are expected to be referred to the owners and Beri and Jack take the decisions on marketing, appointing employees and what equipment is used. They argue that because everyone in the business knows how it works everyone is more aware of opportunities and has a structure to get their ideas to the top, which is where the decisions are made.

1 Giving your reasons, explain what corporate culture BJL Electrical has.
2 How has corporate culture contributed to the success of BJL Electrical?
3 What future events might make BJL Electrical change their corporate culture?

Key term

Change culture: an organisation with a change culture will accept change and contain the capacity to make changes happen.

Developing a change culture

Businesses that are developing and implementing new strategies are starting from one place and moving to somewhere different. They start with a set of policies, strategies and tactics supported by a corporate culture. Once the strategy is implemented they will be in a new situation. It is therefore very important that whatever their corporate culture happens to be it must include the capacity for change – in fact, it must be a change culture. This means accepting changes and what they will mean for the organisation and this will lead to a smoother, faster and cheaper strategic implementation period. Unless there is a culture which accepts and embraces change there will be resistance to the changes that a strategic plan must involve.

Techniques for changing corporate culture

- Concentrate on what is going well in the business. Focus on these things with individuals and teams. This will create a positive climate.
- Make sure that all key employees become committed to changing the culture. These key leaders must be recognised as being influential and must begin spreading the message for change.
- Establish new objectives and a mission statement that really represents the new values and beliefs and make sure that everyone in the organisation knows about them.
- Make sure that everyone is involved in the process of analysing problems and solutions. It is important that change becomes built into the thinking of all employees. It is important that everyone is given the chance to have a say and comment on the changes to the culture.
- Provide training and rewards in change management at an appropriate level for everyone. New attitudes and behaviours will not happen automatically and employees need to be led to understand the benefits of a change culture.

Case Study

No change culture at the World Bank – a critical view

The World Bank is an international organisation that has provided loans, grants and advice to developing countries since 1947. It has 10000 employees in 100 countries, though two-thirds are stationed in Washington DC in the USA. It took the World Bank President several years to get the first mission statement approved in 1998. This stated that it would "fight poverty with passion and professionalism for lasting results".

In an article for Forbes Magazine, Steve Denning discusses how the organisation has come under heavy criticism for focusing on funding large-scale infrastructure projects and insisting on fundamental free-market reforms in countries it lends to as a condition of producing the money. It is managed by a board of 25 people, one each from France, Germany, Japan, the UK and the USA, with a president selected by the USA. The remaining 20 members are from developing countries. This, and the location of its head office in the USA, has led many analysts to conclude that it is failing to meet the real needs of developing nations in a time of rapid economic and social change.

From 2005 to 2011 successive presidents of the Bank had little effect on its structure despite attempts to achieve a more decentralised way of working.The World Bank would appear to be a slow-moving traditional hierarchical bureaucracy, with an inward looking perspective. Its mission statement is largely unsupported by a management structure and systems that drive a focus on lending to individual, often large-scale projects. These projects are often controversial and appear to benefit large multinational companies and local politicians more than the populations of the countries they take place in. An alternative strategy of funding small-scale loan-efficient projects under the control of local people is a minor part of its spending.

These corporate cultural factors are reinforced by a view that puts more value on working in Washington than in developing countries in the poorer areas. The organisation is filled with talented staff but lacks the agility to meet the challenges of today. In late 2013 the World Bank announced that it would be moving from a "command and control" structure to more collaborative working across functions, groups and regions.

1 Assuming that these criticisms of the World Bank are accurate, assess the evidence that the World Bank lacks a change culture.
2 Explain how not having a corporate culture of change is holding back the implementation of different strategies at the World Bank.
3 Assess the chances of the 2013 move to collaborative working being implemented successfully.

Managing and controlling strategic change

The importance of leading and managing change

Change is a perpetual feature of life. Businesses are not excempt from this. In fact, running a successful enterprise is all about change. A business will always be making things happen and will be responding to political, social and technological events. Some factors for change are internal, e.g. key employees leave, objectives change or new products are developed. Some factors for change are external, e.g. corporate tax changes, market demographics change or a new competitor appears. Some reasons for change will be unforeseen and these make the need for a change culture even more important as this provides a sound basis for dealing with these sudden events. A business should be able to detect changes which are occurring or likely to occur and then take steps to set up different ways of working to manage the effects of the changes. This need to deal with change has itself become a key management topic as whenever change occurs there are common principles for dealing with it. These principles can be applied to any functional area in a business, as well as to change in the corporate culture.

Business leaders must be aware of the importance of managing change. If they do not actively do this change will happen anyway, but in directions that may not be beneficial for the business. Part of the successful management of change is to build into the corporate culture the expectation of change and a willingness to engage in strategies to manage it.

Strategic change will affect all or most of a business, it will involve large-scale adjustments, and take months or years, but this cannot happen without individuals in the organisation changing. This represents a real challenge to managers. They have to get employees on board to implement strategic plans. A change culture will be enormously helpful in doing this as it will avoid much of the resistance to change that humans naturally feel.

Overcoming resistance to change

It is important to understand that there will be resistance to change. Employees will say "this will never work", will avoid engaging with change and sometimes will actively oppose change. Much resistance comes from a feeling that change brings loss and disruption. Other reasons may include a worry about losing status or power, insecurity, different ideas about what is required in the situation or a fear of the unknown.

Getting employees to talk about these feelings with reference to their situation can be a positive first step to managing change successfully. Having a change culture is a big step towards overcoming such resistance to change. Within that framework a business can facilitate change by communicating the reasons for change, giving employees all the information needed, consulting with them, and providing support and training. A key in achieving success is involving those likely to be affected and giving them a sense of security and trust.

Change management techniques

Many of these focus on preparing the employees for change. Businesses which have "people-centred" structures, leadership styles, communication channels and reward systems will be better placed for managing change than those which are centralised and autocratic. However, successful change management can happen in these organisations if the culture is strong. Employees will then accept the decisions from above. As long as these are thought through and meet the needs of the employees change will be successful. The key factor in managing change successfully is developing trust.

- Start by allowing the maximum time possible to prepare for the change and give good indications that change is coming.
- Make sure that there are sufficient resources available for the change and for what is needed to make the change happen.
- Have a clear vision for the change. This may mean a new mission statement and/or values, and use storytelling to get that vision across. This involves a key person telling the story of change and

where it is going in such a way that employees understand the need for change and have a clear idea about where it might lead them.

- Start with the top, identify the key leadership teams and get their commitment to the change. It will be essential for them to agree or it will be very difficult to get others to agree, especially when they see a divided leadership.
- Involve every relevant layer and person in the organisation structure. Use managers in their role as team leaders to communicate the reasons for change clearly and set out clear proposals.
- Use communication channels which give everyone the chance to say what they think of the proposals. This means that those opposed to change can make their points and may have valid ideas which had been missed. This allows ownership of the change to be with the people who will make the change.
- Provide training and support for the new procedures or methods of working. Staff who are given the tools to work will accept and work for the change in a motivated way.
- Set up different management structures when needed, but remember that new structures must follow the needs of the strategic change – they will not cause it. Nor will simply buying in new management teams.

Today there are many external consultants who give advice on managing change and it may be beneficial to employ one of these specialists. This will mean business leaders can still focus on their core roles. However, managing change is increasingly seen as a core function of management and an outside consultant should be used to support, not take responsibility for, managing change.

Progress questions

6 What is a change culture?
7 Outline two reasons why a change culture is beneficial for an organisation.
8 How can a business leader overcome resistance to change in employees?

Project champions

If the change involves a particular project, one way that will assist in carrying out the above techniques is to use project champions. A project champion is someone who promotes the benefits of the change and explains the reasons for it. They act like a salesperson and it is essential that they believe in the change. They can speak for the change to leaders who may be doubtful and assist when barriers to change are met. Project champions must have enough status in the organisation for their views to be listened to, a real commitment to the change and the right people skills to interact with all types of employees.

Key term

Project champion: a person assigned to support and drive a project forward who explains the benefits of change and assists and supports the team putting change into practice.

Case Study

Continental AG Tyres

In the mid-1990s Continental was the world's fourth-largest tyre manufacturer. Business leaders knew that in a global market Continental would have to expand beyond its core products and sell more globally by joining with other businesses. Instead of giving seminars on strategy the then CEO Huburtus von Grunberg told a story to the company leaders about changing roles of the business in an increasingly competitive industry, with loss of market share. He dwelt on the history of corporate pride in quality and said that he had to alter his thinking about joining with other businesses with lower standards. As a result the other Continental managers investigated companies they might work with and became change catalysts or champions, successfully getting the company to adopt the new strategy of expansion abroad into new markets through acquisition of other businesses.

1 Identify three techniques for successfully managing change that were used in Continental AG Tyres.

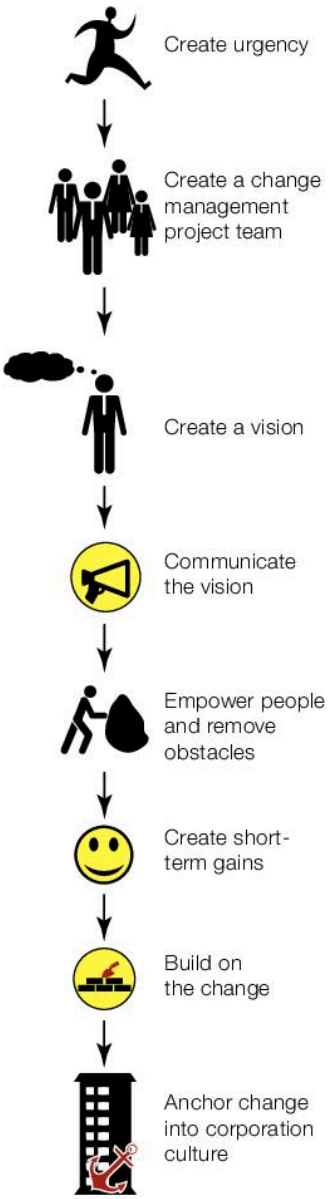


Figure 6.4.2 Kotter's eight steps strategy ▲

Kotter's eight steps strategy

Once a business decides that a change is needed, the change will have to be promoted and brought about. John Kotter, the change management expert, suggests a strategic approach – the eight steps for leading change. This model can be used to structure a change process. A business can use the techniques for change outlined above where appropriate at each step.

Create urgency

Make sure everyone involved knows there is a need for change. Set up future scenarios and get people talking about and expecting change.

Create a change team

Make up a team of committed change leaders from all relevant levels and departments These must be recognised as influential people.

Create a vision

Determine the values and beliefs that will drive the change. Create a clear vision for the future that offers benefits for the organisation and people in it.

Communicate the vision

Use the business communication channels to get the vision across. Make sure it is fresh in employees' minds. Make sure the vision covers all areas – from training to production techniques and performance reviews.

Empower people and remove obstacles

Find out reasons for resistance to the change and work at removing them. Use change leaders or project champions to push the change ideas. Start restructuring, reward people who change and work on those who are slowing change down.

Create short-term gains

Use short-term targets to achieve success. Make sure that success will come in small ways. This way everyone will see the benefits and become committed to the change.

Build on the change

After each successful step make sure the change carries on by continuing to review progress and make improvements. Keep the ideas fresh.

Anchor change into corporate culture

Make the business have a change culture. Ensure that the business leaders support the idea of change. Tell success stories about change. Include change values when hiring and training staff and praise change leaders.

Case Study

Managing change in practice: a Mauritius hospital

The problem

Nurses on a ward were handing over to the next shift by giving a one-way verbal report in a room well away from the patients. The patients' notes were not used and only a medical report was given, meaning that some key points were missed and there was no reference to well-being of the patients.

The solution

The handovers were to be done at each patients' bedside. Patients' notes were to be used and patients would be involved in the discussion that would cover medical and psychological issues. To do this would involve a major shift in nurses' behaviour and attitudes.

Managing the change

The manager set a timescale of three months and carried out a force field analysis. This showed that the driving forces were the support of the ward manager, the need to reduce medical incidents and staff desire for improvement. The forces against the change were lack of information, uncertainty, fear of increased accountability and non-overlapping shift patterns. On the basis of this a programme for change was set up.

Techniques for change

- Change announced well in advance with opportunity for initial discussion
- New arrangements described in detail and amended following comments from nurses
- Meetings with nurses to discuss change and reach an agreed view
- Informal nurse leaders given responsibilities for aspects of the change
- Practice new-style handovers arranged with opportunity for nurses and patients to comment
- After the change constructive feedback was given to all nurses until all were implementing the change positively

Result

The change to the handover procedure was successful as measured by nurses and patients as well as a fall in reported emergencies and patients requiring additional treatment.

1 Discuss the importance of having a clear strategy for the success of this change.
2 What were the most important elements in the strategy for achieving this successful change?

Progress questions

9 What role might a project champion play in change?
10 Outline five techniques for successfully achieving change in the order you would recommend they are to be used.

Key terms

Crisis management: the process by which a business deals with a major event that poses a threat to its operation.
Contingency planning: planning how to respond to unlikely events that are a threat to a business.

Contingency planning and crisis management

Crisis management is the process by which a business deals with a major event that poses a threat to its operation. Contingency planning is how a business deals with planning for responding to unlikely events (crises) that are a threat to the business. It has the aim of minimising the negative impacts of a crisis which may be foreseeable but unlikely. These include fire, flood, resignations of key staff, failure of the IT systems or an employees' strike. Because the events are foreseeable it is possible to prepare by gathering information and setting up procedures

to be implemented if the event happens. If a business is unprepared when a crisis occurs it is likely to suffer, e.g. production may be lost, share value falls, sales fall or staff morale decreases.

Stages in contingency planning

1 Recognise the need for contingency planning. If this is not done there will be no plan.

2 Identify potential events that could affect the business negatively, no matter how remote the chances of them happening. Give each a probability rating to identify the more likely ones to prepare for. This will enable the business to make a judgment in relation to the cost of planning. Make sure that general events like floods are included as well as ones that are industry specific. Finally, determine which events are critical to the business, e.g a bank's IT system going down means the bank cannot function and may lose all of its records. Others will be disruptive but not critical, e.g. if IT systems fail they can be replaced by paper. Critical events must be planned for.

3 Develop a plan to deal with the events identified as being important. The aim will be to minimise the negative effects of the event and return to business operations as soon as possible. The plan will cover dealing with the immediate problems caused and then how to restore or resume business functions in order of importance. Staff training will be vital at this stage. The plan may involve roles of employees, contacting emergency services and dealing with the media.

4 Carry out a test of the plan as far as is possible and revise it where needed.

5 Review and keep the plan up to date.

Progress questions

11 Explain the difference between crisis planning and contingency planning.

12 Outline the stages in planning for a crisis or a very unlikely event.

13 Explain two advantages and two disadvantages of contingency planning.

Table 6.4.3 Advantages and disadvantages of contingency planning ▼

Advantages	Disadvantages
• Enables quick response to events • Reassures customers, governments, employees that prompt effective action will be taken • Enables effective public relations exercises by appropriate senior managers • Maintains confidence in the business	• Costly and time consuming in preparation and training • Costs of review and updating divert resources from other business activities • Makes for complacency and loss of focus on avoiding disasters • Likely to be a waste of resources as the planned for events are unlikely to happen

Case Study

Contingency planning in action – Sony 2011

In April 2011 Sony realised that an external hacker had gained entry to their PlayStation and Qriocity networks. There was the possibility that the personal details of 100 million users across the world, including usernames, passwords and email addresses would become available, as well as some credit card details, though these were encrypted. Computer system security businesses like McAfee had been warning that attacks from hackers were increasing and Sony had been prepared for such a possibility. Once unusual online activity was detected Sony acted quickly. Within a day a security company was asked to investigate and shortly afterwards a second business was also tasked to find out what had happened. The networks were closed down. The chairman

of Sony made statements including an apology and posted a video reassuring customers. Sony offered one year free identity theft monitoring and protection. Within two weeks the accounts had been checked and Sony put increased encryption and firewall protection in place, as well as activating a new password system. No credit card details had been taken. The networks were then restarted within two weeks and users were offered free games and other incentives in a Welcome Back package. A high-level corporate security information officer was hired and security system monitoring was stepped up. Despite this, hacking has continued and in 2012 several games were withdrawn as they offered a potential route in for hackers. Estimates of the cost to Sony of this episode are in the order of $100 million–$200 million. PlayStation has continued to be the top-selling games console in Europe and Asia and the way the crisis was managed has largely contributed to continued confidence in Sony's products.

1 What evidence is there that Sony had prepared a contingency plan in case someone hacked into its networks?
2 Evaluate the importance of contingency planning in this case.

Exam-style questions

1 A housing development for old people who need care has been owned and operated by a profit-making private company for many years. A charity has been successful in buying the development from the company. Explain the steps the new management might have to take to change the culture of the organisation. [20 marks]
2 "The effective management of strategic change in today's world will be the main factor determining the success or failure of a multinational business." To what extent do you agree with this view? [20 marks]
3 Evaluate the view of a food manufacturer that: "Contingency planning is a waste of resources, as major accidents are often unavoidable but, in any case, they rarely occur." [20 marks]
4 "In markets with increasing competition resulting from globalisation, it is essential for all businesses to adopt an entrepreneurial culture if they are to succeed." To what extent do you agree with this view? [20 marks]

Key concepts

- **Change** can be addressed through management of change, changing cultures and factors affecting implementation.
- **Management** is central to implementing change.
- **Customer focus** has an impact on strategic choice.
- **Innovation** is often the product of strategic change.
- **Strategy** is central to strategic decisions.

Progress check

You should now be able to:

- analyse the key elements and evaluate the usefulness of a business plan
- evaluate different types of corporate culture
- evaluate the importance of corporate culture to the effective implementation of a strategy
- evaluate the importance of developing a change culture to allow effective implementation of new strategies
- apply and evaluate techniques for change management
- develop and recommend a strategy to manage change
- evaluate contingency planning and crisis management.

You should be able to relate these to a range of businesses in different situations.

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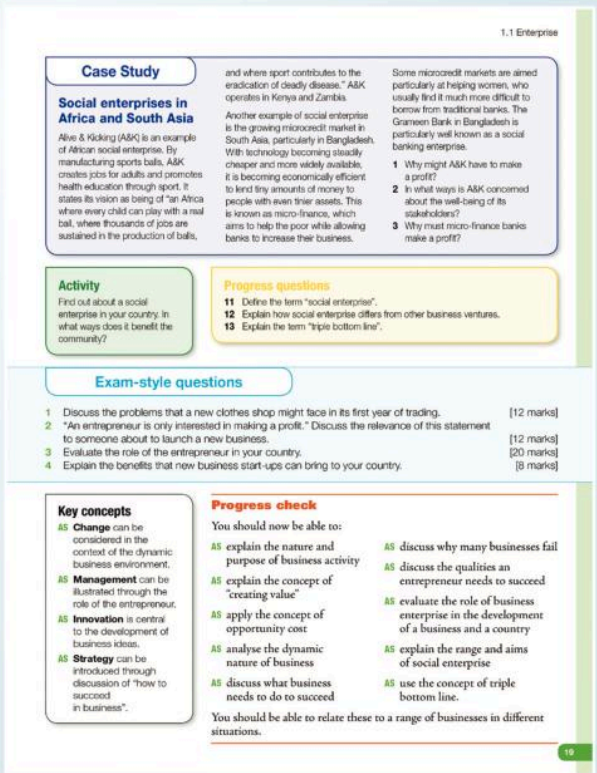
1.1 Enterprise

Case Study

Social enterprises in Africa and South Asia

Alive & Kicking (A&K) is an example of African social enterprise. By manufacturing sports balls, A&K creates jobs for adults and promotes health education through sport. It states its vision as being of "an Africa where every child can play with a real ball, where thousands of jobs are sustained in the production of balls, and where sport contributes to the eradication of deadly disease." A&K operates in Kenya and Zambia.

Another example of social enterprise is the growing microcredit market in South Asia, particularly in Bangladesh. With technology becoming steadily cheaper and more widely available, it is becoming economically efficient to lend tiny amounts of money to people with even tinier assets. This is known as micro-finance, which aims to help the poor while allowing banks to increase their business.

Some microcredit markets are aimed particularly at helping women, who usually find it much more difficult to borrow from traditional banks. The Grameen Bank in Bangladesh is particularly well known as a social banking enterprise.

1 Why might A&K have to make a profit?
2 In what ways is A&K concerned about the well-being of its stakeholders?
3 Why must micro-finance banks make a profit?

Activity

Find out about a social enterprise in your country. In what ways does it benefit the community?

Progress questions

11 Define the term "social enterprise".
12 Explain how social enterprise differs from other business ventures.
13 Explain the term "triple bottom line".

Exam-style questions

1 Discuss the problems that a new clothes shop might face in its first year of trading. [12 marks]
2 "An entrepreneur is only interested in making a profit." Discuss the relevance of this statement to someone about to launch a new business. [12 marks]
3 Evaluate the role of the entrepreneur in your country. [20 marks]
4 Explain the benefits that new business start-ups can bring to your country. [8 marks]

Key concepts

AS **Change** can be considered in the context of the dynamic business environment.
AS **Management** can be illustrated through the role of the entrepreneur.
AS **Innovation** is central to the development of business ideas.
AS **Strategy** can be introduced through discussion of "how to succeed in business".

Progress check

You should now be able to:

AS explain the nature and purpose of business activity
AS explain the concept of "creating value"
AS apply the concept of opportunity cost
AS analyse the dynamic nature of business
AS discuss what business needs to do to succeed
AS discuss why many businesses fail
AS discuss the qualities an entrepreneur needs to succeed
AS evaluate the role of business enterprise in the development of a business and a country
AS explain the range and aims of social enterprise
AS use the concept of triple bottom line.

You should be able to relate these to a range of businesses in different situations.

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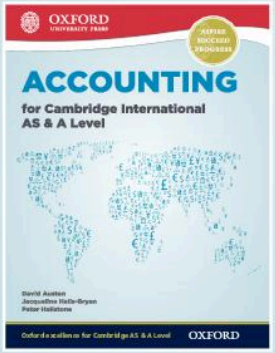

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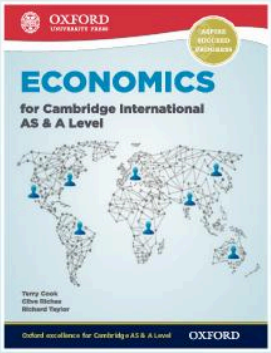

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